Interim Financial Statements

1 January - 30 September 2012

Unaudited

Arion Bank
Borgartún 19
105 Reykjavík
Iceland

Reg. no. 581008 - 0150

Contents

Endorsement and Statement by the Board of Directors and the CEO

The Interim Financial Statements of Arion Bank for the period ended 30 September 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, investment banking and asset management and comprehensive wealth management for private banking clients.

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

Operations during the period

Net earnings amounted to ISK 14,537 million for the period ended 30 September 2012. Total equity amounted to ISK 128,432 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 22.5%. 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 31% and 18% 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 core subsidiaries.

Deposits in domestic banks have declined gradually and are expected to continue to do so in the near future, the main drivers being new investment opportunities for individuals and institutional investors. Arion Bank is fully aware of this trend and continues to strengthen and 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. Arion Bank was also the first Icelandic bank to issue fixed rate, non index-linked, covered bonds. In May and June the Bank issued a total of ISK 2.5 billion 6.5% fixed rate covered bonds maturing in 2015. In April the Icelandic rating agency Reitun ehf. published its B+ rating of Arion Bank's senior unsecured bonds issuance. This rating is two notches below the rating of the Republic of Iceland. The Agency furthermore issued a rating of A to Arion Bank's covered bond issuance, which is at par with the rating of the Republic of Iceland.

The Bank has placed emphasis on selling its shareholding in legal entities which were acquired as a result of a foreclosure. During the first two quarters of the year the Bank sold a large part of its shareholding in Hagar hf. or 15.7% effective share. The remaining shareholding in Hagar is classified as a trading asset. After receiving the approvals of the Icelandic Competition Authority the sale of B.M. Vallá ehf. was finalized in May, the sale of 38.9% share in N1 hf. in June and the sale of Penninn á Íslandi ehf. in August. In June the Bank sold its 20% shareholding in Ölgerdin Egill Skallagrímsson ehf. and in July a Finnish subsidiary of Fram Foods ehf., Boyfood OY was sold.

Progress has been made toward simplifying the Group structure by merging subsidiaries into the Bank and by liquidating several subsidiaries. The main entities merged into the Bank were Verdis ehf. and Sparisjódur Ólafsfjardar, both wholly owned by the bank.

The quality of the Bank‘s balance sheet continues to improve. The recovery work on loans to larger corporations is largely completed and work continues with SME‘s and individuals. On 15 February 2012, the Supreme Court passed a judgment regarding interest on FX linked loans, adding uncertainty regarding the book value of foreign currency lending. The ruling was not decisive enough for all disputed aspects of FX loans and further clarification from Court rulings was deemed necessary. Recent rulings have significantly reduced the uncertainties related to the February judgment and the Group has announced that certain currency-linked loans will be recalculated. Further discussion about the legality of foreign currency loans is contained in Note 52.

On 6 November the FME published its conclusions concerning a valuation of Arion Bank's loan book. The sample used in the valuation was 43% of the corporate loans, and the main findings were that there is no indication of any overvaluation of the Bank's loan book.

There continue to be positive signs in the Icelandic economy which is forecasted to grow by 2.7% this year. A number of the Group's customers have experienced growth in their operations, a trend underlined in the Bank's marketing. A key step in customer interface was taken by the Bank when the Arion App was launched in August and in September motor financing was added to the product portfolio. The Group has performed strongly. It has been able to attract existing pension funds to its asset management services as well as to add valuable customers to the corporate loan book. The primary focus in investment banking activities has until recently been on selling assets held by the Group but now when this assignment is coming to an end the focus has shifted to customer originated projects which are at different stages in their process.

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 30 September 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 30 September 2012, its financial position as at 30 September 2012 and its cash flows for the period ended 30 September 2012.

Further, in our opinion the Interim Financial Statements and the Endorsement of the Board of Directors and the CEO give a true and 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 ended 30 September 2012 and confirm them by means of their signatures.

Reykjavík, 28 November 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 30 September 2012

	Notes	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Interest income		43,463	34,672	11,310	11,052
Interest expense		(23,329)	(17,836)	(5,056)	(5,376)
Net interest income	12	20,134	16,836	6,254	5,676
Increase in book value of loans and receivables	13	8,073	29,795	905	457
Impairment of loans and receivables	14	(7,594)	(6,443)	(2,958)	(642)
Changes in compensation instrument	15	-	(19,593)	-	-
Net interest income less valuation changes on loans and receivables		20,613	20,595	4,201	5,491
Fee and commission income		12,089	12,300	4,121	3,921
Fee and commission expense		(4,036)	(4,726)	(1,406)	(1,446)
Net fee and commission income	16	8,053	7,574	2,715	2,475
Net financial income (expense)	17-20	491	348	161	386
Net foreign exchange gain (loss)	21	559	1,979	708	2
Share of profit or loss of associates	39	13	(1)	6	-
Other operating income	22	4,630	3,478	1,631	1,161
Operating income		34,359	33,973	9,422	9,515
Salaries and related expense	24	(8,813)	(8,221)	(2,644)	(2,705)
Administration expense		(6,055)	(5,400)	(1,908)	(1,632)
Depositors' and investors' guarantee fund	50	(683)	(875)	(238)	(318)
Depreciation and amortisation		(714)	(655)	(251)	(225)
Other operating expense	25	(609)	(624)	(189)	(160)
Earnings before tax		17,485	18,198	4,192	4,475
Income tax expense	26	(3,375)	(3,079)	(462)	(562)
Bank Levy	27	(771)	(684)	(261)	(238)
Net earnings from continuing operations		13,339	14,435	3,469	3,675
Net gain (loss) from discontinued operations, net of tax	28	1,198	(787)	(181)	(219)
Net earnings		14,537	13,648	3,288	3,456
Attributable to:					
Shareholders of Arion Bank		14,176	13,046	3,124	3,221
Non-controlling interest		361	602	164	235
Net earnings		14,537	13,648	3,288	3,456
Other comprehensive income					
Exchange difference on translating foreign subsidiaries		-	112	-	(2)
Total comprehensive income for the period		14,537	13,760	3,288	3,454
Earnings per share from continuing operations					
Basic and diluted earnings per share from continuing operations attributable to the shareholders of Arion Bank (ISK)	29	6.49	6.92	1.65	1.72

The notes on pages 10 to 44 are an integral part of these Interim Financial Statements.

Arion Bank Interim Financial Statements 30 September 2012 5 Amounts are in ISK millions

Interim Statement of Financial Position
as at 30 September 2012

Assets	Notes	30.09.2012	31.12.2011	30.09.2011
Cash and balances with Central Bank	30	16,026	29,200	38,000
Loans and receivables to credit institutions	31-32	88,007	69,103	60,422
Loans and receivables to customers	33-34,55	572,484	561,550	444,074
Bonds and debt instruments	35-36	119,697	140,568	158,549
Shares and equity instruments with variable income	35	15,860	14,045	14,324
Derivatives	35,46	969	674	1,057
Securities used for hedging	35	1,398	2,372	365
Investment property	38	28,171	27,100	26,912
Investments in associates	39	3,024	2,987	2,756
Property and equipment		6,147	6,271	6,433
Intangible assets		5,102	4,765	4,681
Tax assets	40	475	724	377
Non-current assets and disposal groups held for sale	41	13,711	23,886	40,193
Other assets	42	5,174	8,876	24,909
Total Assets		876,245	892,121	823,052
Liabilities				
Due to credit institutions and Central Bank	35	16,459	16,160	30,209
Deposits	35	454,405	489,995	511,473
Financial liabilities at fair value	35	11,122	4,907	6,111
Tax liabilities	40	3,220	3,421	7,085
Non-current liabilities and disposal groups held for sale	41	2,683	4,950	11,901
Other liabilities	43	35,010	38,822	36,421
Borrowings	35,44	192,412	187,203	67,317
Subordinated liabilities	35,45	32,502	32,105	31,875
Total Liabilities		747,813	777,563	702,392
Equity				
Share capital	47	2,000	2,000	2,000
Share premium	47	73,861	73,861	73,861
Other reserves	48	1,637	1,637	1,637
Retained earnings		47,126	32,950	35,504
Total Shareholders' Equity		124,624	110,448	113,002
Non-controlling interest		3,808	4,110	7,658
Total Equity		128,432	114,558	120,660
Total Liabilities and Equity		876,245	892,121	823,052

The notes on pages 10 to 44 are an integral part of these Interim Financial Statements.

