

# Interim Consolidated Financial Statements

1 January - 30 September 2016

Unaudited

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# ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

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The Interim Financial Statements of Arion Bank for the period from 1 January to 30 September 2016 include the Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

## Outlook

Iceland's economic indicators continue to be strong. Economic growth was 4.1% in the first half of 2016, inflation continues to be below the Central Bank's inflation target and unemployment measured 2.6% in the third quarter of 2016. The economic outlook has improved and Arion Research forecasts that economic growth will remain strong, especially in the coming year. Inflation is expected to remain below the Central Bank's inflation target throughout 2017 but is expected to rise in 2018 and peak at 3.5% in the second quarter of 2018. Important steps towards lifting the capital controls were taken this autumn when parliament passed into law a bill that significantly eases the controls on residents and legal entities, both domestic and foreign.

Standard & Poor's upgraded Arion Bank's credit rating from BBB- with a positive outlook to BBB with a positive outlook in October. The upgrade reflects the improving conditions in the Icelandic economy, the deleveraging of Icelandic households and corporations and the positive impact of the continued liberalization of capital controls. It also takes into account Arion Bank's enhanced access to international funding markets and improved capital following the sale of legacy equity positions.

Kaupthing ehf., now a holding company, has expressed its interest in exploring its options in respect to its 87% shareholding in Arion Bank, held by its subsidiary Kaupskil ehf. On 15 June Arion Bank and Kaupthing issued the following press release: "In the context of the continued strong development of the Icelandic economy, Arion Bank and Kaupthing, its majority owner, are currently assessing a range of strategic alternatives with regards to Kaupthing's shares held in the Bank. This may include a possible IPO; however, no decision has been made at this point in time with respect to any specific transaction and timing thereof".

## Operations during the period

Net earnings amounted to ISK 17,262 million for the period ended 30 September 2016, and the Group's equity amounted to ISK 207,006 million at the end of the period. Return on equity was 11.2% for the period. The capital ratio, based on the reported capital base on 30 September 2016, was 26.1% and the corresponding Tier 1 ratio was 25.5%. According to the Financial Undertakings Act No. 161/2002 the official capital ratio shall be based on the audited or reviewed capital base. Since the interim financial statements for the first nine months are not audited the official capital ratio is based on the audited capital base on 30 June 2016 and risk-weighted assets on 30 September 2016. The official capital ratio on 30 September 2016 was 25.2% and the Tier 1 ratio was 24.5%, which comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also strong at period end and well above the regulatory minimum.

On 30 September 2016 Arion Bank acquired all shares in the insurance company Vörður tryggingar hf., the fourth largest insurance company in Iceland, following the approval of the Icelandic Competition Authority. At period end assets and liabilities of Vörður tryggingar hf. are included in the Interim Consolidated Statement of Financial position. In July Arion Bank sold the majority of its shareholding in the subsidiary Kolufell ehf. The main asset of Kolufell ehf. was investment property. The remaining shareholding is classified as Financial instruments.

In June the Bank's subsidiary Valitor Holding hf. completed the sale of its shareholding in Visa Europe Ltd. to Visa Inc. The profit from the sale was ISK 5,291 million, after taking into account conditional payments to Landsbankinn hf. and two savings funds, which formed part of the agreement when Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014. The profit was recognized as Net financial income in the Statement of Comprehensive Income in the second quarter of 2016. The shareholding was classified as Financial assets available for sale at year end 2015.

The main changes on the Balance Sheet from year end 2015 relate to changes in the structure of funding, increased lending and increased liquidity. Loans to customers have increased by ISK 35.6 billion, or 5.2%, during the period. New lending is mainly to corporates in several sectors, most in real estate, industry, energy and manufacturing and wholesale and retail.

The Bank's equities and bond portfolios performed well during the third quarter of 2016 after difficult conditions prevailed on the Icelandic equities and bond markets during the first six months. The Bank holds substantial equity positions in listed companies on the Icelandic market and sustained some losses during the first nine months, after a number of favorable years. The Icelandic krona strengthened against most foreign currencies and the effect is some currency loss.

