

ARION BANK'S H1 2014 FINANCIAL RESULTS

Arion Bank reported net earnings of ISK 17.4 billion for the first six months of 2014, compared with ISK 5.9 billion for the same period in 2013. Return on equity was 23.4%, compared with 8.9% in the same period of 2013. Total assets amounted to ISK 949.0 billion, compared with ISK 938.9 billion at the end of 2013.

The Bank's capital ratio at the end of the period was 25.6%, compared with 23.6% at the end of 2013.

Highlights of the interim financial statement:

- Net earnings of ISK 17.4 billion, compared with ISK 5.9 billion during the same period of 2013.
- Earnings during the second quarter of 2014 of ISK 14.5 billion, compared with ISK 4.5 billion during the second quarter of 2013.
- Operating income increased between years to ISK 25.7 billion, compared with ISK 20.7 billion in the same period of 2013. All types of income grew except net interest income, the largest increase being in net financial income.
- Net interest income of ISK 12.0 billion, compared with ISK 12.7 billion during the same period of 2013.
- Net commission income of ISK 6.6 billion, compared with ISK 5.3 billion during the same period of 2013. The increase is largely attributable to higher commission income on cards and to activities in Investment Banking.
- Income tax and the bank levy amounted to ISK 3.8 billion, compared with ISK 1.9 billion during the same period of 2013.
- Earnings from discontinued operations of ISK 6.5 billion, compared with a loss of ISK 65 million in the same period of 2013. These earnings relate almost entirely to the sale of the Bank's 18.8% shareholding in HB Grandi hf.
- Operating expenses of ISK 13.0 billion, compared with ISK 12.9 billion during the same period of 2013.
- The net valuation change during the period is positive, amounting to ISK 2.0 billion, compared with a negative figure of ISK 134 million in the same period last year. The net valuation change on loans to companies totalled ISK 2.3 billion during the first half and retail loan write-downs amounted to ISK 0.9 billion. The valuation increase of other assets totalled ISK 0.7 billion.
- Return on equity was 23.4%, compared with 8.9% in the same period of 2013.
- The net interest margin as a percentage of the average interest-bearing assets was 2.8%, compared with 3.1% in the same period of 2013.
- The cost-to-income ratio was 50.5%, compared with 62.4% in the same period of 2013.
- Total assets of ISK 949.0 billion, compared with ISK 938.9 billion at the end of 2013.
- Total equity amounted to ISK 154.5 billion, compared with ISK 144.9 billion at the end of 2013. The Bank paid a dividend of ISK 7.8 billion to its shareholders during the period.
- The capital ratio was 25.6% at the end of the period, compared with 23.6% at the end of 2013.

Höskuldur H. Ólafsson, CEO of Arion Bank:



“Arion Bank’s financial results for the first six months of 2014 are excellent and in line with our expectations. Core operations remain stable and the Bank continues to build on its financial strength. We have made a focused effort to increase the contribution of commission to overall income and we are pleased to see results in this respect in the latest figures. The Bank’s sale of the majority of its shareholding in HB Grandi hf. had a positive impact on the financial results. The sale of HB Grandi and the company’s flotation on the Main List of NASDAQ OMX Iceland was not only a significant step for us but it was also important for the Icelandic stock market to have a robust fisheries company join its ranks. These strong results have further reinforced the Bank’s capital ratio, which now stands at 25.6%, comfortably above the requirements made of the Bank. The Bank also paid its shareholders a dividend during the first half of the year.

We are especially pleased to have been involved in two major investment projects in Iceland in recent months, namely projects for United Silicon and Silicor Materials. The United Silicon project is in the execution phase while Silicor is still in the development phase. Both are hugely exciting projects and they will add to the diversity of the Icelandic business sector by generating new jobs and foreign exchange revenue in the future. Each requires significant investment in Iceland, a lack of which in recent years has held back the Icelandic economy. We are therefore delighted that Arion Bank can use its strength to support these investment projects.”

