



FINANCIAL STATEMENTS 31.12.2013

INVESTOR PRESENTATION
26 FEBRUARY 2014

HIGHLIGHTS OF 2013

- **Reduced risk in the business model**
- **New loans – increased by 60%**
- **Positive changes on balance sheet**
- **Challenge to maintain net interest income**
- **Commission income on track**
- **Strong net financial income**
- **Focus ongoing on operating expenses**
- **Financial strength and strong liquidity**
- **Irregular items still have too much effect**
- **Bank of the year in Iceland 2013 – The Banker**



HIGHLIGHTS OF 2013



HIGHLIGHTS OF 2013

FINANCIALLY ROBUST BANK WITH STABLE UNDERLYING OPERATIONS

BALANCE SHEET AND INCOME STATEMENT

- Stable underlying operations
 - ROE of 9.2 %
 - ROE on regular operations of 10.5%
- Satisfactory return on constantly growing equity
- Agreements on settlement of Drómi bond between Central Bank holding company ESÍ and Arion Bank
- Irregular items still have an effect

FUNDING

- The Bank completed its first international bond offering in Norwegian kroner, arranged by Pareto Öhman
 - Bonds admitted to trading on Oslo Stock Exchange
- Arion Bank completed offering of new series of covered bonds, Arion CBI 19
- Credit rating assigned by Standard & Poor's (S&P) at the beginning of 2014 – BB+

HIGHLIGHTS OF 2013

STRONG PERFORMANCE BY ALL BUSINESS SEGMENTS

OPERATIONS

- Arion Bank chosen bank of year in Iceland for 2013 by The Banker magazine
- Frjálsi Pension Fund named best pension fund in European country with under 1 million inhabitants
- Strong performance by Asset Management – assets under management increased by 9% between years
- Growth in loan portfolio
 - High relative increase in retail loans in past few years – from 25% to 50% since 2010
- Problem loans
 - Ratio of problem loans dropped from 12.5% to 6.3%
 - Would have fallen to 4.5% without Drómi bond
- The Bank is a leader in major new investment opportunities – Alvogen
- Implementation of A Plus went well in 2013
- Branch at Smári celebrated its 30th anniversary
- CEO held 10 meetings with more than 100 employees in total to further discuss the results of the employee survey
- New managing director of Corporate Banking in June – Freyr Thórdarson
- Two new Directors elected to the Board
 - Benedikt Olgeirsson
 - Björgvin Skúli Sigurdsson

HIGHLIGHTS OF 2013

RANGE OF PRODUCTS AND GOOD SERVICE

SERVICE

- Good results of service indicators
- Wider choice of non-indexed mortgages
 - Non-indexed mortgages based on Central Bank interest rates
 - Non-indexed mortgages with fixed interest for three years
- New features in Arion app:
 - Pay bills
 - Fast payments
 - Deposit into credit card
 - Fetch PIN
- Fjárhæðaprep 30 account – new way to save
 - Non-indexed high interest account with 30 day minimum investment term after withdrawal request submitted
- The Bank began to offer clients insurance quotes in collaboration with insurance company Euler Hermes
- Pension Portal allowed fund members to view all their acquired pension rights
- The Bank began to issue new credit card with travel-related benefits in cooperation with Icelandair
- The Bank bought the property Borgartún 18 – a new branch of Arion Bank will open there this summer

HIGHLIGHTS OF 2013

GROWING BUSINESS IN INVESTMENT BANKING

INVESTMENT BANKING

 <p>HB GRANDI</p> <p>IPO In progress</p>	 <p>REITIR Fasteignafélag</p> <p>Restructuring In progress</p>	 <p>Skipti</p> <p>Bond offering 2013</p>	 <p>Reginn FASTEIGNAFÉLAG</p> <p>Bond offering 2013</p>	 <p>VÍS</p> <p>IPO 2013</p>
 <p>Skeljungur</p> <p>Advice on acquisition 2013</p>	 <p>N1</p> <p>IPO 2013</p>	 <p>LANDFESTAR FASTEIGNAFÉLAG</p> <p>Direct sale 2013</p>	 <p>Landsvirkjun</p> <p>Bond offering 2013</p>	

HIGHLIGHTS OF 2013

SOCIALLY RESPONSIBLE BANK – FOCUS ON INNOVATION AND FINANCIAL EDUCATION

SOCIAL ISSUES

- Arion Bank supported the distribution of Christmas aid organized by Icelandic Church Aid, Mæðrastyrksnefnd and the Icelandic Red Cross
- The Bank supported the awareness and fundraising campaigns Moustache March and Pink Ribbon
- Employees raised ISK 1.5 million for the Icelandic Cancer Society
- Arion Bank and Disney Reading Week – held in January and October
- Reflectors distributed to all 6-year old children
- Arion Bank football tournament held in Reykjavík. Total of 2,100 children took part

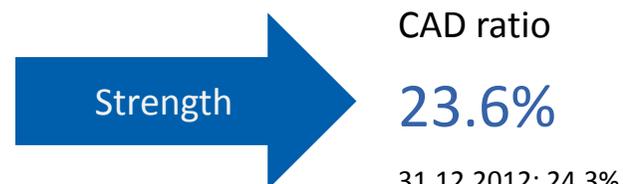
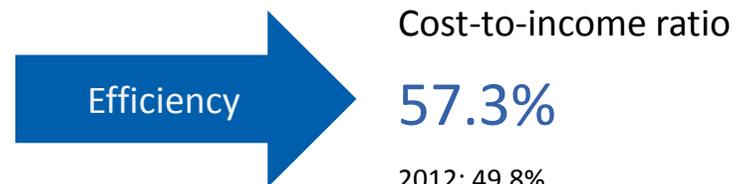
INNOVATION AND EDUCATION

- Business accelerator Startup Reykjavík held for second time with great success
 - We have invested in 20 innovation projects
- Arion Bank was one of founders of Startup Energy Reykjavík business accelerator
- Number of meetings, courses, conferences and lectures held in Borgartún

FINANCIAL STATEMENTS



FINANCIAL HIGHLIGHTS



INCOME STATEMENT



INCOME STATEMENT

BANK LEVY AND THE DRÓMI TRANSACTION HAVE A MAJOR IMPACT ON THE FOURTH QUARTER

Decrease in net interest income related to lower inflation and higher funding costs

Other income is higher in Q4 due to valuation changes in investment properties and associates

Effect of Drómi within net change in valuation is ISK 1.616 million

Bank levy for 2013 was raised from 0.041% to 0.376% at the end of the year. These changes have major impact on net earnings in Q4 2013