In January, the subsidiary BG12 slhf. sold its entire shareholding in Bakkavor Group Ltd. The main effect from the sale was recognized as a valuation change in the Statement of Comprehensive Income in 2015. During the first quarter of 2016 the total effect through the Statement of Comprehensive Income was ISK 498 million.

## ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

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One of Arion Bank's main tasks in recent years has been to improve the quality of its loan portfolio and to reduce the amount of problem loans. The Bank has succeeded in this respect as the distribution of loans between individuals and companies is satisfactory and the ratio of problem loans has decreased to 2.0%.

With strong emphasis on digital banking and mobile service solutions in recent years Arion Bank has made changes to the network of branches in Iceland in order to enhance service, increase efficiency and reduce costs, for example in its business premises, changes in the opening hours of its branches and sharing of services and other measures which increase operational synergies. In May 2016 Arion Bank opened a new branch at Keflavík International Airport, which offers a wide range of opportunities for services to increasing numbers of tourists. Arion Bank will continue to seek opportunities to change and increase efficiency in its branch network.

In January Arion Bank reached an agreement with Kaupthing under which Arion Bank issued a bond in the amount of USD 747.8 million (ISK 97 billion). The bond was issued under Arion Bank's EMTN programme and is a 7-year instrument, callable on interest payment dates during the first two years. The bond bears floating LIBOR plus 2.6% interest for the first two years and will then be repriced at market terms. The bond offsets loans in foreign currency, taken by Arion Bank from the Central Bank of Iceland and later purchased by Kaupthing, and Kaupthing deposits in foreign currency at Arion Bank. The bond issue forms part of the capital control liberalization process relating to Kaupthing, first announced by the Ministry of Finance and Economic Affairs on 8 June 2015.

In April Arion Bank issued a total of EUR 300 million (ISK 42 billion) in new senior unsecured bonds. Orders totaling over EUR 500 million from more than 70 investors were received. The 3-year bonds have a fixed coupon of 2.5% and were sold at rates corresponding to a 2.7% margin over interbank rates. This represents the second euro benchmark issue by Arion Bank. Part of the new issuance, EUR 221 million (ISK 31 billion), was used to partially prepay the EMTN bond held by Kaupthing.

Arion Bank settled the subordinated liabilities with the Ministry of Finance with a prepayment at the end of September.

In 2016 the Bank started to issue privately placed bonds under its EMTN programme. This is an important step for the Bank in diversifying its funding sources. Arion Bank will continue the issuance of private placements, depending on the prevailing market conditions and the Bank's funding needs.

Arion Bank continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. In the first nine months of 2016 the Bank issued a total of ISK 20.4 billion of covered bonds in the domestic market, of which ISK 10.6 billion were inflation-linked bonds and ISK 9.8 billion were fixed rate bonds. Arion Bank will continue to issue covered bonds on a regular basis on the domestic market in 2016.

The Group had 1,189 full-time equivalent positions at the end of the period compared with 1,147 at the end of 2015; 887 of these positions were at Arion Bank, compared with 876 at the end of 2015. A new wage round was conducted in the Icelandic labour market, effective 1 January, last. The wage increases are substantial and put an increased burden on Icelandic banks, which also must to deal with high capitalization and stringent tax burden. In September Arion Bank laid off around 6% of its workforce. The layoffs came from all divisions of the Bank.

### Group ownership

On behalf of its creditors, Kaupthing ehf., through its subsidiary Kaupskil ehf., holds 87% of the shares in Arion Bank hf. The remaining shareholding of 13% is held by Icelandic State Financial Investments on behalf of the Icelandic government.

The Board of Directors has eight members, four women and four men. The ratio of men to women is therefore in compliance with the law which states that companies with more than 50 employees should ensure that the ratio of either sex on the board of directors should not be less than 40%. Seven directors are appointed by Kaupskil ehf. and one by Icelandic State Financial Investments.

# ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

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## Endorsement of the Board of Directors and the Chief Executive Officer

The Interim Financial Statements of Arion Bank for the period ended 30 September 2016 have been prepared in accordance with International Financial Reporting Standards (IAS 34 Interim Financial Statements) as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

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 2016 and its financial position as at 30 September 2016.

Furthermore, in our opinion the Interim Financial Statements and the Endorsement of the Board of Directors and the CEO give a fair view of the development and performance of the Group's operations and its position and describe 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 2016 and confirm them by means of their signatures.

Reykjavík, 16 November 2016

### Board of Directors



Monica Caneman  
Chairman



Benedikt Olgeirsson



Brynjólfur Bjarnason



Kirstín Þ. Flygenring



Máns Höglund



Þóra Hallgrímsdóttir

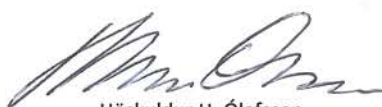


Guðrún Johnsen



John P. Madden

### Chief Executive Officer



Höskuldur H. Ólafsson

# INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE PERIOD FROM 1 JANUARY TO 30 SEPTEMBER 2016

	Notes	2016 1.1.-30.9.	2015 1.1.-30.9.	2016 1.7.-30.9.	2015 1.7.-30.9.
Interest income .....		46,246	42,808	14,851	15,148
Interest expense .....		(24,188)	(22,521)	(7,419)	(8,036)
<b>Net interest income</b> .....	6	<u>22,058</u>	<u>20,287</u>	<u>7,432</u>	<u>7,112</u>
Fee and commission income .....		17,436	15,609	6,191	5,373
Fee and commission expense .....		(7,223)	(4,883)	(2,725)	(2,081)
<b>Net fee and commission income</b> .....	7	<u>10,213</u>	<u>10,726</u>	<u>3,466</u>	<u>3,292</u>
Net financial income .....	8	4,339	10,176	844	453
Share of profit of associates .....	24	710	6,956	16	2,739
Other operating income .....	9	2,642	2,232	781	709
<b>Operating income</b> .....		<u>39,962</u>	<u>50,377</u>	<u>12,539</u>	<u>14,305</u>
Salaries and related expense .....	10	(12,252)	(10,320)	(3,826)	(3,153)
Other operating expense .....	11	(10,393)	(9,016)	(3,423)	(3,012)
Bank levy .....	12	(2,190)	(2,168)	(705)	(779)
Net impairment .....	13	6,827	(114)	5,882	(33)
<b>Earnings before tax</b> .....		<u>21,954</u>	<u>28,759</u>	<u>10,467</u>	<u>7,328</u>
Income tax expense .....	14	(5,261)	(3,639)	(3,170)	(1,272)
<b>Net earnings from continuing operations</b> .....		<u>16,693</u>	<u>25,120</u>	<u>7,297</u>	<u>6,056</u>
Net gain from discontinued operations, net of tax .....	15	569	277	206	15
<b>Net earnings</b> .....		<u>17,262</u>	<u>25,397</u>	<u>7,503</u>	<u>6,071</u>
<b>Other comprehensive income</b>					
Net gain on AFS financial assets, net of tax .....		(2,903)	-	-	-
Exchange difference on translating foreign subsidiaries .....	32	281	47	187	277
<b>Net other comprehensive income to be reclassified to profit or loss in subsequent periods</b> .....		<u>(2,622)</u>	<u>47</u>	<u>187</u>	<u>277</u>
<b>Total comprehensive income</b> .....		<u>14,640</u>	<u>25,444</u>	<u>7,690</u>	<u>6,348</u>
<b>Attributable to</b>					
Shareholders of Arion Bank .....		14,154	25,606	7,701	6,539
Non-controlling interest .....		486	(162)	(11)	(191)
<b>Total comprehensive income</b> .....		<u>14,640</u>	<u>25,444</u>	<u>7,690</u>	<u>6,348</u>
<b>Earnings per share from continuing operations</b>					
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK) .....	16	8.10	12.64	3.65	3.12

The Notes on pages 11 to 57 are an integral part of these Interim Consolidated Financial Statements.

# INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 2016

<b>Assets</b>	Notes	30.9.2016	31.12.2015
Cash and balances with Central Bank .....	17	85,645	48,102
Loans to credit institutions .....	18	68,257	87,491
Loans to customers .....	19	715,907	680,350
Financial instruments .....	20-22	128,357	133,191
Investment property .....	22	5,113	7,542
Investments in associates .....	24	869	27,299
Intangible assets .....	25	11,077	9,285
Tax assets .....	26	241	205
Other assets .....	27	23,014	17,578
<b>Total Assets</b>		<u>1,038,480</u>	<u>1,011,043</u>
<b>Liabilities</b>			
Due to credit institutions and Central Bank .....	21	9,375	11,387
Deposits .....	21	431,929	469,347
Financial liabilities at fair value .....	21	5,097	7,609
Tax liabilities .....	26	5,754	4,922
Other liabilities .....	28	52,565	49,461
Borrowings .....	21, 29	326,754	256,058
Subordinated liabilities .....	21, 30	-	10,365
<b>Total Liabilities</b>		<u>831,474</u>	<u>809,149</u>
<b>Equity</b>			
Share capital and share premium .....	32	75,861	75,861
Other reserves .....	32	1,926	4,548
Retained earnings .....		129,153	112,377
<b>Total Shareholders' Equity</b>		<u>206,940</u>	<u>192,786</u>
Non-controlling interest .....		66	9,108
<b>Total Equity</b>		<u>207,006</u>	<u>201,894</u>
<b>Total Liabilities and Equity</b>		<u>1,038,480</u>	<u>1,011,043</u>

The Notes on pages 11 to 57 are an integral part of these Interim Consolidated Financial Statements.

## INTERIM CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE PERIOD FROM 1 JANUARY TO 30 SEPTEMBER 2016

	Share capital and share premium	Other reserves	Retained earnings	Total share- holders' equity	Non- controlling interest	Total equity
<b>Equity 1 January 2016</b> .....	75,861	4,548	112,377	192,786	9,108	201,894
Net earnings .....	-	-	16,776	16,776	486	17,262
Other comprehensive income .....	-	(2,622)	-	(2,622)	-	(2,622)
<b>Total comprehensive income</b> .....	-	(2,622)	16,776	14,154	486	14,640
Disposal of non-controlling interest .....	-	-	-	-	(9,528)	(9,528)
<b>Equity 30 September 2016</b> .....	<u>75,861</u>	<u>1,926</u>	<u>129,153</u>	<u>206,940</u>	<u>66</u>	<u>207,006</u>
<b>Equity 1 January 2015</b> .....	75,861	1,632	83,218	160,711	1,501	162,212
Net earnings .....	-	-	25,559	25,559	(162)	25,397
Other comprehensive income .....	-	47	-	47	-	47
<b>Total comprehensive income</b> .....	-	47	25,559	25,606	(162)	25,444
Dividend paid .....	-	-	(12,809)	(12,809)	-	(12,809)
Acquisition of non-controlling interest .....	-	-	-	-	(52)	(52)
<b>Equity 30 September 2015</b> .....	<u>75,861</u>	<u>1,679</u>	<u>95,968</u>	<u>173,508</u>	<u>1,287</u>	<u>174,795</u>

In June 2016 the Icelandic parliament passed an amendment to the Icelandic Act on Financial Statements, with an effective date of 1 January 2016. The amendment will affect the presentation of Equity in the Financial Statements and thus may affect future dividend payments to shareholders of Arion Bank. The Group is currently assessing the impact of the amendment on the presentation of Equity. The Annual Financial Statements 2016 will present Equity in accordance with the amendments.