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Interim Statement of Changes in Equity
for the Period from 1 January to 30 September 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 30 September 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			14,176	14,176		14,176
Total comprehensive income for the period attributable to the non-controlling interest					361	361
Acquisition of non-controlling interests					(664)	(664)
Equity 30 September 2012	75,861	1,637	47,126	124,624	3,808	128,432
Changes in equity from 1 January to 30 September 2011:						
Equity 1 January 2011	75,861	1,525	28,531	105,917	3,619	109,536
Dividend paid			(6,073)	(6,073)		(6,073)
Total comprehensive income for the period attributable to the shareholders of Arion Bank		112	13,046	13,158		13,158
Total comprehensive income for the period attributable to the non-controlling interest					602	602
Disposal of non-controlling interests					3,437	3,437
Equity 30 September 2011	75,861	1,637	35,504	113,002	7,658	120,660

The notes on pages 10 to 44 are an integral part of these Interim Financial Statements.

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Condensed Interim Statement of Cash Flows
for the Period from 1 January to 30 September 2012

	Notes	2012 1.1.-30.9.	2011 1.1.-30.9.
Cash flows from (used in) operating activities			
Earnings from continuing operations before tax		17,485	18,198
Adjustments to reconcile earnings before income tax to net cash from (used in) operating activities:			
Non-cash items included in net earnings before income tax and other adjustments		(26)	(1,377)
Changes in operating assets and liabilities	54	(31,859)	(15,893)
Income taxes paid		(3,326)	(544)
Net cash from (used in) operating activities		(17,726)	384
Net cash from (used in) investing activities		15,104	4,792
Net increase (decrease) in cash and cash equivalents		(2,622)	5,176
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		2,322	1,234
Cash and cash equivalents at the end of the period		82,515	79,212
Cash and cash equivalents comprises			
Cash in hand and demand deposits		16,026	38,000
Due from credit institutions		74,051	49,001
Mandatory reserve with Central Bank		(7,562)	(7,789)
Cash and cash equivalents at period-end		82,515	79,212
Non-cash investing and financing transactions:			
Tier II subordinated notes issued in settlement of dividend		-	(6,073)
Change in retained earnings for settlement of dividend with Icelandic State		-	6,073

The notes on pages 10 to 44 are an integral part of these Interim Financial Statements.

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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 30 September 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 and comprehensive wealth management for private banking clients.

The Interim Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 28 November 2012.

2. Basis of preparation

a) *Statement of compliance*

The Interim Financial Statements 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 Bank´s annual Financial Statements for the year 2011. The statements are available at Arion Bank´s 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 evaluating 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 53 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.

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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. Merger of entities

The boards of Arion Bank and the Bank´s wholly owned subsidiary Verdis hf. approved the merger of these two entities. On 29 June 2012 FME approved the merger. The merger took effect from 1 January 2012.

The boards of Arion Bank and the Bank´s wholly owned subsidiary Sparisjódur Ólafsfjardar approved the merger of these two entities. On 14 September 2012 FME approved the merger. The merger took effect from 1 January 2012.

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 Einkaklúbburinn ehf. which is a new subsidiary of Arion Bank.

6. 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 deal is 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 the fourth quarter of 2012.

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

7. Acqusition of subsidiaries

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

8. Disposal of subsidiaries

The subsidiaries AB-fjárfestingar ehf., ENK 1 ehf. and Vesturland ehf. were liquidated in the first quarter of 2012.

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. B.M. Vallá ehf. was classified as non-current assets and disposal groups classified as held for sale at year-end 2011. The effects from the sale of this entity has minor effects on the Statement of Comprehensive income in the second quarter of 2012.

In June 2012 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in Penninn á Íslandi ehf. Approval from the Icelandic Competition Authority was obtained in August 2012. Penninn á Íslandi ehf. was classified as non-current assets and disposal groups classified as held for sale at year-end 2011. The effects from the sale of this entity has minor effects on the Statement of Comprehensive income.

On 3 July 2012 Fram Foods ehf. sold its subsidiary Boyfood Oy in Finland. Fram Foods ehf. is a wholly owned subsidiary of Eignabjarg ehf. Fram foods Oy was classified as non-current assets and disposal groups classified as held for sale at year-end 2011. The effects from the sale of this entity has minor effects on the Statement of Comprehensive income.

Notes to the Interim Financial Statements

Operating Segment Reporting

9. 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) and AFL sparisjódur 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 25 branches all around Iceland are over 100,000.

Asset Management and Stefnir 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 Stefnir 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., 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

10. Summary of the Group's business segments:

1.1.-30.9.2012	Corporate Banking	Retail Banking	Asset Managem. and Stefnir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Headquart. and Elimination	Total
Net interest income	8,131	7,507	1,609	41	3,993	(1,107)	(40)	20,134
Other income	1,954	(695)	1,714	4,168	(248)	6,709	623	14,225
Operating income	10,085	6,812	3,323	4,209	3,745	5,602	583	34,359
Operating expense	(435)	(3,982)	(782)	(423)	(130)	(3,458)	(7,664)	(16,874)
Allocated cost	(1,390)	(3,356)	(577)	(456)	(533)	(43)	6,355	-
Earnings before tax	8,260	(526)	1,964	3,330	3,082	2,101	(726)	17,485
Net seg. rev. from ext. customers	16,848	13,649	253	4,142	(8,173)	7,126	514	34,359
Net seg. rev. from oth. segments	(6,763)	(6,837)	3,070	67	11,918	(1,524)	69	-
Operating income	10,085	6,812	3,323	4,209	3,745	5,602	583	34,359
Depreciation and amortisation	-	127	-	-	-	153	434	714
Total assets 30.09.2012	264,011	312,157	4,072	19,263	192,168	84,574	-	876,245
Allocated equity 30.09.2012	42,241	26,078	3,084	3,082	42,243	11,704	-	128,432

1.1.-30.9.2011	Corporate Banking	Retail Banking	Asset Managem. and Stefnir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Headquart. and Elimination	Total
Net interest income	8,929	9,445	1,065	(44)	(344)	(1,976)	(239)	16,836
Other income	7,992	(771)	1,118	1,441	(961)	7,581	737	17,137
Operating income	16,921	8,674	2,183	1,397	(1,305)	5,605	498	33,973
Operating expense	(358)	(4,035)	(732)	(505)	(153)	(3,672)	(6,320)	(15,775)
Allocated cost	(1,079)	(3,177)	(607)	(156)	(482)	(212)	5,713	-
Earnings before tax	15,484	1,462	844	736	(1,940)	1,721	(109)	18,198
Net seg. rev. from ext. customers	18,941	5,197	(447)	1,340	(1,003)	7,511	2,434	33,973
Net seg. rev. from oth. segments	(2,020)	3,477	2,630	57	(302)	(1,906)	(1,936)	-
Operating income	16,921	8,674	2,183	1,397	(1,305)	5,605	498	33,973
Depreciation and amortisation	-	123	-	-	-	158	374	655
Total assets 31.12.2011	271,208	299,207	3,621	16,477	207,099	94,509	-	892,121
Allocated equity 31.12.2011	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.

Discontinued operations are excluded from the segmental information.