Million ISK	Q4 2013	Q3 2013	Q2 2013	Q1 2013
Net interest income	5,487	5,646	6,379	6,288
Net commission income	2,939	2,986	2,849	2,449
Net financial income	721	658	1,123	(827)
Other income	3,615	1,610	1,249	1,176
Operating income	12,762	10,900	11,600	9,086
Salaries and related cost	(4,098)	(2,760)	(3,357)	(3,322)
Other operating expenses	(3,114)	(2,516)	(2,951)	(3,277)
Net change in valuation	(561)	(253)	456	(322)
Net earnings before taxes	4,989	5,371	5,748	2,165
Income tax	(292)	(1,102)	(1,163)	(586)
Bank levy	(2,572)	(112)	(97)	(91)
Net gain from discontinued operations, net of tax	402	62	14	(79)
Net earnings	2,527	4,219	4,502	1,409
Shareholders of Arion Bank	2,789	4,093	4,440	1,697
Minority interest	(262)	126	62	(288)

INCOME STATEMENT

REDUCED RISK IN THE BUSINESS MODEL EFFECTS NET INTEREST INCOME

In addition to increased mortgage portfolio a lower net interest income is mainly due to lower inflation and increased demand deposits resulting in higher interest expenses

Commission income continues to increase

Million ISK	2013	2012	%
Net interest income	23,800	27,142	(12%)
Net commission income	11,223	10,748	4%
Net financial income	1,675	2,017	(17%)
Other income	7,650	9,595	(20%)
Operating income	44,348	49,502	(10%)
Salaries and related cost	(13,537)	(12,459)	9%
Other operating expenses	(11,858)	(12,209)	(3%)
Net change in valuation	(680)	(4,690)	(86%)
Net earnings before taxes	18,273	20,144	(9%)
Income tax	(3,143)	(3,633)	(13%)
Bank levy	(2,872)	(1,062)	170%
Net gain from discontinued operations, net of tax	399	1,607	(75%)
Net earnings	12,657	17,056	(26%)
Shareholders of Arion Bank	13,019	16,622	(22%)
Minority interest	(362)	434	(183%)

CORE INCOME

CHALLENGING TO MAINTAIN ACCEPTABLE PROFITABILITY WITH INCREASED EQUITY

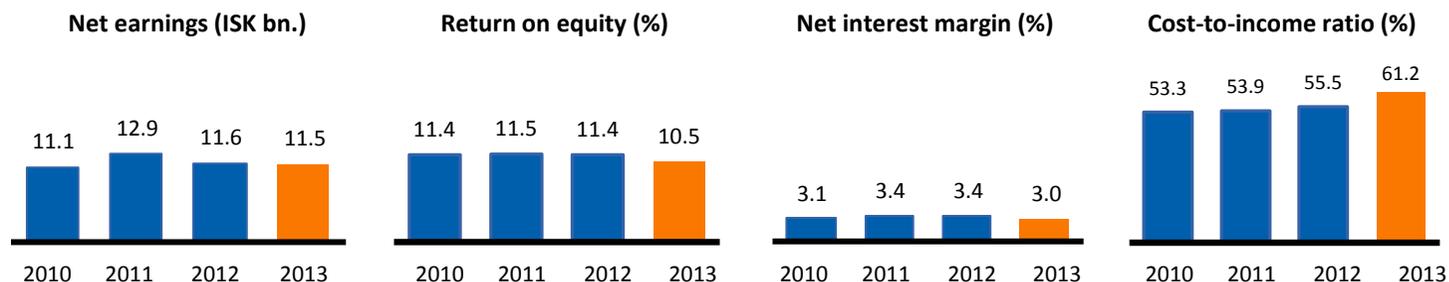
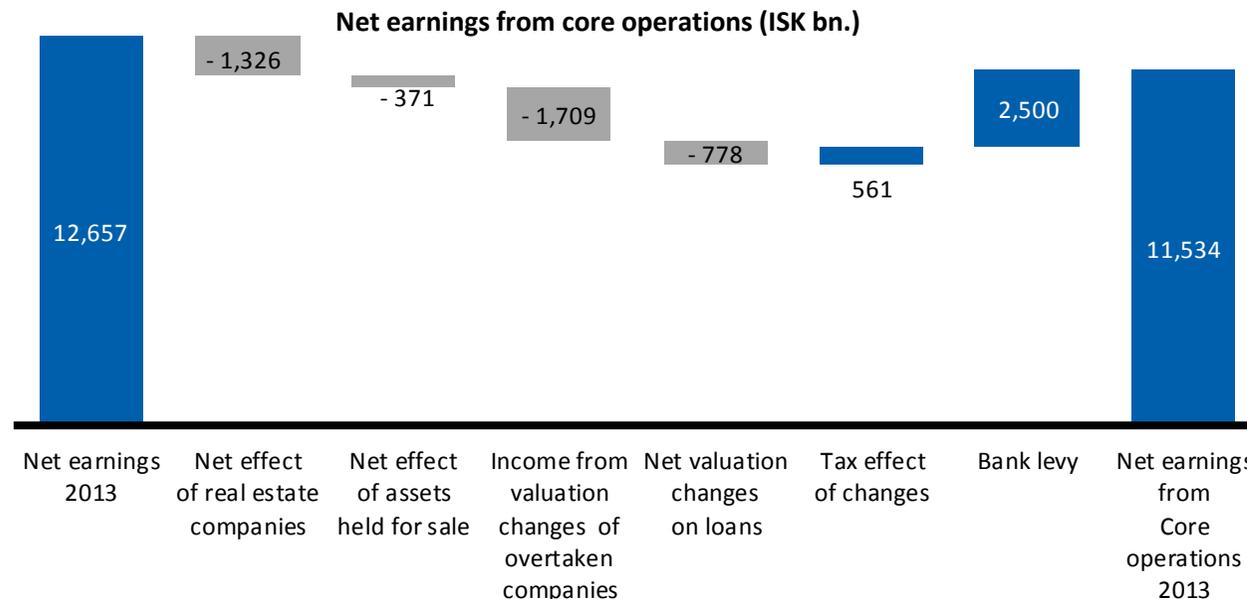
FX loss included in core operating income

- Has a negative effect on performance

Challenging to maintain core ROE due to high capitalization

Decrease in net interest margin have the most single negative effect on core operations