*The Notes on pages 11 to 57 are an integral part of these Interim Consolidated Financial Statements.*



# INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 30 SEPTEMBER 2016

	2016 1.1.-30.9.	2015 1.1.-30.9.
<b>Operating activities</b>		
Net earnings .....	17,262	25,397
Non-cash items included in net earnings and other adjustments .....	(25,759)	(24,521)
Changes in operating assets and liabilities .....	3,352	39,629
Interest received .....	35,777	29,085
Interest paid .....	(11,466)	(9,639)
Dividend received .....	603	6,798
Income tax paid .....	(3,507)	(2,321)
Net cash from operating activities	<u>16,262</u>	<u>64,428</u>
<b>Investing activities</b>		
Acquisition of associates .....	(13)	(115)
Proceeds from sale of associates .....	27,112	7,868
Dividends received from associates .....	41	506
Acquisition of subsidiary .....	(5,300)	-
Disposal of subsidiary .....	293	-
Acquisition of intangible assets .....	(745)	(324)
Acquisition of property and equipment .....	(924)	(400)
Proceeds from sale of property and equipment .....	215	110
Net cash from investing activities	<u>20,679</u>	<u>7,645</u>
<b>Financing activities</b>		
Payment of subordinated liabilities .....	(8,785)	(19,883)
Dividend paid to shareholders of Arion Bank .....	-	(12,809)
Disbursement of share capital and dividend to non controlling interest .....	(9,386)	-
Acquisition of non-controlling interest .....	-	(58)
Net cash used in financing activities	<u>(18,171)</u>	<u>(32,750)</u>
Net increase in cash and cash equivalents .....	18,770	41,403
Cash and cash equivalents at beginning of the year .....	110,000	91,715
Cash and cash equivalents acquired through business combinations .....	1,068	-
Effect of exchange rate changes on cash and cash equivalents .....	(5,159)	(1,320)
<b>Cash and cash equivalents</b> .....	<u>124,679</u>	<u>131,798</u>
<b>Non-cash investing transactions</b>		
Assets acquired through foreclosure on collateral from customers with view to resale .....	1,297	1,425
Settlement of loans through foreclosure on collateral from customers with view to resale .....	(1,297)	(1,425)
<b>Non-cash changes due to funding agreement with Kaupthing</b>		
Deposits .....	41,409	-
Borrowings .....	(41,409)	-

Financial effects due to the acquisition of Vörður tryggingar hf. is further described in Note 3.

The Notes on pages 11 to 57 are an integral part of these Interim Consolidated Financial Statements.

# NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 30 SEPTEMBER 2016

	2016 1.1.-30.9.	2015 1.1.-30.9.
<b>Non-cash items included in net earnings and other adjustments</b>		
Net interest income .....	(22,058)	(20,287)
Net impairment .....	(6,827)	114
Income tax expense .....	5,261	3,639
Bank levy .....	2,190	2,168
Net foreign exchange loss .....	829	393
Net gain on financial instruments .....	(4,565)	(3,771)
Depreciation and amortisation .....	1,346	1,218
Share of profit of associates and fair value change .....	(710)	(6,956)
Investment property, fair value change .....	(25)	-
Net gain from discontinued operations, net of tax .....	(569)	(277)
Other changes .....	(631)	(762)
<b>Non-cash items included in net earnings and other adjustments .....</b>	<b>(25,759)</b>	<b>(24,521)</b>
<b>Changes in operating assets and liabilities</b>		
Mandatory reserve with Central Bank .....	3,240	185
Loans to credit institutions, excluding bank accounts .....	(7,625)	750
Loans to customers .....	(34,058)	(22,547)
Financial instruments and financial liabilities at fair value .....	6,133	(12,903)
Investment property .....	1,449	(213)
Other assets .....	1,123	1,949
Due to credit institutions and Central Bank .....	(1,922)	(11,177)
Deposits .....	638	47,915
Borrowings .....	42,682	38,401
Other liabilities .....	(8,308)	(2,731)
<b>Changes in operating assets and liabilities .....</b>	<b>3,352</b>	<b>39,629</b>
<b>Cash and cash equivalents</b>		
Cash and demand deposits .....	85,645	73,289
Due from credit institutions .....	48,429	67,259
Mandatory reserve with Central Bank .....	(9,395)	(8,750)
<b>Cash and cash equivalents .....</b>	<b>124,679</b>	<b>131,798</b>

The Notes on pages 11 to 57 are an integral part of these Interim Consolidated Financial Statements.