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Notes to the Interim Financial Statements

Quarterly Statements

11. Operations by quarters:

2012	Q3	Q2	Q1	Total
Net interest income	6,254	7,666	6,214	20,134
Increase in value of loans and receivables	905	7,049	119	8,073
Impairment on loans and receivables	(2,958)	(4,441)	(195)	(7,594)
Net fee and commission income	2,715	3,002	2,336	8,053
Net financial income (expense)	161	(16)	346	491
Net foreign exchange gain (loss)	708	(1,232)	1,083	559
Other operating income	1,637	2,054	952	4,643
Operating income	9,422	14,082	10,855	34,359
Salaries and related expense	(2,644)	(3,124)	(3,045)	(8,813)
Administration expense	(2,397)	(2,495)	(2,560)	(7,452)
Other operating expense	(189)	(223)	(197)	(609)
Earnings before tax	4,192	8,240	5,053	17,485
Income tax expense	(462)	(1,852)	(1,061)	(3,375)
Bank Levy	(261)	(242)	(268)	(771)
Net earnings from continuing operations	3,469	6,146	3,724	13,339
Net gain (loss) from discontinued operations, net of tax	(181)	652	727	1,198
Net earnings	3,288	6,798	4,451	14,537

2011				
Net interest income	5,676	5,274	5,886	16,836
Increase in value of loans and receivables	457	27,281	2,057	29,795
Impairment on loans and receivables	(642)	(6,241)	440	(6,443)
Changes in compensation instrument	-	(16,683)	(2,910)	(19,593)
Net fee and commission income	2,475	2,607	2,492	7,574
Net financial income (expense)	386	(767)	729	348
Net foreign exchange gain (loss)	2	2,289	(312)	1,979
Other operating income	1,161	1,217	1,099	3,477
Operating income	9,515	14,977	9,481	33,973
Salaries and related expense	(2,705)	(2,858)	(2,658)	(8,221)
Administration expense	(2,175)	(2,458)	(2,297)	(6,930)
Other operating expense	(160)	(298)	(166)	(624)
Earnings before tax	4,475	9,363	4,360	18,198
Income tax expense	(562)	(1,472)	(1,045)	(3,079)
Bank Levy	(238)	(379)	(67)	(684)
Net earnings from continuing operations	3,675	7,512	3,248	14,435
Net gain (loss) from discontinued operations, net of tax	(219)	(286)	(282)	(787)
Net earnings	3,456	7,226	2,966	13,648

Arion Bank Interim Financial Statements 30 September 2012 15 Amounts are in ISK millions

Notes to the Interim Statement of Comprehensive Income

Net interest income

12. Interest income and expense is specified as follows:

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Cash and balances with Central Bank	461	381	160	134
Loans and receivables	36,121	28,036	8,643	8,899
Securities	6,530	5,722	2,366	1,923
Compensation instrument	-	322	-	-
Other	351	211	141	96
Interest income	43,463	34,672	11,310	11,052
Deposits	12,943	14,243	3,322	4,088
Borrowings	9,095	1,966	1,344	651
Subordinated loans	1,169	1,404	357	433
Other	122	223	32	204
Interest expense	23,329	17,836	5,056	5,376
Net interest income	20,134	16,836	6,254	5,676
Interest income from assets at fair value	6,530	6,044	2,366	1,923
Interest income from assets not at fair value through profit or loss	36,934	28,628	8,945	9,129
Interest expense from liabilities not at fair value through profit or loss	(23,330)	(17,836)	(5,057)	(5,376)
Net interest income	20,134	16,836	6,254	5,676

Increase in book value of loans and receivables

13. 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

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

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Impairment of loans and receivables to credit institutions	3	(40)	5	408
Impairment of loans and receivables to customers	7,591	6,483	2,953	234
Impairment of loans and receivables	7,594	6,443	2,958	642

Arion Bank Interim Financial Statements 30 September 2012 16 Amounts are in ISK millions

Notes to the Interim Financial Statements

Changes in compensation instrument

15. 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.

Compensation instrument is specified as follows:	31.12.2011
Balance 1 January 2011	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 31 December 2011	-

Net fee and commission income

16. Fee and commission income and expense is specified as follows:

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Fee and commission income				
Asset management	1,881	1,921	666	673
Cards	6,816	7,486	2,339	2,411
Collection and payment services	762	773	268	311
Derivatives	127	139	36	48
Interbank clearing	532	512	183	173
Lending and guarantees	792	535	340	142
Security trading	127	192	40	94
Other fee and commission income	1,052	743	249	70
Fee and commission income	12,089	12,300	4,121	3,921
Fee and commission expense				
Asset management	136	147	55	32
Cards	2,965	3,810	1,055	1,167
Collection and payment services	13	21	4	7
Interbank clearing	545	531	184	177
Security trading	33	31	6	12
Other fee and commission expense	344	187	102	51
Fee and commission expense	4,036	4,726	1,406	1,446
Net fee and commission income	8,053	7,574	2,715	2,475

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.

Arion Bank Interim Financial Statements 30 September 2012 17 Amounts are in ISK millions

Notes to the Interim Financial Statements

Net financial income

17. Net financial income is specified as follows:

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Dividend income	24	7	3	1
Net gain (loss) on financial assets and liabilities classified as held for trading	(610)	(879)	(303)	(486)
Net gain (loss) on financial assets and liabilities designated at fair value through profit or loss	1,077	1,220	461	871
Net financial income	491	348	161	386

18. Dividend income is specified as follows:

Dividend income on trading assets	15	4	-	-
Dividend income on financial assets designated at fair value through profit or loss	9	3	3	1
Dividend income	24	7	3	1

19. Net gain (loss) on trading assets and liabilities is specified as follows:

Net gain (loss) on equity instruments and related derivatives	(51)	157	(137)	50
Net gain (loss) on interest rate instruments and related derivatives	(445)	(718)	9	(164)
Net gain (loss) on other derivatives	(114)	(318)	(175)	(372)
Net gain (loss) on trading portfolio	(610)	(879)	(303)	(486)

20. Net gain (loss) on assets and liabilities designated at fair value through profit or loss is specified as follows:

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Net gain (loss) on interest rate instruments designated at fair value	317	572	(56)	836
Net gain (loss) on equity instruments designated at fair value	760	648	517	35
Net gain (loss) on assets and liabilities designated at fair value through profit and loss	1,077	1,220	461	871

Net foreign exchange gain (loss)

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

FX gain (loss) of loans and receivables	1,851	5,410	1,527	(1,503)
FX gain (loss) on bank accounts	2,322	1,234	1,443	(647)
FX gain (loss) from deposits and borrowings	(2,646)	(4,455)	(1,287)	1,120
FX gain (loss) from subordinated liabilities	(402)	(725)	(337)	1,098
FX gain (loss) on bonds, equity and derivatives	(557)	58	(670)	(45)
FX gain (loss) from compensation instrument	-	325	-	-
FX gain (loss) on other assets and liabilities	(9)	132	32	(21)
Net foreign exchange gain (loss)	559	1,979	708	2

Arion Bank Interim Financial Statements 30 September 2012 18 Amounts are in ISK millions

Notes to the Interim Financial Statements

Other operating income

22. Other operating income is specified as follows:

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Rental income from investment properties	1,558	1,706	554	577
Fair value changes on investment property	1,007	-	288	-
Realised gain on investment property	500	-	403	-
Earned premiums, net of reinsurance	649	651	228	224
Net gain (loss) on disposals of assets other than held for sale	389	334	4	339
Other income	527	787	154	21
Other operating income	4,630	3,478	1,631	1,161

Personnel and salaries

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

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Average number of full time equivalent positions during the period	1,160	1,248	1,160	1,225
Full time equivalent positions at the end of the period	1,177	1,168	1,177	1,168

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

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Average number of full time equivalent positions during the period	921	950	924	955
Full time equivalent positions at the end of the period	936	870	936	870

Former employees of Verdis hf. and Sparisjódur Ólafsfjardar are included in Parent company numbers for 2012.

24. Salaries and related expense are specified as follows:

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Salaries	6,688	6,529	1,978	2,087
Defined contribution pension plans	916	881	271	281
Salary related expense	1,209	811	396	337
Salaries and related expense	8,813	8,221	2,645	2,705

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

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Salaries	5,185	4,859	1,542	1,573
Defined contribution pension plans	710	656	211	212
Salary related expense	968	640	316	282
Salaries and related expense	6,863	6,155	2,069	2,067

Salaries and related expense from Verdis hf. and Sparisjódur Ólafsfjardar are included in Parent company numbers for 2012.