Aim for cost-to-income ratio below 50% is optimistic in changed business model



NET INTEREST INCOME

LOWER BUSINESS RISK IS AN IMPORTANT FACTOR IN LOWER NET INTEREST INCOME

Increased mortgage portfolio

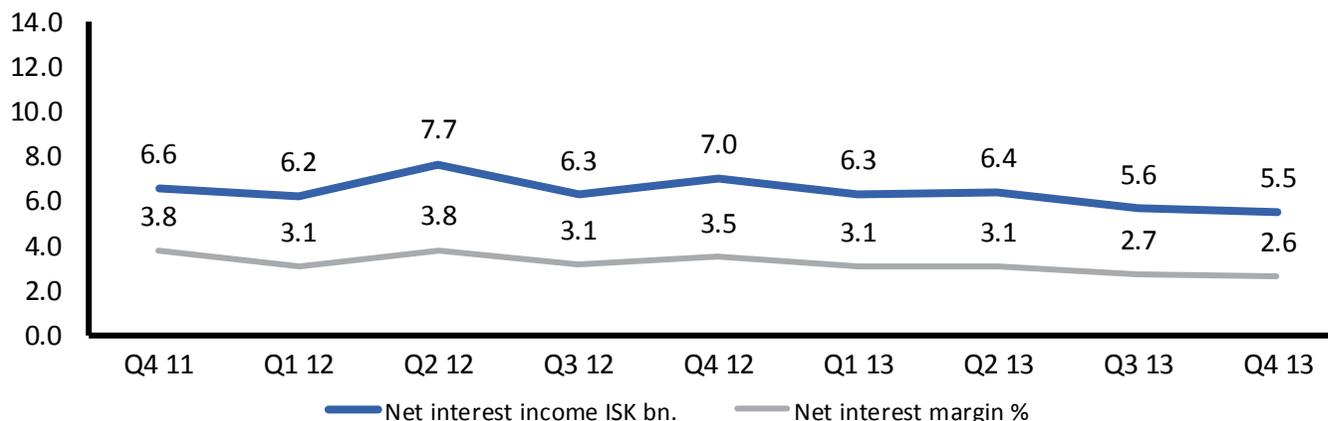
Continued pressure on interest margin due to more competition in lending

Focus on maturity of deposits and wholesale funding with effect on interest expense

Net interest income further affected by low inflation

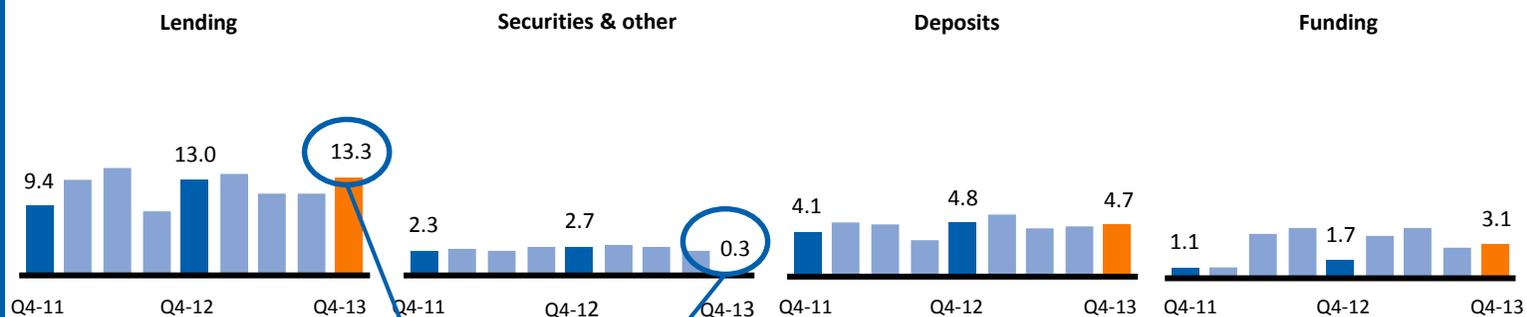
The effect of the Drómi transaction is increased interest income in lending and decreased interest income in securities

By quarters from Q4 2011 – Q4 2013 (ISK bn.)



Interest income by type (ISK bn.)

Interest expense by type (ISK bn.)



Affected by the Drómi transaction

NET COMMISSION INCOME

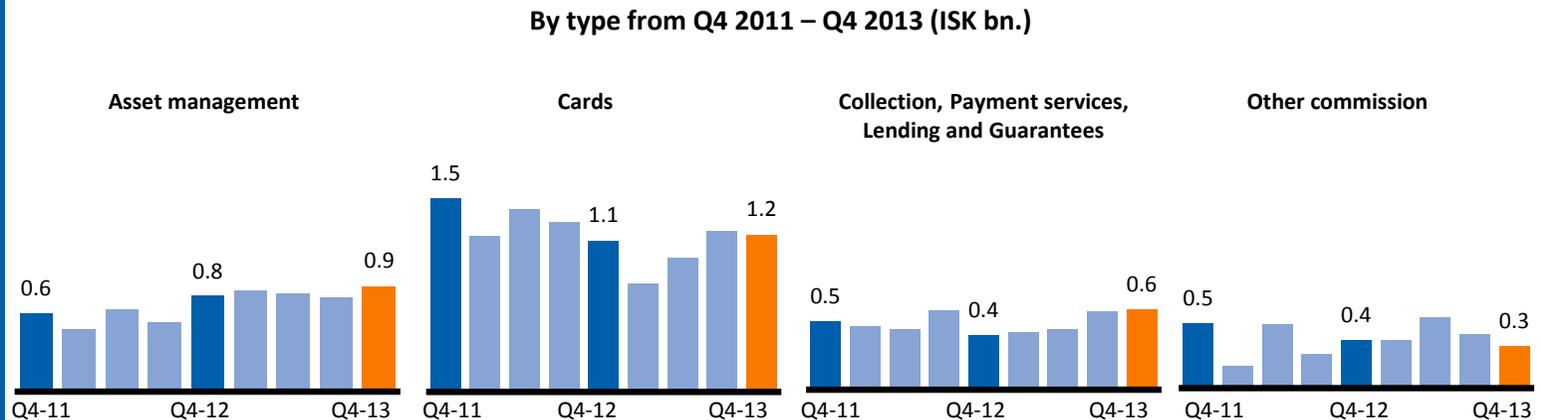
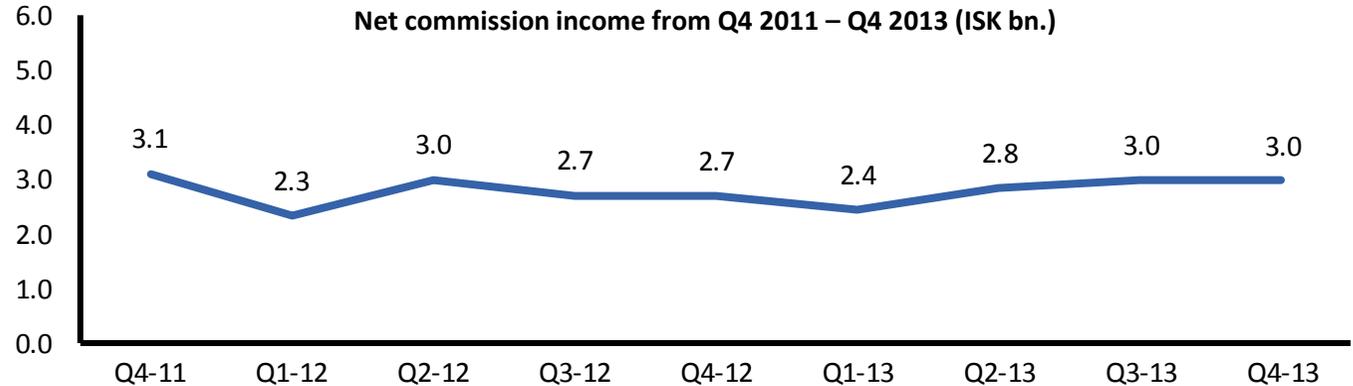
STRONG PLATFORM FOR FUTURE GROWTH