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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## GENERAL INFORMATION

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 2016 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

### 1. Basis of preparation

#### *Statement of compliance*

The Interim Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standard, IAS 34 Interim Financial Reporting, as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and rules on Accounting for Credit Institutions. 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 2015. The statements are available at Arion Bank's website [www.arionbanki.is](http://www.arionbanki.is).

The Interim Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 16 November 2016.

#### *Basis of measurement*

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

- financial assets and financial liabilities held for trading are measured at fair value;
- financial assets and financial liabilities at fair value are measured at fair value;
- financial assets classified as available-for-sale are measured at fair value;
- investment properties are measured at fair value; and
- non-current assets and disposal groups classified as held for sale are stated at the lower of their carrying amount and fair value, less costs to sell.

#### *Functional and presentation currency*

The Interim Financial Statements are presented in Icelandic Krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the period the exchange rate of the ISK against the USD was 113.80 and 127.92 for the EUR (31.12.2015: USD 130.08 and EUR 141.28).

### 2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Interim Financial Statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

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

The key sources of estimation uncertainty are within impairment losses and reversal of impairment losses on loans.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 3. The Group

Shares in main subsidiaries in which Arion Bank held a direct interest at the end of the period

	Operating activity	Currency	Equity interest	
			30.9.2016	31.12.2015
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland .....	Retail banking	ISK	100.0%	100.0%
BG12 Slhf., Katrínartún 2, Reykjavík, Iceland .....	Holding company	ISK	62.0%	62.0%
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland .....	Holding company	ISK	100.0%	100.0%
Eignarhaldsfélagið Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland .....	Real estate	ISK	100.0%	100.0%
Kolufell ehf., Borgartún 19, Reykjavík, Iceland .....	Real estate	ISK	-	68.9%
Okkar líftryggingar hf., Laugavegur 182, Reykjavík, Iceland .....	Life insurance	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland .....	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjörður, Iceland .....	Payment solutions	ISK	100.0%	100.0%
Vörður tryggingar hf., Borgartún 25, Reykjavík, Iceland .....	Insurance	ISK	100.0%	-

In July 2016 Arion Bank sold majority of shareholding in the subsidiary Kolufell ehf. The main asset of Kolufell ehf. was investment property. The profit from the sale and valuation change on the remaining shareholding amounts to ISK 493 million and is recognised in the Statement of Comprehensive Income. The remaining shareholding is classified as Financial instruments.

On 30 September 2016 Arion Bank acquired 100% shareholding in the insurance company Vörður tryggingar hf. Vörður tryggingar hf. is classified as subsidiary of Arion Bank from the day of acquisition. The effects on the Statement of Financial Position is as follows:

	30.9.2016
<b>Assets</b>	
Cash and balances with Central Bank .....	(5,300)
Loans to credit institutions .....	1,069
Financial instruments .....	8,773
Intangible assets .....	2,139
Tax assets .....	147
Other assets .....	2,355
	<u>9,183</u>
<b>Liabilities</b>	
Tax liabilities .....	7
Other liabilities .....	9,176
	<u>9,183</u>

The acquisition had no impacts on the Statement of Comprehensive Income during the period. Net earnings of Vörður tryggingar hf. in 2015 was ISK 658 million.

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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## OPERATING SEGMENT REPORTING

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. In presenting the geographic information, segment revenue has been based on the geographic location of customers or assets.

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

### Operating segments

The Group comprises the following operating segments:

**Asset Management** comprises Institutional Asset Management, Private Banking, Investment Services and Pension Fund Administration. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefmir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Asset Management also administers pension funds. Stefmir hf. is an independently operating financial company owned by Arion Bank. Stefmir manages a broad range of mutual funds, investment funds and institutional investor funds.

**Corporate Banking** provides comprehensive financial services and integrated solutions across the banks divisions, to larger corporate clients in Iceland. Corporate Banking provides a full range of lending products, deposit accounts as well as value added electronic corporate solutions to meet the needs of each customer.