Arion Bank Interim Financial Statements 30 September 2012 19 Amounts are in ISK millions

Notes to the Interim Financial Statements

Other operating expense

25. Other operating expense:

	2012	2011	2012	2011
	1.1.-30.9.	1.1.-30.9.	1.7.-30.9.	1.7.-30.9.
Direct operating expense (including repairs and maintenance) derived from				
rental-earning investment properties	364	356	117	103
Claims incurred, net of reinsurance	245	267	72	56
Other operating expense	-	1	-	1
Other operating expense	609	624	189	160

Tax expense

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

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Current tax expense				
Current period	3,689	2,525	693	609
Deferred tax expense				
Changes in temporary differences	(314)	554	(231)	(47)
Total income tax expense	3,375	3,079	462	562

Reconciliation of effective tax rate:	1.1.-30.9.2012		1.1.-30.9.2011	
Earnings before tax		17,485		18,198
Income tax using the Icelandic corporation tax rate	20.0%	3,497	20.0%	3,640
Additional 6% tax on financial institutions	4.1%	718	0.0%	-
Non-deductible expense	0.1%	17	0.0%	9
Tax exempt revenues	(0.6%)	(110)	(0.4%)	(52)
Tax incentives not recognised in the statement of Comprehensive Income	(3.5%)	(616)	(1.3%)	(243)
Non-deductible taxes	0.7%	131	0.0%	-
Other changes	(1.5%)	(262)	(1.5%)	(275)
Effective tax rate	19.3%	3,375	16.9%	3,079

27. Bank Levy

Bank levy is calculated according to law. The levy is 0.041% on total debt excluding tax liabilities at end of period. Non-financial subsidiaries are exempt from this levy. Additional temporary levy of 0,0875% is assessed for the years 2012 and 2013 to meet the funding of a special interest relief provided to individual tax payers.

Arion Bank Interim Financial Statements 30 September 2012 20 Amounts are in ISK millions

Notes to the Interim Financial Statements

Net gain (loss) from discontinued operations net of tax

28. Net gain (loss) from discontinued operations net of tax is specified as follows:

	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.7.-30.9.	2011 1.7.-30.9.
Net gain (loss) from legal entities	903	178	3	(382)
Net gain (loss) from associated companies	868	-	-	-
Net gain (loss) from other assets	(24)	(166)	279	(51)
Net gain (loss) on revaluation and disposal of real estate	(549)	(34)	(463)	214
Impairment loss on remeasurement to fair value of legal entities	-	(2,027)	-	-
Effect of compensation instrument	-	1,262	-	-
Net gain (loss) from discontinued operations net of tax	1,198	(787)	(181)	(219)

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

29. Earnings per share are specified as follows:

	Excluding		Including	
	Discontinued operations			
	2012 1.1.-30.9.	2011 1.1.-30.9.	2012 1.1.-30.9.	2011 1.1.-30.9.
Net earnings attributable to the shareholders of Arion Bank	12,978	13,833	14,176	13,046
Weighted average share capital:				
Weighted average number of outstanding shares for the period, million	2,000	2,000	2,000	2,000
Basic earnings per share	6.49	6.92	7.09	6.52
Diluted earnings per share	6.49	6.92	7.09	6.52
Number of outstanding shares at the end of the period, million	2,000	2,000	2,000	2,000
Number of total shares at the end of the period, million, diluted	2,000	2,000	2,000	2,000

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

Notes to the Interim Statement of Financial Position

Cash and balances with Central Bank

30. Cash and balances with Central Bank are specified as follows:

	30.09.2012	31.12.2011
Cash on hand	3,574	2,954
Cash with Central Bank	4,890	17,686
Mandatory reserve deposit with Central Bank	7,562	8,560
Cash and balances with Central Bank	16,026	29,200

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

Arion Bank Interim Financial Statements 30 September 2012 21 Amounts are in ISK millions

Notes to the Interim Financial Statements

Loans and receivables to credit institutions

31. Loans and receivables to credit institutions specified by types of loans:

	30.09.2012	31.12.2011
Bank accounts	74,051	62,175
Money market loans	10,830	4,720
Overdrafts	8	19
Other loans	3,895	2,963
Provision on loans and receivables	(777)	(774)
Loans and receivables to credit institutions	88,007	69,103

32. 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	3	199
Write-offs during the period	-	(784)
Balance at the end of the period	777	774

Loans and receivables to customers

33. Loans and receivables to customers specified by types of loans:

30.09.2012	Individuals	Corporates	Total
Overdrafts	17,441	17,031	34,472
Credit cards	10,059	642	10,701
Mortgage loans	194,228	4,790	199,018
Subordinated loans	-	549	549
Other loans and receivables	38,215	349,335	387,550
Provision on loans and receivables	(22,674)	(37,132)	(59,806)
Loans and receivables to customers	237,269	335,215	572,484
31.12.2011			
Overdrafts	16,353	11,375	27,728
Credit cards	14,679	771	15,450
Mortgage loans	192,869	3,603	196,472
Subordinated loans	-	550	550
Other loans and receivables	28,208	349,431	377,639
Provision on loans and receivables	(12,821)	(43,468)	(56,289)
Loans and receivables to customers	239,288	322,262	561,550

The total book value of pledged loans at 30 September 2012 was ISK 169 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.

34. Changes in the provision for losses on loans and receivables to customers are specified as follows:

	30.09.2012	31.12.2011
Balance at the beginning of the period	56,289	41,843
Provision for losses during the period	7,591	27,225
Write-offs during the period	(4,317)	(13,230)
Payment of loans previously written-off	243	451
Balance at the end of the period	59,806	56,289
Specific	55,392	46,776
Collective	4,414	9,513
	59,806	56,289

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Notes to the Interim Financial Statements

Financial assets and liabilities

35. Financial assets and liabilities are specified as follows:

30.09.2012	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
Cash and balances with Central Bank	16,026	-	-	-	16,026
Loans and receivables to credit institutions	88,007	-	-	-	88,007
Loans and receivables to customers	572,484	-	-	-	572,484
Loans and receivables	676,517	-	-	-	676,517
Bonds and debt instruments					
Listed	-	3,354	42,402	-	45,756
Unlisted	-	62	73,879	-	73,941
Bonds and debt instruments	-	3,416	116,281	-	119,697
Shares and equity instruments with variable income					
Listed	-	1,338	1,364	-	2,702
Unlisted	-	687	8,328	-	9,015
Bond funds with variable income	-	2,395	1,748	-	4,143
Shares and equity instruments	-	4,420	11,440	-	15,860
Derivatives					
OTC derivatives	-	969	-	-	969
Derivatives	-	969	-	-	969
Securities used for hedging					
Bonds and debt instruments	-	777	-	-	777
Shares and equity instruments	-	621	-	-	621
Securities used for hedging	-	1,398	-	-	1,398
Other financial assets	-	-	-	4,067	4,067
Financial assets	676,517	10,203	127,721	4,067	818,508
Liabilities at amortised cost					
Due to credit institutions and Central Bank	-	-	-	16,459	16,459
Deposits	-	-	-	454,405	454,405
Borrowings	-	-	-	192,412	192,412
Subordinated liabilities	-	-	-	32,502	32,502
Liabilities at amortised cost	-	-	-	695,778	695,778
Financial liabilities at fair value					
Short position in bonds held for trading	-	11,019	-	-	11,019
Derivatives	-	103	-	-	103
Financial liabilities at fair value	-	11,122	-	-	11,122
Other financial liabilities	-	-	-	29,705	29,705
Financial liabilities	-	11,122	-	725,483	736,605

Arion Bank Interim Financial Statements 30 September 2012 23 Amounts are in ISK millions

Notes to the Interim Financial Statements

35. cont.

31.12.2011	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
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
Bonds and debt instruments					
Listed	-	2,919	52,688	-	55,607
Unlisted	-	44	84,917	-	84,961
Bonds and debt instruments	-	2,963	137,605	-	140,568
Shares and equity instruments with variable income					
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
Derivatives					
OTC derivatives	-	674	-	-	674
Derivatives	-	674	-	-	674
Securities used for hedging					
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
Liabilities at amortised cost					
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
Financial liabilities at fair value					
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 hf. in March 2009.

Arion Bank Interim Financial Statements 30 September 2012 24 Amounts are in ISK millions

36. Bonds and debt instruments designated at fair value specified by issuer:

	30.09.2012	31.12.2011
Financial institutions	69,900	70,640
Public	45,152	59,368
Corporates	1,229	7,597
Bonds and debt instruments designated at fair value	116,281	137,605

The total amount of pledged bonds at 30 September 2012 was ISK 21.3 billion (31.12.2011: Nil).