Commission income from cards increasing again after changes in revenue model at Valitor

Gradual increase in commission from asset management

Other commission mainly from investment banking activities

Commission income expected to have bottomed out in Q1 2013



NET FINANCIAL INCOME

GOOD PERFORMANCE OF SECURITIES BUT AFFECTED BY STRENGTHENING ISK

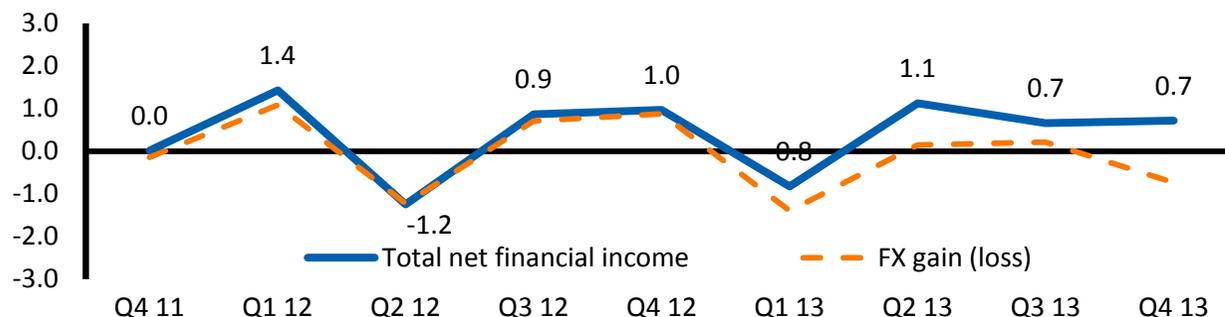
Good performance in bonds and equity markets

Increasing FX imbalance resulting from revaluation of FX loans and changes in associated company

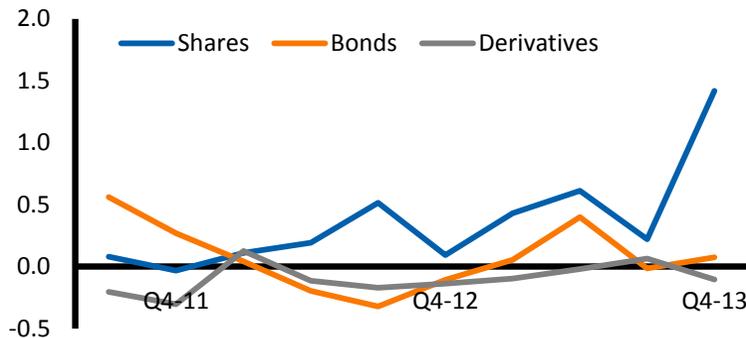
The gain from shares in Q4 is mainly explained by Stodir

The increase in FX imbalance from Q3 2013 is mainly due to Bakkavör Group Ltd.

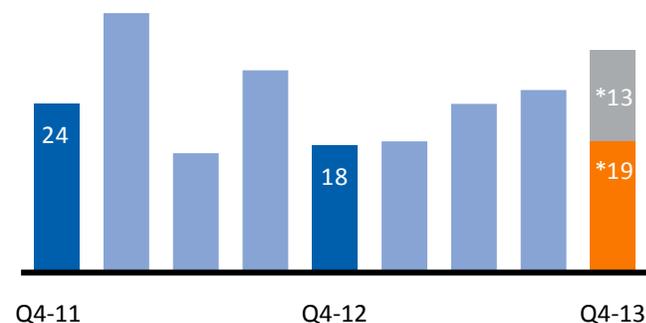
By quarters from Q4 2011 – Q4 2013 (ISK bn)



Other financial income from Q4 2011 – Q4 2013 (ISK bn.)



FX imbalance from Q4 2011 – Q4 2013 (ISK bn.)



*At year end Arion Bank has ISK 19 bn. and subsidiaries ISK 13 bn. in FX imbalance

OTHER INCOME

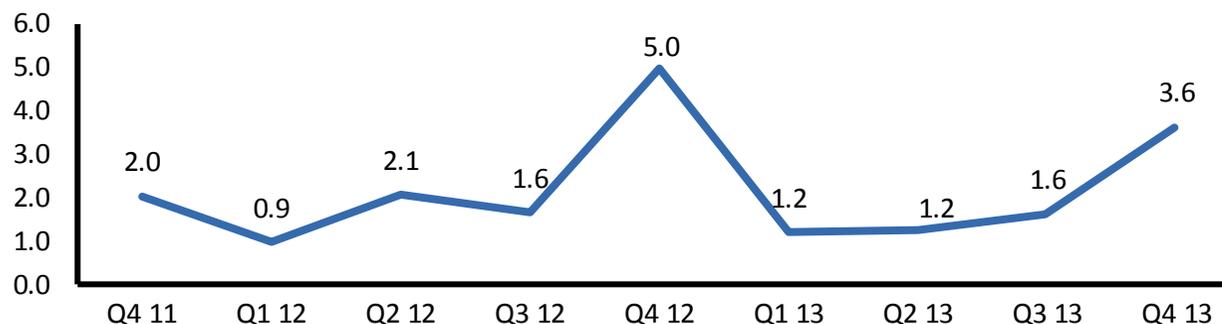
VALUATION CHANGES HAVE A STRONG IMPACT

The increase in Q4 2012 and Q4 2013 is mainly due to valuation changes in investment properties and fair value changes in associated companies