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Income statement - highlights

Income Statement				
<i>In ISK million</i>	6M 2014	6M 2013	Diff.	Diff. %
Net interest income	11,966	12,667	(701)	(6%)
Net commission income	6,593	5,298	1,295	24%
Net financial income	3,715	1,544	2,171	141%
Net gain/ -loss on foreign exchange	152	(1,248)	1,400	-
Other income	3,274	2,425	849	35%
Operating income	25,700	20,686	5,014	24%
Salaries and related expense	(7,164)	(6,679)	(485)	7%
Other operating expense	(5,811)	(6,228)	417	(7%)
Net impairment	2,001	134	1,867	1393%
Net earnings before taxes	14,726	7,913	6,813	86%
Income tax	(2,467)	(1,749)	(718)	41%
Bank levy	(1,375)	(188)	(1,187)	631%
Net earnings from continuing operation	10,884	5,976	4,908	82%
Net gain/ -loss from discont. operation net of tax	6,525	(65)	6,590	-
Net earnings	17,409	5,911	11,498	195%

Operating income

Operating income has increased considerably between years, up ISK 5,104 million. Operating income amounted to ISK 25,700 million during the first half of 2014, compared with ISK 20,686 million during the same period of 2013. This increase is primarily due to increases of ISK 2,171 million in net financial income, ISK 1,400 million in net gain on foreign exchange and ISK 1,295 million in net commission income.

Net interest income during the period amounted to ISK 11,966 million, compared with ISK 12,667 million in the same period of 2013. This represents a decrease of ISK 700 million between years and is largely a result of lower inflation than in the first half of 2013. The net interest margin as a percentage of average interest-bearing assets was 2.8% during the period, compared with 3.1% during the same period of 2013.

Net commission income increased by 24% between years to ISK 6,593 million, compared with ISK 5,298 million during the first half of 2013. The increase is largely due to higher commission income from cards and higher income generated by Investment Banking.

Net financial income increased sharply between years to ISK 3,715 million during the first half of 2014, compared with ISK 1,544 million during the same period of 2013. Earnings on holdings in equities and bonds amounted to ISK 3,877 million during the first half of 2014, compared with ISK 1,660 million during the same period in 2013. The main difference is the change in value of the shareholding in HB Grandi hf. which was listed on the Main List of NASDAQ OMX Iceland in April 2014. With the exception of HB Grandi hf., the conditions on the Icelandic securities market have had a negative impact on the Group's holdings in equities and bonds. Dividend income was over ISK 600 million higher in the first half of 2014 than the same period of 2013.

Net exchange rate gain amounted to ISK 152 million, compared with a loss of ISK 1,248 million in the same period of 2013. The Bank's net foreign exchange imbalance was ISK 16.2 billion at the end of the period, meaning that volatility in the exchange rate has a significant impact on operating income. The net foreign exchange imbalance was ISK 31.6 billion at the end of 2013 and the Bank has made a targeted effort to reduce its net foreign exchange position. The foreign exchange balance of the parent company is well within the 15% limit stipulated by the Central Bank of Iceland.



Other operating income amounted to ISK 3,274 million, compared with ISK 2,425 million in the same period of 2013. The main types of income included in other operating income are lease income, valuation changes and profits from the sale of commercial property owned by Landfestar ehf. and Landey and income from insurance premiums at OKKAR Life Insurance hf., all of which are subsidiaries of the Bank. The increase over last year is primarily a result of higher valuation changes on investment properties and profits from the sale of the Bank's shareholding in Landfestar ehf.

Operating expenses

Operating expenses totalled ISK 12,975 million and decreased slightly from the same period last year. The cost-to-income ratio decreased to 50.5% from 62.4% in the first half of 2013. The cost-to-assets ratio was 2.9%, compared with 2.8% in the first half of 2013.

Salaries and related expenses amounted to ISK 7,164 million, compared with ISK 6,679 million during the same period of 2013. The increase is partly explained by contractual salary increases of 2.8% and the estimated cost of the incentive scheme which was not in place in 2013. There were on average 1,133 full-time equivalent positions at Arion Bank during the period, compared with 1,177 in the same period of 2013.