37. 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:

30.09.2012	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL	2,444	123,400	1,877	127,721
Financial assets held for trading	6,077	4,104	22	10,203
	8,521	127,504	1,899	137,924
Financial liabilities held for trading	11,019	103	-	11,122
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
	11,613	144,025	2,021	157,659
Financial liabilities held for trading	3,711	1,196	-	4,907

The classification of assets between financial 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 hierachy for financial assets and financial liabilities which are recorded at fair value:

	Transfers from Level 1 to Level 2	
Financial assets	30.09.2012	31.12.2011
Financial assets designated at FV through PL	-	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.

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37. 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.

	30.09.2012	31.12.2011
Balance at the beginning of the period	2,021	1,688
Gain (loss) recognised in Statement of Comprehensive Income	153	771
Acquisition	105	160
Disposal	(389)	(599)
Transfer into Level 3	9	1
Balance at the end of the period	1,899	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:

	30.09.2012	31.12.2011
Net interest income	125	176
Net financial income (expense)	(1)	520
Net foreign exchange gain (loss)	29	75
Net gain (loss) recognised in the Statement of Comprehensive Income	153	771

Investment property

38. Investment property is specified as follows:	Investment property	Investment property in progress	Total 30.09.2012	Total 31.12.2011
Balance at the beginning of the period	21,949	5,151	27,100	27,642
Additions during the period	112	2,312	2,424	3,527
Disposals during the period	(178)	(2,182)	(2,360)	(5,760)
Transferred from property and equipment	-	-	-	775
Fair value adjustments	321	686	1,007	916
Investment property	22,204	5,967	28,171	27,100

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Investments in associates

39. The Group´s interest in its principal associates are as follows:

	30.09.2012	31.12.2011
Audkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20.0%	20.0%
Bakkavör Group ehf., Thorvaldsenstræti 6, 101 Reykjavík, Iceland	31.3%	-
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	36.3%	44.9%
Kríuvarp ehf., Borgartún 35, 105 Reykjavík, Iceland	-	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%
Sementsverksmidjan 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., Grjóthnáls 7-11, 110 Reykjavík, Iceland	-	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	24	2,854
Transferred to held for sale assets	-	(2,525)
Transferred from associates due to step acquisition	-	(9)
Impairment	-	(54)
Share of profit (loss)	13	8
Carrying amount at the end of the period	3,024	2,987

In May 2012 the Bank acquired 31.3% share in Bakkavör Group ehf. as a result of the conversion of the Bank´s convertible loans to equity.

In March the Bank sold its 20.6% shareholding in Hótel Borgarnes hf. The effects from the sale has minor effects on the Statement of Comprehensive Income. In June the Bank sold its 20% shareholding in Ölgerdin Egill Skallagrímsson ehf.

The Group's equity interest in Klakki ehf. has been diluted from 44.9% to 36.3% following the conversion of further creditor claims on Klakki ehf. to equity shareholdings.

Tax assets and tax liabilities

40. Tax assets and liabilities are specified as follows:

	30.09.2012		31.12.2011	
	Assets	Liabilities	Assets	Liabilities
Current tax	13	2,027	6	2,284
Deferred tax	462	1,193	718	1,137
Tax assets and liabilities	475	3,220	724	3,421

Non-current assets and disposal groups held for sale

41. Non-current assets and disposal groups held for sale are specified as follows:

	30.09.2012	31.12.2011
Legal entities	3,459	8,458
Associates	6,384	12,073
Real estates	3,250	2,875
Other assets	618	480
Non-current assets and disposal groups held for sale	13,711	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 entitiy was Fram Foods ehf. which is held by the Group's holding company Eignabjarg ehf.

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Notes to the Interim Financial Statements

41. cont.

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 was approval by the Icelandic Competition Authority. Approval was obtained in June 2012. The gain resulting from this transaction was ISK 868 million and is recognised in the Statement of Comprehensive Income.

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 was approval by the Icelandic Competition Authority, which was obtained in April 2012. The effects from the sale of this entity has minor effects on the Statement of Comprehensive Income.

On 15 June 2012 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in Penninn á Íslandi ehf. A condition precedent for the sale was approval by the Icelandic Competition Authority, which was obtained in August 2012. The effects from the sale of this entity has minor effects on the Statement of Comprehensive Income.

On 3 July 2012 Fram Foods ehf. sold its subsidiary Boyfood Oy in Finland. Fram Foods ehf. is a wholly owned subsidiary of Eignabjarg ehf. The effects from the sale of this entity has minor effects on the Statement of Comprehensive Income.

The associate classified as disposal groups held for sale in accordance with IFRS 5 is HB Grandi hf.

At end of 2011 the Group held 20.9% effective share in Hagar hf. During the period the Group sold 15.7% effective share in Hagar hf. The gain resulting from this transaction was ISK 875 million and is recognised 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:	30.09.2012	31.12.2011
Legal entities, total liabilities	2,683	4,950

Other assets

42. Other assets are specified as follows:

Unsettled securities trading	290	708
Accounts receivable	2,748	6,511
Accrued income	566	455
Prepaid expenses	868	678
Sundry assets	702	524
Other assets	5,174	8,876

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

Other liabilities

43. Other liabilities are specified as follows:

Accounts payable	19,416	18,944
Kaupthing hf. due to investment in ABMIIF	-	3,048
Withholding tax	462	2,186
Depositors' and investors' guarantee fund	2,910	3,018
Insurance claim	2,198	2,023
Unsettled securities and loans	520	132
Sundry liabilities	9,504	9,471
Other liabilities	35,010	38,822

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

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Borrowings

44. Borrowings are specified as follows:

	30.09.2012	31.12.2011
Covered bonds	123,894	124,524
Bonds issued	6,434	-
Other loans	62,084	62,679
Borrowings	192,412	187,203

The Group did not repurchase any own debts during the first nine 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 119.8 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 1.5 billion a year, currently total payment including repayment of principal, indexation and interest is 7.4 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.

In May 2012 Arion Bank completed its first non-indexed fixed rate covered bond offering, issuing ISK 1.32 billion worth of bonds in the Series Arion CB15. In June 2012 Arion Bank completed its second offering, issuing ISK 1.2 billion worth of bonds in the same series. The series was admitted for trading on NASDAQ OMX Iceland on 21 May 2012. The bonds bear 6.50% interest and mature in 2015.

Book value of listed bonds is ISK 8,126 million at end of September 2012. Market value of those bonds is ISK 8,392 million.

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

45. Subordinated liabilities are specified as follows:

	30.09.2012	31.12.2011
Tier II capital	32,502	32,105
Subordinated liabilities	32,502	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.

Derivatives

46. Derivatives at fair value are specified as follows:

	Fair value	
30.09.2012	Assets	Liabilities
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	103	21
Interest rate and exchange rate agreements	441	27
	544	48
Bond derivatives:		
Bond swaps, agreements unlisted	45	53
Options - sold agreements	380	2
Derivatives	969	103
31.12.2011		
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	193	671
Interest rate and exchange rate agreements	463	415
	656	1,086
Bond derivatives:		
Bond swaps, agreements unlisted	18	110
Derivatives	674	1,196

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Equity

Share capital and share premium

47. 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 (million)	30.09.2012	Number (million)	31.12.2011
Issued share capital	2,000	75,861	2,000	75,861
	2,000	75,861	2,000	75,861

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

Other reserves

48. Other reserves are specified as follows:

	30.09.2012	31.12.2011
Statutory reserve	1,637	1,637
	1,637	1,637

Off Balance Sheet information

Obligations

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

	30.09.2012	31.12.2011
Guarantees	10,628	8,662
Unused overdrafts	34,899	34,258
Loan commitments	35,262	17,687

50. Depositors' and Investors' Guarantee fund

The Group expensed ISK 683 million in the first nine months of 2012 to meet payments requirements to the Depositors' and Investors' Guarantee fund according to act no 98/1999 as amended in 2012.

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. Due to uncertainty of the shape of future legislation 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 3,252 million.