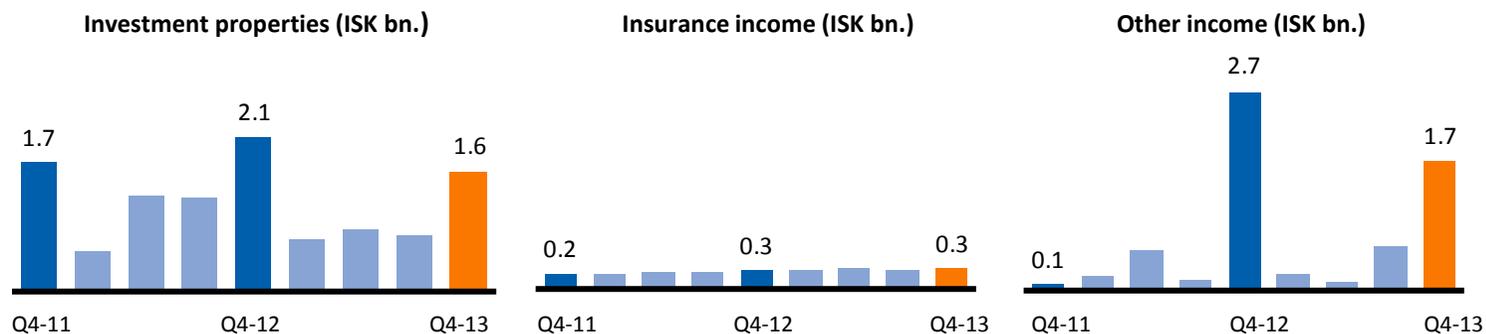
Income from investment properties are from real estate subsidiaries Landfestar and Landey

Stable insurance income from Okkar líf which is a core life insurance subsidiary

By quarters from Q4 2011 – Q4 2013



Other income by type from Q4 2011 – Q4 2013



TOTAL OPERATING EXPENSE

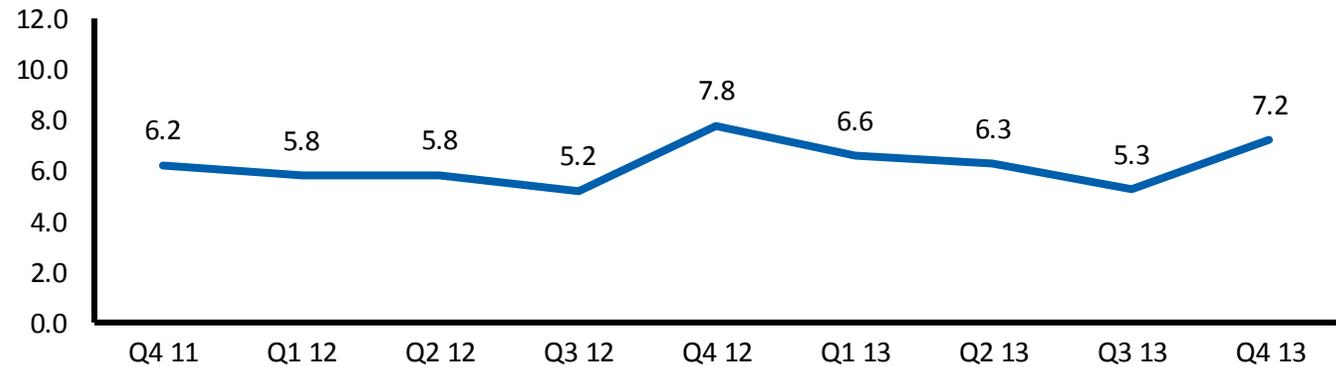
AFFECTED BY ONE OFF ITEMS

Large one-off expense in Q4 2013.

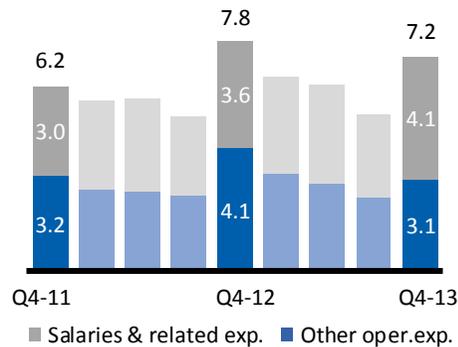
- Depreciation on Housing and IT software

Number of employees gradually reducing

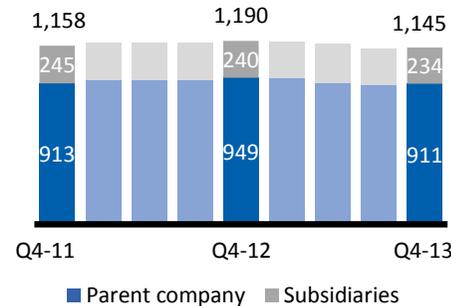
By quarters from Q4 2011 – Q4 2013 (ISK bn.)



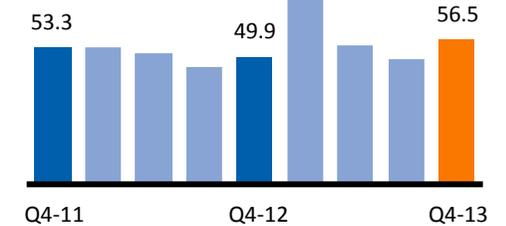
By type (ISK bn.)