Other operating expenses amounted to ISK 5,811 million, compared with ISK 6,228 million in the same period of 2013. This represents a decrease of ISK 417 million and is largely explained by the fine imposed on the subsidiary Valitor hf. by the Competition Authority in the first quarter of 2013. Other operating expenses are in line with expectations.

Net valuation change amounted to ISK 2,001 million and is broadly divided into three types. Firstly, net valuation increases on loans of ISK 2,253 million, mainly relating to loans to large companies. Secondly, net loan impairment on retail loans of ISK 935 million during the period. Thirdly, the net valuation increase of other assets totalled ISK 683 million.

Taxes

Income tax amounted to ISK 2,467 million, compared with ISK 1,749 million during the same period of 2013. Income tax, as reported in the interim financial statement, comprises 20% income tax on earnings and a special 6% financial tax which is levied on the earnings of financial institutions in excess of ISK 1 billion. The effective income tax rate was 16.8% for the first half of 2014, compared with 22.1% during the same period of 2013.

The bank levy amounted to ISK 1,375 million, compared with ISK 188 million during the same period of 2013. The tax rate increased from 0.041% to 0.376% at the end of 2013.

Earnings from discontinued operations

Earnings from discontinued operations amounted to ISK 6,525 million, compared with a loss of ISK 65 million during the same period of 2013. In April the Bank sold 18.8% in HB Grandi hf. (previously held 31%) and the majority of these earnings originate from this sale. Following this transaction and the company's stock market listing the Bank's remaining shareholding was classed as a financial asset and it changes in value in accordance with the listed price. These valuation changes are categorized under net financial income in the income statement.



Second quarter of 2014

The financial results for the second quarter of 2014 were excellent, with the sale and listing of shares in HB Grandi hf. having a significant impact. Return on equity was 38.4%, compared with 13.4% in the same period of 2013.

Income Statement				
<i>In ISK million</i>	Q2 2014	Q2 2013	Diff.	Diff. %
Net interest income	6,483	6,379	104	2%
Net commission income	3,445	2,849	596	21%
Net financial income	3,811	974	2,837	291%
Net gain/ -loss on foreign exchange	628	149	479	321%
Other income	2,356	1,249	1,107	89%
Operating income	16,723	11,600	5,123	44%
Salaries and related expense	(3,714)	(3,357)	(357)	11%
Other operating expense	(3,064)	(2,951)	(113)	4%
Net impairment	34	456	(422)	(93%)
Net earnings before taxes	9,979	5,748	4,231	74%
Income tax	(1,152)	(1,163)	11	(1%)
Bank levy	(715)	(97)	(618)	637%
Net earnings from continuing operation	8,112	4,488	3,624	81%
Net gain/ -loss from discount. operation net of tax	6,433	14	6,419	45850%
Net earnings	14,545	4,502	10,043	223%

Operating income in the second quarter increased substantially between years, up 44%. All types of operating income increased, with the largest rise being in net financial income, mainly as a result of the increase in the market value of the Bank's holding in HB Grandi hf.

Operating expenses were overall slightly higher in the second quarter of 2014 than the same period of 2013. This is mainly linked to the rise in salary expenses relating to a new incentive scheme at the Bank and contractual salary increases.

Net income from discontinued activities was substantial during the quarter and is almost entirely related to the Bank's sale of 18.8% in HB Grandi hf. in April.