Assets under management and under custody

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

	30.09.2012	31.12.2011
Assets under management	770,692	659,024
Assets under custody	1,538,934	1,716,230

Contingent liabilities

52. Litigation is common in the banking industry due to the nature of the business undertaken. Due to the current economic climate in Iceland litigation against the Group has been uncommonly frequent. 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 the end of the period, the Group had several unresolved legal claims.

Legal proceedings regarding Drómi hf.

One significant court case is a case between Drómi hf. 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 hf. According to the decision the resolution committee of SPRON hf. is supposed to establish a specific limited liability company owned by SPRON hf., later Drómi hf., 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 hf.'s claims. The subsidiary was then supposed to take over all SPRON hf.'s obligations to the Group relating to the acquisition of SPRON hf.'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 hf. 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 hf. in an attempt to annul the FME's decision of 4 February 2011. On 4 May 2011 Drómi hf. brought legal action against the FME and the Group. Drómi hf. principally demands the annulment of all decisions by the FME on interest rates, and secondly demands a different interest rate from the outset. In two judgments pronounced on 7 November 2012, the District Court acquitted Drómi hf. and the FME of the Group's claims in its case, and also acquitted the Group and the FME of Drómi hf's. claims in its case. The parties have a period of three months from the passing of the judgments to appeal them to the Supreme Court.

Claims from Private Banking clients

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.

Legal proceedings regarding FX loans

Although there is now more clarity in the matters of FX loans, due to judgments on FX loans pronounced by the Supreme Court since the Group's last interim statement, there still remains uncertainty regarding a number of issues. There are a number of court cases, to which the Group is a party, whereby e.g. the legality of the Group's FX loans are called into question. In some 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., a listed company, announced to the Icelandic Stock Exchange 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.

Legal proceeding regarding Stefnir hf.

The winding-up committee of Landsbankinn hf. has brought legal action against Stefnir hf. in Reykjavík District Court. The legal action is based on the winding-up committee's demand to rescind Landsbankinn's hf. payment of money market deposits which matured early in October 2008 to two funds managed by Stefnir hf. The amount involved is ISK 450 million plus interest. Stefnir hf. condsiders the winding-up committee's claim to be baseless and the case will be heard by Rekjavík District Court in January 2013.

Investigation by the EFTA Surveillance Authority

Two formal investigations involving the Bank were launched by the EFTA Surveillance Authority (ESA) in 2010, which have now both been concluded.

52. cont.

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 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 Stefnir hf.) on 30 October 2008. On 11 July 2012, ESA concluded that the Icelandic authorities had granted state aid with the acquisition by each of the new banks of the assets in the above funds. However, ESA found the aid to be compatible with the EEA Agreement as ESA considered that the Government had to implement extraordinary measures in an attempt to stabilize the economy and that the measures at issue were necessary in order to try to restore faith in the financial sector. In this respect it was necessary and appropriate to protect the investors from even greater losses on their savings.

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 were launched in relation to the restoration and capitalisation of Íslandsbanki hf. and Landsbankinn hf. In its investigation, ESA considered the appropriateness of the capitalisation measures taken by the Icelandic authorities, which were not notified to the ESA in advance of their implementation. On 11 July 2012, ESA concluded that the aid measures taken constitute state aid compatible with the EEA Agreement. In connection with this decision, the Group has undertaken certain commitments to increase competition. The Group will provide information on its website how customers can move their business to another bank. The Group has also undertaken not to acquire other financial companies until 1 of December 2014, except if it obtains the Authority´s approval beforehand. In the ESA decision, it is stated that this means that further concentration of the Icelandic financial market through acquisitions by the Group can be prevented, unless further mergers would be necessitated by financial stability considerations. The Group commits to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring in line with Article 22 of the Act on Financial Undertakings No. 161/2002. The Group commits to follow the procedure and time-limits, which are set out in this provision and as interpreted by the FME. This commitment is a legal obligation already present. The Group furthermore committed to maintain up-to-date information on its website, or a subsidiary, on subsidiaries and shareholdings that are held for sale.

Investigation by the Icelandic Competition Authority

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 Tryggingamidstödin 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 Tryggingamidstödin 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.

Other matters

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, but the claimant has appealed the judgment to the Supreme Court. 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.

The uncertainty regarding the book value of foreign currency lending

53. 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 krona 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. In a judgment on 16 September 2010, the Supreme Court of Iceland stated that a loan agreement, which was ruled to be in Icelandic krona indexed to a foreign currency exchange rate, should bear the non-indexed Icelandic krona 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 krona 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 krona posted by the Central Bank. Furthermore, the law required 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 recalculated all mortgage loans for personal residents in foreign currency to individuals.

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 krona 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 krona and indexed to a foreign currency exchange rate.

Notes to the Interim Financial Statements

53. cont.

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 corporates.

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 loans to individuals have been recalculated into ISK denominated loans.

The first Supreme Court judgment which discussed the legality of a loan owned by the Group was pronounced on 15 June 2012, in the case Arion Bank v Háttur ehf. The case concerned the legality of the company's loan agreement where the loan amount is specified as "the equivalent to" a certain amount in Icelandic krónur; the loan amount was disbursed to the borrower in foreign currency and the majority of the loan was repaid in foreign currency. The majority of the Supreme Court concluded that it was a legitimate FX loan, particularly with reference to the name of the loan agreement, the specification of the loan amount and interest and the way in which the loan was paid out and how repayments and interest were repaid, as it was considered that both parties had discharged their duties with amounts in foreign currencies having changed hands. The Supreme Court came to the same conclusion in a judgment pronounced on 1 November 2012, in the case of Arion Bank v P. Arnason fasteignir ehf. In that case, the loan amount is specified as "the equivalent to" a certain amount in Icelandic krónur; the loan amount was disbursed to the borrower in foreign currency, but the loan had been repaid in Icelandic krónur. In its reasoning the Supreme Court stated that according to the loan agreement between the parties, the borrower was intended to repay the loan in foreign currencies, irrespective of whether he actually did. As both parties had or were intended to discharge their duties with foreign currency changing hands, the Supreme Court considered the loan to be a legitimate loan in foreign currencies. The Group believes that comparable loan agreements with companies and individuals at the Group are subject to the precedent set by both these judgments. It is therefore clear that a decision has been reached by the courts on the legality or, in some circumstances, illegality of the majority of the Bank's FX loans to companies and individuals. However, it should be pointed out that the courts have not ruled on all types of the Bank's FX loans.

On 15 February 2012, the Supreme Court passed a judgment in the case of Frjálsi fjárfestingarbankinn hf. In the judgment, it was stated that loans, which are deemed to be illegal foreign currency-linked loans, can be recalculated with the non-indexed interest rate set by the Central Bank of Iceland, however the Group 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 Group's payment slips. As the judgment dealt with a dispute which rose from special circumstances, the Group considered precedent not entirely clear. However, the Group estimated that the loss to the Group's foreign loan portfolio arising from the judgment was 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.

On 18 October 2012, the Supreme Court pronounced a judgment in the case Borgarbyggd v Arion Bank. The case tested some of the questions raised by the court's judgment of 15 February 2012, including whether the principle of that case applied to legal entities. In this case the Supreme Court applied the same principle as in the judgment from February, i.e. that a financial company could not demand from the borrower higher interest that the borrower actually paid according to payment slips. This applied irrespective of whether it involved a legal entity or not. It can therefore be said that the legal uncertainty relating to the judgment from February has been significantly reduced.

The aforementioned judgments, which have been pronounced since the judgment of 15 February 2012, have not affected the provision of ISK 13.8 billion.

The Group issued a press release on 2 November 2012 announcing that the Group had decided to recalculate foreign currency-linked loans, which were similar to the loan disputed in the judgment of 18 October 2012. The loans in question were loans to individuals and smaller companies where there was a payment slip for payment of interest and capital in accordance with each loan's original terms.

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 judgments of 15 February and 18 October 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 judgments of 15 February and 18 October 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 the end of the period.