Total employees



Cost-to-income ratio (%)



TAX EXPENSE

TAXES INCREASE DUE TO NEW TAXES ON FINANCIAL INSTITUTIONS AND HIGHER TAX RATES

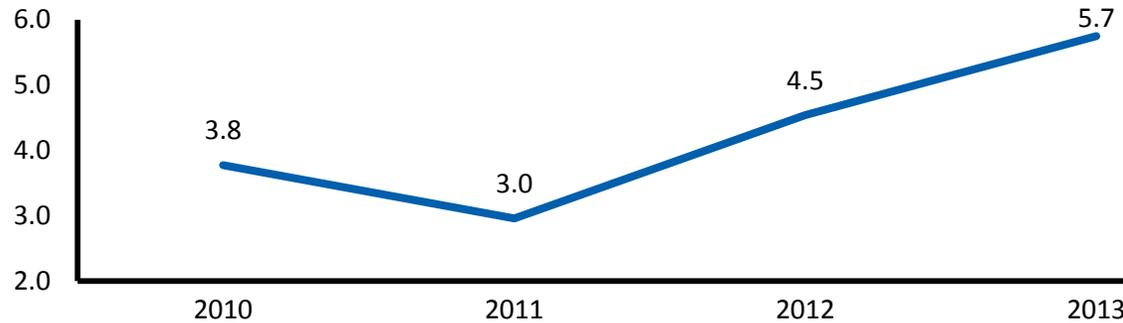
Income tax rate has increased from 18% to 20% on taxable income from 2010

Financial institutions pay an additional 6% income tax on taxable income above ISK 1 bn.

Bank levy is calculated on total debt above ISK 50 bn. Bank levy has increased from 0.041% in 2010 to 0.376% in 2013.

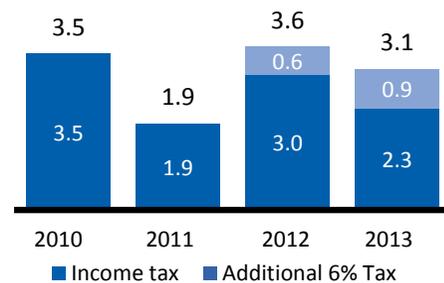
Financial institutions pay an additional 6.75% tax on employee salaries

Tax expense from 2010-2013 (ISK bn.)

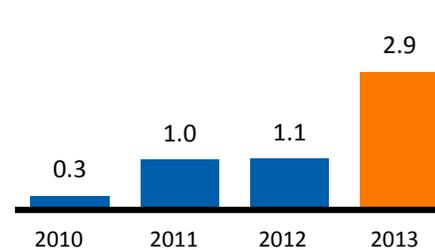


Income tax and special taxes on financial institutions (ISK bn.)

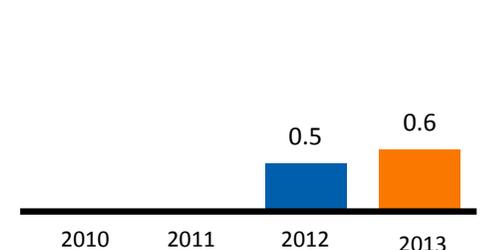
Income tax and additional 6% income tax



Bank levy



Additional tax on employee salaries



BALANCE SHEET



BALANCE SHEET

SUCCEEDED IN MAINTAINING BALANCE SHEET IN A LOW INVESTMENT ENVIRONMENT

Increase in loans to customers is largely explained by the Drómi transaction. The transaction also reduces financial assets

Loans to customers increased by 12% from year end 2012

Moderate growth in deposits

Funding profile is strong

Assets					
Billion ISK	31.12.2013	31.12.2012	Diff%	31.12.2011	Diff%
Cash & balances with CB	38	30	28%	29	30%
Loans to credit institutions	102	101	1%	69	48%
Loans to customers	636	567	12%	562	13%
Financial assets	87	138	(37%)	158	(45%)
Investments properties	29	29	(1%)	27	5%
Other assets	48	37	29%	47	2%
Total assets	939	901	4%	892	5%

Liabilities and Equity					
Billion ISK	31.12.2013	31.12.2012	Diff%	31.12.2011	Diff%
Due to credit institutions & CB	28	33	(15%)	16	73%
Deposits from customers	472	449	5%	490	(4%)
Other liabilities	58	59	(2%)	52	10%
Borrowings	205	195	5%	187	9%
Subordinated loans	32	34	(7%)	32	(1%)
Equity	145	131	11%	115	27%
Total liabilities and equity	939	901	4%	892	5%

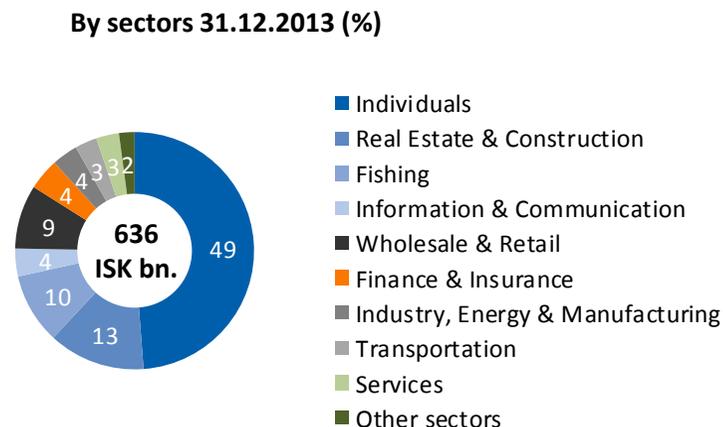
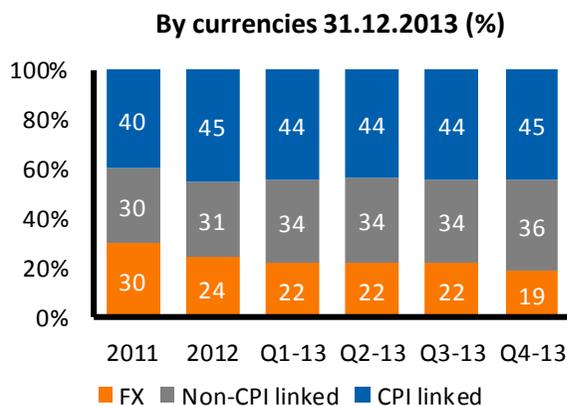
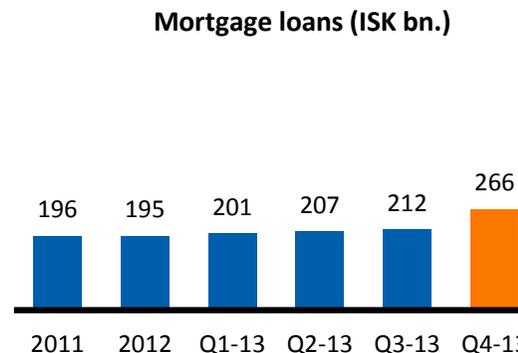
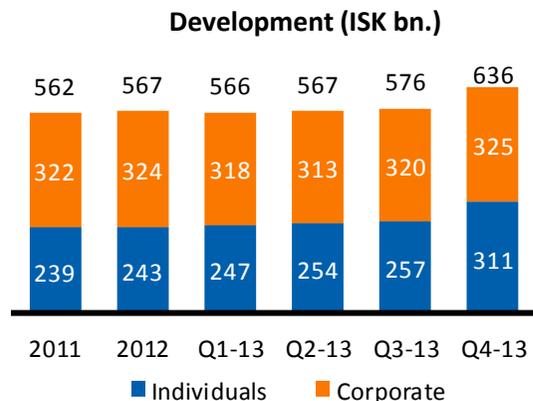
LOANS TO CUSTOMERS ARE WELL DIVERSIFIED