Balance sheet - highlights

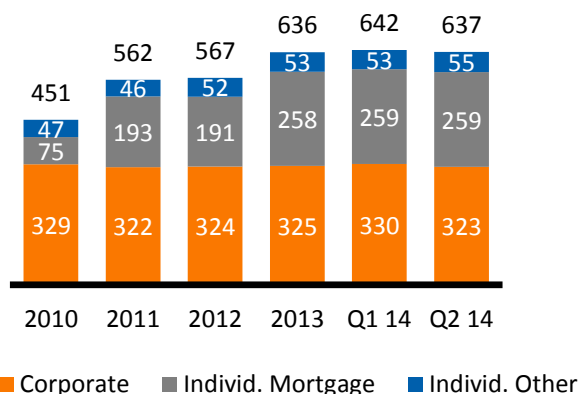
Assets					
<i>In ISK million</i>	30.06.2014	31.12.2013	Diff.%	30.06.2013	Diff.%
Cash & balances with CB	17,361	37,999	(54%)	25,717	(32%)
Loans to credit institutions	139,838	102,307	37%	109,732	27%
Loans to customers	637,085	635,774	0%	567,257	12%
Financial assets	99,271	86,541	15%	153,771	(35%)
Investment properties	6,020	28,523	(79%)	28,911	(79%)
Investment in associates	25,128	17,929	40%	14,424	74%
Non-current assets & disp.groups HFS	4,329	10,046	(57%)	10,086	(57%)
Other assets	19,961	19,731	1%	19,132	4%
Total assets	948,993	938,850	1%	929,030	2%

Arion Bank had *total assets* of ISK 948,993 million at the end of the period, compared with ISK 938,850 million at the end of 2013. Changes to individual asset classes during the period are mainly due to changes in the Bank's liquidity management, which results in lower deposits at the Central Bank of Iceland, higher loans and receivables at credit institutions and increased securities holdings.

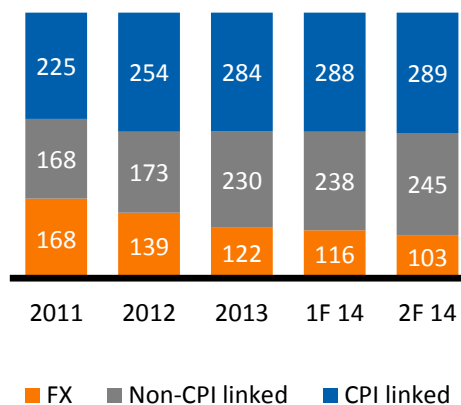
Loans to customers

Loans to customers amounted to ISK 637,085 million at the end of June 2014, compared with ISK 635,774 million at the end of 2013. Since 2010 the structure of the Group's loan book has undergone substantial change, both in terms of the split between corporate and retail loans and whether the loans are indexed, non-indexed or in foreign currency. The diagrams show this development, with two events being prominent. Firstly, the Bank's acquisition of Arion Bank Mortgage Institutional Investor Fund, Kaupthing Bank's mortgage fund, at the end of 2011, and secondly the settlement of the Drómi bond where the Bank took over retail loans of a value of more than ISK 50 billion at the end of 2013. Retail loans now represent almost 50% of the Bank's loans to customers which is in line with the Bank's target. Mortgage loans represent a large proportion of loans to individuals and a substantial percentage of these are high quality, low-risk loans with strong collateral. Loans to companies have remained at a stable level since 2010 although the portfolio has undergone change as loans mature and new corporate loans are issued.

Development (ISK bn.)



By type (ISK bn.)





Securities

Securities holdings amounted to ISK 99,271 million at the end of the period, compared with ISK 86,541 million at the end of 2013.

Securities					
<i>In ISK million</i>	30.06.2014	31.12.2013	Diff.%	30.06.2013	Diff.%
Bonds	66,227	62,171	7%	132,744	(50%)
Shares and instruments w. variable income	24,000	17,449	38%	16,735	43%
Derivatives	1,298	1,070	21%	832	56%
Securities used for hedging	7,746	5,851	32%	3,460	124%
Securities total	99,271	86,541	15%	153,771	(35%)

This increase is particularly attributable to changes in the Bank's liquidity management and the growth in the Bank's equities holdings following the listing and re-categorization of the holding in HB Grandi hf. in the Bank's accounts.