Notes to the Interim Financial Statements

Notes to the Condensed Interim Statement of Cash Flow

54. Changes in operating assets and liabilities specified as follows:	2012 1.1.-30.9.	2011 1.1.-30.9.
Mandatory reserve with Central Bank	998	(20)
Loans and receivables to credit institutions	(7,028)	6,767
Loans and receivables to customers	(11,539)	34,758
Bonds and debt instruments	19,948	(38,936)
Shares and equity instruments	117	(884)
Derivatives and financial liabilities at fair value	5,777	69
Securities used for hedging	-	2,811
Other assets	115	3,303
Due to credit institutions and Central Bank	299	(1,234)
Deposits	(37,839)	(17,666)
Borrowings	1,080	1,639
Subordinated loans	-	(1,181)
Financial liabilities at fair value	-	698
Other liabilities	(3,787)	(6,017)
Changes in operating assets and liabilities	(31,859)	(15,893)

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Notes to the Interim Financial Statements

Risk Management Disclosures

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

Credit risk

55. Credit risk

a) Maximum exposure to credit risk

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position at the end of the reporting period before the effect of mitigation due to collateral agreements or other credit enhancements.

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

	30.09.2012	31.12.2011
Cash and balances with Central Bank	16,026	29,200
Loans and receivables to credit institutions	88,007	69,103
Loans and receivables to customers:		
Overdrafts	34,472	27,728
Credit cards	10,701	15,450
Mortgage loans	199,018	196,472
Subordinated loans	549	550
Other loans and receivables	387,550	372,534
Provision on loans and recivables	(59,806)	(51,184)
Bonds and debt instruments :		
Listed	45,756	55,614
Unlisted	73,941	84,954
Derivatives	969	674
Bonds and debt instruments, hedging, listed	777	1,922
Other assets with credit risk	4,067	8,004
On balance sheet maximum exposure to credit risk	802,027	811,021

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

Guarantees	10,628	8,662
Unused overdrafts	34,899	34,258
Loan Commitments	35,262	17,687
Off balance sheet maximum exposure to credit risk	80,789	60,607
Maximum exposure to credit risk	882,816	871,628

Arion Bank Interim Financial Statements 30 September 2012 35 Amounts are in ISK millions

55. cont.

b) Credit quality by class of financial assets:

30.09.2012	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Cash and balances with Central Bank	16,026	-	-	16,026
Loans and receivables to credit institutions	88,007	-	-	88,007
Loans and receivables to customers				
Loans to corporates	272,681	21,366	41,429	335,476
Loans to individuals	191,462	20,356	25,190	237,008
Bonds and debt instruments	119,697	-	-	119,697
Derivatives	969	-	-	969
Securities used for hedging	777	-	-	777
Other assets	4,067	-	-	4,067
Total	693,686	41,722	66,619	802,027

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:

30.09.2012	Up to 30 days	31 to 60 days	61 to 90 days	More than 91 days	Total
Loans to corporates	10,604	1,715	199	8,848	21,366
Loans to individuals	9,404	2,329	200	8,423	20,356
Past due but not impaired loans	20,008	4,044	399	17,271	41,722

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
Past due but not impaired loans	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 1.226 million, all which the Group is in the process of selling, see Note 41.

Arion Bank Interim Financial Statements 30 September 2012 36 Amounts are in ISK millions

Notes to the Interim Financial Statements

55. cont.

e) Loans and receivables to customers specified by sectors:

	30.09.2012	31.12.2011
Individuals	41.4%	39.7%
Financial and insurance activities	10.5%	10.8%
Manufacturing, mining and other industry	7.9%	7.7%
Real estate activities	10.6%	9.8%
Agriculture, forestry and fishing	9.3%	11.1%
Wholesale and retail trades, transport, accommodation and food service activities	11.1%	11.7%
Business services	5.2%	5.3%
Construction	1.2%	1.5%
Public administration, defence, education, human health and social work activities	1.1%	1.2%
Other services	1.7%	1.2%
Loans and receivables to customers	100.0%	100.0%

f) Impaired loans and receivables to customers by sector:

	30.09.2012	
	Impaired amount	Impaired loans
Individuals	19,994	45,184
Financial and insurance activities	7,732	10,058
Manufacturing, mining and other industry	2,185	9,283
Real estate activities	3,513	8,682
Agriculture, forestry and fishing	4,114	12,852
Wholesale and retail trades, transport, accommodation and food service activities	6,577	17,904
Business services	8,383	10,463
Construction	1,793	5,231
Public administration, defence, education, human health and social work activities	469	1,111
Other services	632	1,243
Impairment on loans and receivables to customers	55,392	122,011

During the period, the Group has modified its basis for determining Impaired loans and receivables to customers by sector. The cost of recalculating the comparative information on a consistent basis outweighs the benefit in the viewpoint of the Group and therefore no comparative information is presented.

In prior financial years, loans where the impairment did not exceed the remaining acquisition discount were not classified as impaired loans as the Group's management wanted to disclose impaired loan information reflecting the deterioration in loan quality subsequent to acquisition. As the Group's restructuring of acquired loans in 2008 is nearing completion, the Group's management has reclassified the remaining acquisition discount to an impairment provision.

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 30 billion (31.12.2011: ISK 33 billion) before taking account of eligible collateral, excluding claim on Drómi. The Group has four large exposures at period-end (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.

The sum of all large exposures is 108% before collateral mitigation or 63% net of eligible collateral, which is well below the 400% legal maximum and the Group’s internal 150% limit net of collateral.

Arion Bank Interim Financial Statements 30 September 2012 37 Amounts are in ISK millions

Notes to the Interim Financial Statements

Market risk

56. 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.

30.09.2012		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked	ISK	(57)	(2,089)	(247)	(4,425)	(1,295)
Non Indexed linked	ISK	(250)	(791)	(65)	(105)	(29)
	EUR	108	(2)	-	-	-
	Other	(75)	(17)	(101)	-	-
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)	-	-

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

30.09.2012 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	16,026	8,617	-	7,409	-	-	-
Loans and receivables to credit institutions	88,007	73,981	13,779	-	247	-	-
Loans and receivables to customers	572,484	5,414	45,059	69,879	238,528	213,604	-
Bonds and debt instruments	119,697	4,763	4,470	33	68,919	41,512	-
Shares and equity instruments	15,860	-	-	-	-	-	15,860
Derivatives	969	-	527	(2)	444	-	-
Assets leg	17,108	-	13,094	267	3,747	-	-
Liabilities leg	(16,139)	-	(12,567)	(269)	(3,303)	-	-
Securities used for hedging	1,398	777	-	-	-	-	621
Investment property	28,171	-	-	-	-	-	28,171
Investments in associates	3,024	-	-	-	-	-	3,024
Property and equipment	6,147	-	-	-	-	-	6,147
Intangible assets	5,102	-	-	-	-	-	5,102
Tax assets	475	-	-	-	-	-	475
Non-current assets held for sale	13,711	-	-	-	-	-	13,711
Other assets	5,174	64	1,489	2,009	458	47	1,107
Total assets 30.09.2012	876,245	93,616	65,324	79,328	308,596	255,163	74,218

Notes to the Interim Financial Statements

56. cont.

Liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Due to credit inst. and Central Bank	16,459	11,025	3,072	2,362	-	-	-
Deposits	454,405	277,939	113,950	33,777	26,056	2,683	-
Financial liabilities at fair value	11,122	-	11,084	15	5	18	-
Assets leg	(24,617)	-	(9,953)	(188)	(8,623)	(5,853)	-
Liabilities leg	24,720	-	10,018	203	8,628	5,871	-
Short position bonds & derivatives	11,019	-	11,019	-	-	-	-
Tax liabilities	3,220	-	822	2,398	-	-	-
Non-current liabilities held for sale	2,683	-	-	-	-	-	2,683
Other liabilities	35,010	1,091	4,692	21,259	2,477	188	5,303
Borrowings	192,412	-	1,810	2,288	13,271	175,043	-
Subordinated liabilities	32,502	-	-	-	-	32,502	-
Total liabilities 30.09.2012	747,813	290,055	135,430	62,099	41,809	210,434	7,986
Off balance sheet items							
Guarantees	10,628	2,172	917	4,833	1,372	1,334	-
Unused overdraft	34,899	514	5,831	14,276	14,257	20	-
Loan commitments	35,262	6,087	7,166	12,481	9,408	120	-
Off balance sheet items	80,789	8,773	13,914	31,590	25,037	1,474	-
Net interest sensitivity gap	47,643	(205,212)	(84,020)	(14,361)	241,750	43,255	66,232

31.12.2011

Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	29,200	20,640	-	8,560	-	-	-
Loans and receivables to credit institutions	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

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56. cont.

Liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
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	36,570	-	35,478	-	1,092	-	-
Short position bonds & derivatives	3,711	-	3,711	-	-	-	-
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	-
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

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 267.4 billion (31.12.2011: ISK 230.7 billion) and the total amount of indexed liabilities amount to ISK 223.6 billion (31.12.2011: ISK 218.5 billion).

30.09.2012 Assets - CPI indexed linked	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans and receivables to customers	822	66,558	193,352	260,732
Bonds and debt instruments	-	437	988	1,425
Off balance sheet position	1,998	1,526	4,896	8,420
Total	2,820	68,521	199,236	270,577
Liabilities - CPI indexed linked				
Deposits	65,131	27,613	5,638	98,382
Borrowings	2,156	9,496	110,972	122,624
Total	67,287	37,109	116,610	221,006
Net on balance sheet position	(66,465)	29,886	77,730	41,151
Net off balance sheet position	1,998	1,526	4,896	8,420
Total CPI Balance 30.09.12	(64,467)	31,412	82,626	49,571
Total CPI Balance 31.12.2011	(58,423)	(1,448)	72,027	12,156

Arion Bank Interim Financial Statements 30 September 2012 40 Amounts are in ISK millions

Notes to the Interim Financial Statements

56. cont.

c) Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Group is primarily exposed to currency risk through a currency mismatch between assets and liabilities. The Group has primarily managed this mismatch through the systematic redenomination of foreign currency denominated loans to customers into ISK.

Currency risk strategy

The Bank's strategy towards currency risk is to meet the requirements of the Central Bank on foreign exchange balance at all times. Currency risk due to foreign currency loans to customers with ISK income will be eliminated. Net exposures per currency are monitored centrally in the Bank.

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

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash with Central Bank	14,332	345	231	305	500	92	221	16,026
Loans to credit institutions	22,727	20,425	19,036	2,058	10,000	1,118	12,643	88,007
Loans and receivables to customers	423,962	51,443	20,752	26,433	7,026	19,452	23,416	572,484
Bonds and debt instruments	119,042	-	655	-	-	-	-	119,697
Shares and equity instruments	8,942	5,297	928	-	308	-	385	15,860
Derivatives	904	10	-	7	28	4	16	969
Securities used for hedging	1,398	-	-	-	-	-	-	1,398
Investment property	28,171	-	-	-	-	-	-	28,171
Investments in associates	3,024	-	-	-	-	-	-	3,024
Property and equipment	6,147	-	-	-	-	-	-	6,147
Intangible assets	5,102	-	-	-	-	-	-	5,102
Tax assets	475	-	-	-	-	-	-	475
Non-current assets held for sale	9,204	4,507	-	-	-	-	-	13,711
Other assets	4,708	228	212	-	17	-	9	5,174
Total assets 30.09.2012	648,138	82,255	41,814	28,803	17,879	20,666	36,690	876,245
Liabilities and Equity								
Due to credit inst. and Central Bank	14,136	1,615	199	-	38	235	236	16,459
Deposits	374,601	22,689	15,420	5,220	6,179	1,309	28,987	454,405
Financial liabilities at fair value	11,080	25	-	-	-	-	17	11,122
Tax liabilities	3,220	-	-	-	-	-	-	3,220
Non-current liabilities held for sale	2,683	-	-	-	-	-	-	2,683
Other liabilities	27,611	1,703	3,025	273	442	1,518	438	35,010
Borrowings	130,813	2,909	20,130	20,496	7,071	10,993	-	192,412
Subordinated loans	-	26,031	2,482	-	3,989	-	-	32,502
Equity	128,432	-	-	-	-	-	-	128,432
Total liabilities and equity 30.09.2012	692,576	54,972	41,256	25,989	17,719	14,055	29,678	876,245
Net on balance sheet position	(44,438)	27,283	558	2,814	160	6,611	7,012	
Net off balance sheet position	15,248	(18,418)	3,884	3,595	2,175	(4,166)	(2,318)	
Net position 30.09.2012	(29,190)	8,865	4,442	6,409	2,335	2,445	4,694	
Net position 31.12.2011	(42,631)	8,610	9,500	9,189	2,884	5,785	6,663	
Net real position 31.12.2011	(24,191)	5,788	8,276	1,025	2,793	(122)	6,431	

A natural hedge for currency risk is no longer relevant for the Bank.

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Liquidity risk

57. 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	31%	18%
Maximum	35%	23%
Minimum	30%	13%
Average	33%	18%

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 Group's deposit stickiness at period-end, according to the Group’s classification. The rating 7 means the stickiest deposits and the rating 1 the least sticky.

% of deposit base:

Stickiness rating		30.09.2012		31.12.2011
1 Capital controls	2%	9,904	9%	43,977
2 Resolution process	15%	71,661	11%	58,315
3 Investors	25%	117,245	25%	124,596
4 Deposits - legal entities	13%	60,163	16%	80,494
5 Deposits - retail individuals	12%	54,801	11%	57,559
6 Deposits - legal entities with business relationship	16%	75,772	11%	57,664
7 Deposits - retail individuals with business relationship	17%	81,318	17%	83,550
Total	100%	470,864	100%	506,155

The fall in deposits under Capital Controls is primarily due to a single client‘s withdrawal.

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Notes to the Interim Financial Statements

Capital Adequacy

58. Capital Adequacy Disclosures

Capital base at 30 September 2012 amounts to ISK 155,357 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 22.5%, 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).

It should be noted that the effect of a risk mitigation in the form of natural hedge, due to FX loans to borrowers with ISK income, is no longer reflected in the RWA for market risk whereas 31.12.2011 a 37% effective contribution of the corresponding portion of the FX imbalance was accounted for.

Capital Base	30.09.2012	31.12.2011
Share capital	2,000	2,000
Share premium	73,861	73,861
Statutory reserve	1,637	1,637
Retained earnings	47,126	32,950
Non-controlling interests	3,808	4,110
Total Equity	128,432	114,558
Deduction from Tier 1 capital	(5,577)	(5,489)
Total Tier 1 capital	122,855	109,069
Tier 2 capital	32,502	32,105
Total Capital base	155,357	141,174
Risk weighted assets		
Credit risk	557,607	543,233
Market risk FX	29,980	31,990
Market Risk other	29,455	30,757
Operational risk	58,976	58,976
Total Risk weighted assets	676,018	664,956
Tier 1 ratio	18.2%	16.4%
Capital adequacy ratio	23.0%	21.2%
Official Tier 1 ratio*	17.7%	16.4%
Official Capital adequacy ratio*	22.5%	21.2%

* Official capital ratio is based on reviewed retained earnings at 30 June 2012.

Other information

Related parties

59. 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.

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Notes to the Interim Financial Statements

59. cont.

Balances with related parties:

30.09.2012	Assets	Liabilities	Net balance
Shareholders with significant influence over the Group	-	1,767	(1,767)
Shareholders with control over the Group	546	62,013	(61,467)
Board of Directors and key Management personnel	120	107	13
Associates and other related parties	57,773	15,488	42,285
	58,439	79,375	(20,936)
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
	74,732	72,561	2,171

Events after Balance Sheet date

60. Events after Balance Sheet date

In October 2012 Fram Foods ehf. sold its subsidiary Fram Foods AB in Sweden. Fram foods ehf. is a wholly owned subsidiary of Eignabjarg ehf. The the sale of this entity will have minor effects on the Statement of Comprehensive income in the fourth quarter of 2012.

Subsidiaries

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

Company:	Country	Currency	Equity interest accum. %
AFL - sparisjódur, Adalgata 34, 580 Siglufjördur	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
Eignarhaldsfélagid Landey ehf., Hátún 2b, 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
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
Stefnir hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Tekjuvernd ehf., Hlídasmári 17, 201 Kópavogur (former KB Rádgjöf ehf.)	Iceland	ISK	100.0
Valitor Holding hf., Laugavegur 77, 101 Reykjavík	Iceland	ISK	60.8

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