WITH LOANS TO INDIVIDUALS REPRESENTING 49% OF TOTAL LOANS TO CUSTOMERS

Slow growth in the corporate portfolio is in line with moderate economic growth and modest investment climate

Arion Bank has a strong position on the mortgage loan market and has increased the mortgage portfolio by 36% since year end 2012

It is the strategic objective of the Bank to maintain a well diversified loan portfolio in all corporate sectors



IMPROVING ASSET QUALITY

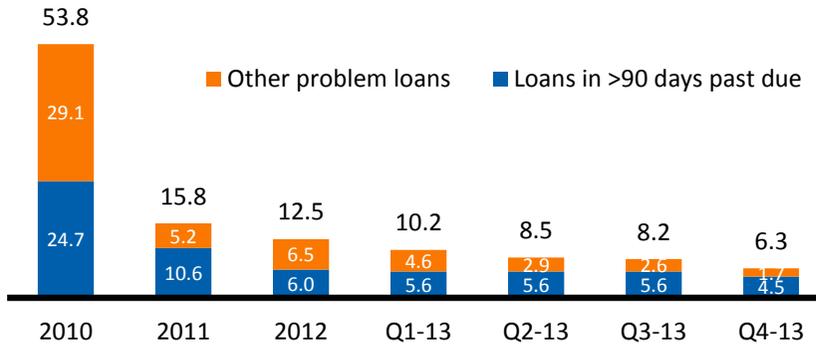
THE BANK HAS FOCUSED ON REDUCING PROBLEM LOANS

Problem loans have continued to decrease since their peak in 2010

Loans in over 90 days default have also been decreasing

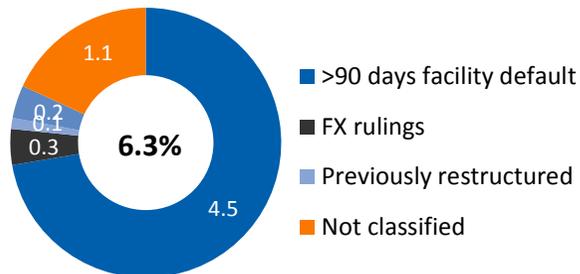
The Bank focuses on problem loans and would have achieved its objective to get problem loans below 5% if not for the Drómi transaction

Development of problem loans (%)

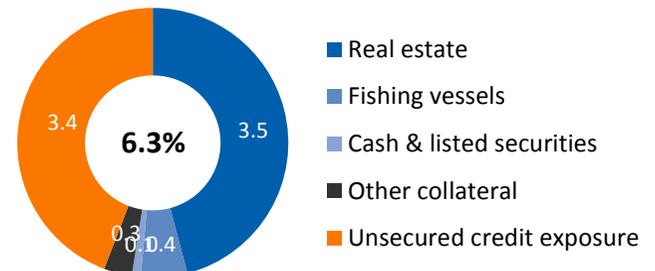


The Bank defines problem loans as book value of loans (i.e. net of impairment) that are either individually impaired or are in over 90 days past due and not impaired as % of total book value of loans to customers

Problem loans by status (%)



Collateral behind problem loans (%)



STRONG FUNDING PROFILE

NO SIGNIFICANT REDEMPTION OF LONG-TERM FUNDING IN THE MEDIUM TERM

Limited need for refinancing

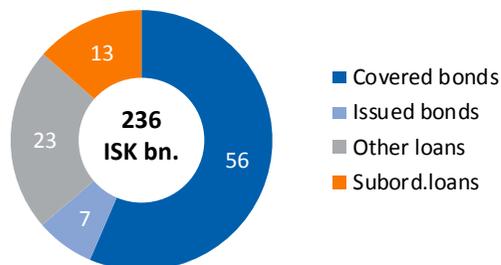
First Icelandic bank since 2007 to access international markets in February 2013

New bond with maturity in 2016

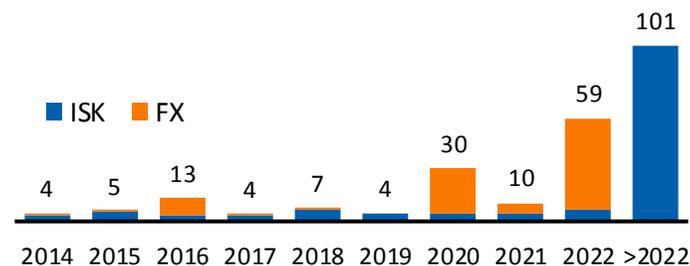
Successfully increased term deposits

A new BB+ credit rating from Standard & Poor's increases possibilities for new funding and potential refinancing

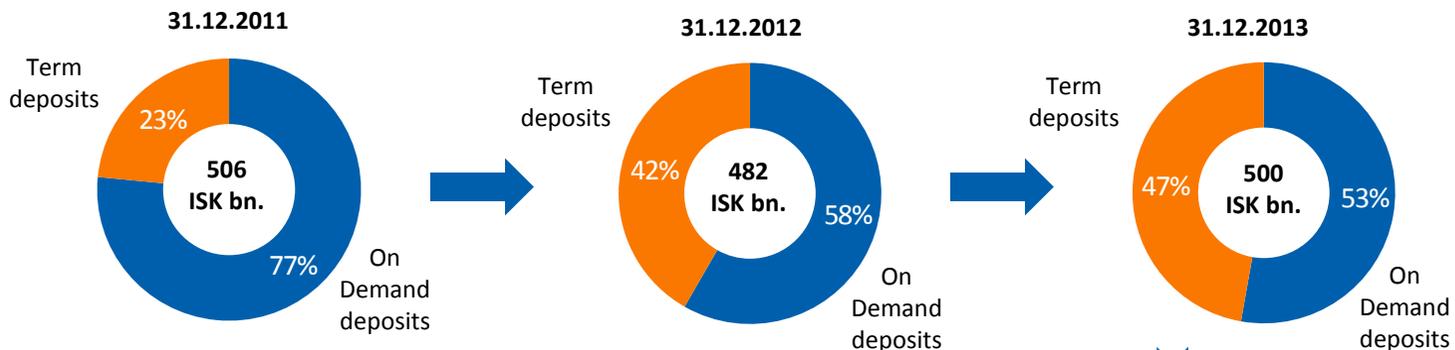
Funding mix (%)



Maturity of long-term funding 31.12.2013 (ISK bn.)