Non-current assets and disposal groups held for sale

Non-current assets and disposal groups held for sale amounted to ISK 4,329 million at the end of June 2014, compared with ISK 10,046 million at the end of 2013. The main assets in this category are now almost entirely real estate properties. The decrease from the end of 2013 is due to changes in the holding in HB Grandi hf. At the end of 2013 the Bank owned 31% of the company and sold 18.8% at the end of April when it was listed on the Main Market of NASDAQ OMX Iceland. The Bank's shareholding at the end of June is now classed under financial assets.

Liabilities and equity

Liabilities and equity					
<i>In ISK million</i>	30.06.2014	31.12.2013	Diff.%	30.06.2013	Diff.%
Due to credit institutions & CB	29,277	28,000	5%	25,727	14%
Deposits from customers	474,229	471,866	1%	466,834	2%
Non current liab. & disp.groups HFS	568	567	0%	614	(7%)
Financial liabilities at fair value	7,646	8,960	(15%)	10,005	(24%)
Other liabilities	51,659	48,024	8%	53,459	(3%)
Borrowings	199,882	204,568	(2%)	203,100	(2%)
Subordinated loans	31,189	31,918	(2%)	32,503	(4%)
Equity	154,543	144,947	7%	136,788	13%
Total liabilities and equity	948,993	938,850	1%	929,030	2%

Total liabilities amounted to ISK 794,450 million at the end of June 2014, compared with ISK 793,903 million at the end of 2013.

Deposits

Total deposits amounted to ISK 503,506 million at the end of June 2014, compared with ISK 499,866 million at the end of 2013. The Bank has managed to retain its market share in total deposits in a competitive environment.

Borrowings

Borrowings amounted to ISK 199,882 million at the end of June 2014, compared with ISK 204,568 million at the end of 2013. The decrease is mainly due to the sale of the real estate company Landfestar



hf. which has issued listed bonds of almost ISK 3 billion. In early 2014 the Bank was assigned a rating by the international ratings agency Standard & Poor's, the first Icelandic bank to obtain a rating for more than five years. The Bank was rated BB+ which will increase Arion Bank's opportunities on the credit markets both in Iceland and abroad in the coming years.

Subordinated liabilities

Subordinated liabilities amounted to ISK 31,189 million at the end of June 2014, compared with ISK 31,918 million at the end of 2013. The change is solely related to changes in the exchange rate of foreign currencies to which the loans are linked.

Equity

Total equity amounted to ISK 154,543 million at the end of June 2014, compared with ISK 144,947 million at the end of 2013. During the second quarter the Bank paid a dividend to shareholders of ISK 7,811 million. Other changes in total equity are attributed to the financial results during the period. The capital ratio calculated in accordance with the rules of the FME was 25.6% at the end of the period, but the statutory minimum is 8%.

Key performance indicators

Key performance indicators			
	H1 2014	2013	H1 2013
Return on equity (ROE)	23.4%	9.2%	8.9%
Return on total assets (ROA)	3.7%	1.4%	1.3%
Net interest margin (int.bearing assets)	2.8%	2.9%	3.1%
Net interest margin (total assets)	2.5%	2.6%	2.8%
Cost-to-income ratio	50.5%	57.3%	62.4%
Cost-to-Total assets ratio	2.9%	2.8%	2.8%
Effective tax rate	16.8%	17.2%	22.1%
CAD-ratio	25.6%	23.6%	24.3%
Tier 1 ratio	21.1%	19.2%	19.5%
Problem loans	5.4%	6.3%	8.5%
RWA/Total Assets	73.9%	76.8%	72.2%
Loans to deposit ratio	134.3%	134.7%	121.5%
The Group's average number of employees	1,133	1,159	1,177
The Group's employees at the end of the period	1,118	1,145	1,153
The parent's average number of employees	900	923	939
The parent's empl. at the end of the period	887	911	918

Financial calendar

The Bank's financial statements are scheduled for publication on the dates stated below.

Third quarter 2014	20 November 2014
Annual financial statement for 2014	25 February 2015
Annual general meeting 2015	19 March 2015
First quarter 2015	20 May 2015



Second quarter 2015
Third quarter 2015

26 August 2015
18 November 2015

This calendar may be subject to change.