Development of total deposits by maturity



VERY SOLID CAPITAL BASE

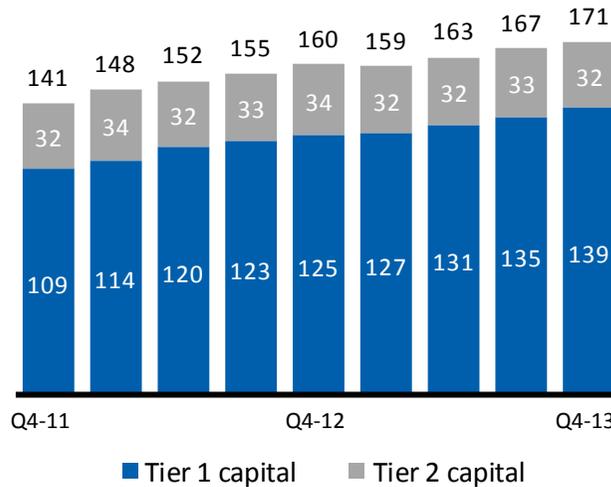
WITH HIGH QUALITY CAPITAL WITH NO RELIANCE ON HYBRID INSTRUMENTS

Arion Bank has maintained very solid levels of capitalization due to strong profit generation and dividend payment restrictions

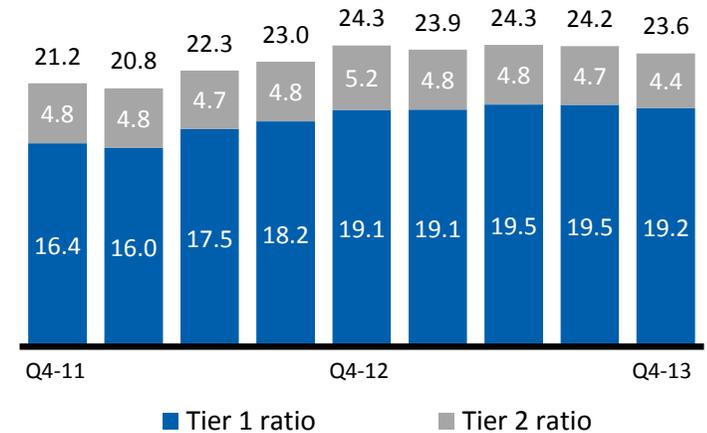
The Bank's capital base is composed of core Tier 1 and Tier 2 capital

Higher risk weight because of the Drómi transaction results in a lower capital ratio

Total capital base (ISK bn.)



Total capital ratio (%)



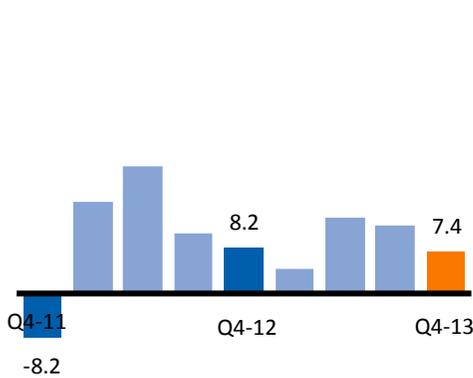
KEY FINANCIAL INDICATORS



KEY FINANCIAL INDICATORS

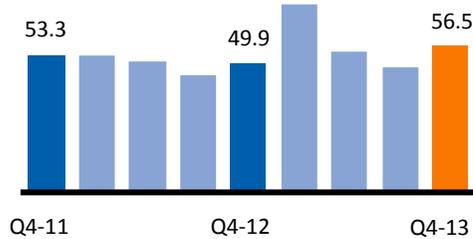
VOLATILITY IN PROFITABILITY DUE TO IRREGULAR ITEMS

Return on equity (%)

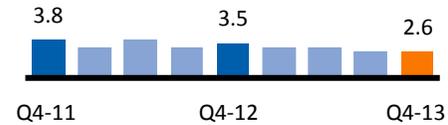


Cost-to-income ratio (%)

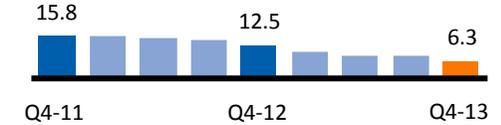
without net valuation change



Net interest margin (%)

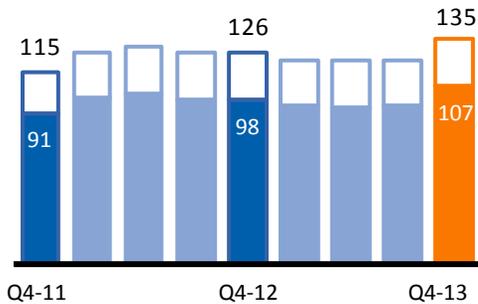


Problem loans* (%)

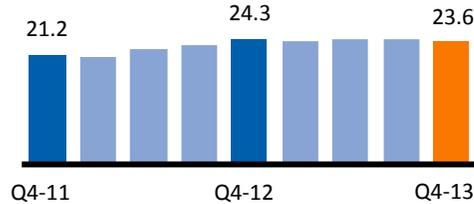


Loans-to-deposits ratio (%)

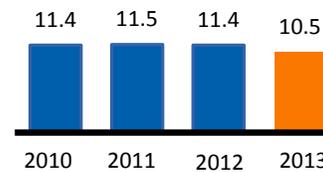
without loans financed with covered bonds



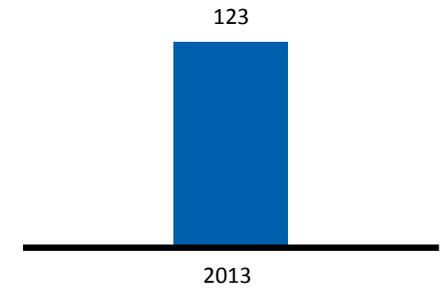
Total capital ratio (%)



Core return on equity (%)



Liquidity coverage ratio (LCR) (%)



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