**Investment Banking** is divided into Corporate Finance, Capital Markets and Research. Corporate Finance arranges the buying and selling of companies and advises on all other major financial decisions undertaken by companies and investors. Corporate Finance advises on financial restructuring of companies and manages IPO's and stock market listings. Capital Markets buy and sell securities and FX for Arion bank's clients. Capital Markets manage securities issuance for clients and advise on hedges used in business operations often in co-operation with Corporate Finance. Research is an independent research team covering the Icelandic economy and securities markets.

**Retail Banking**, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of services. This includes among other deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into five clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Retail Banking's 24 branches all around Iceland have a total of more than 100,000 customers.

**Treasury** has the overall responsibility for the Bank's liquidity, currency and interest rate management. Other functions of Treasury are funds transfer pricing and hedging and pricing of financial products.

**Other divisions and Subsidiaries** include market making in domestic securities and currencies. The subsidiaries are Eignarhaldsfélagið Landey ehf., Okkar líftryggingar hf., Valitor Holding hf., Vörður tryggingar hf., BG12 slhf., EAB 1 ehf. and other smaller entities of the Group.

**Headquarters** include Overhead, Risk Management, Finance (excluding Treasury), Legal, IT and Operations.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 4. Operating segments

	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub- sidiaries	Head- quarters and Elimination	Total
1.1.-30.9.2016								
Net interest income .....	415	4,915	1,031	11,444	3,818	866	(431)	22,058
Net fee and commission income .....	2,864	739	1,072	2,528	(258)	2,887	381	10,213
Net financial income .....	(86)	118	(103)	87	(178)	4,901	(400)	4,339
Share of profit of associates .....	-	-	613	-	-	155	(58)	710
Other operating income .....	12	69	321	16	85	1,810	329	2,642
<b>Operating income .....</b>	<b>3,205</b>	<b>5,841</b>	<b>2,934</b>	<b>14,075</b>	<b>3,467</b>	<b>10,619</b>	<b>(179)</b>	<b>39,962</b>
Operating expense .....	(1,039)	(451)	(747)	(4,577)	(151)	(5,118)	(10,562)	(22,645)
Bank levy .....	-	-	-	-	-	-	(2,190)	(2,190)
Net impairment .....	(1)	60	1,601	5,250	3	(87)	1	6,827
<b>Earnings before tax .....</b>	<b>2,165</b>	<b>5,450</b>	<b>3,788</b>	<b>14,748</b>	<b>3,319</b>	<b>5,414</b>	<b>(12,930)</b>	<b>21,954</b>
Net seg. rev. from ext. customers .....	1,268	11,765	2,732	22,561	(9,584)	11,035	185	39,962
Net seg. rev. from other segments .....	1,937	(5,924)	202	(8,486)	13,051	(416)	(364)	-
<b>Operating income .....</b>	<b>3,205</b>	<b>5,841</b>	<b>2,934</b>	<b>14,075</b>	<b>3,467</b>	<b>10,619</b>	<b>(179)</b>	<b>39,962</b>
Depreciation and amortisation .....	-	-	-	238	-	504	604	1,346
30.9.2016								
<b>Total assets .....</b>	<b>5,106</b>	<b>253,507</b>	<b>18,705</b>	<b>472,439</b>	<b>194,455</b>	<b>64,603</b>	<b>29,665</b>	<b>1,038,480</b>
<b>Total liabilities .....</b>	<b>360</b>	<b>194,996</b>	<b>15,911</b>	<b>401,839</b>	<b>162,965</b>	<b>35,146</b>	<b>20,257</b>	<b>831,474</b>
<b>Allocated equity .....</b>	<b>4,746</b>	<b>58,511</b>	<b>2,794</b>	<b>70,600</b>	<b>31,490</b>	<b>29,457</b>	<b>9,408</b>	<b>207,006</b>
1.1.-30.9.2015								
Net interest income .....	333	4,407	29	10,190	4,782	497	49	20,287
Net fee and commission income .....	2,787	757	1,638	2,147	(251)	3,169	479	10,726
Net financial income .....	117	-	7,099	175	464	476	1,845	10,176
Share of profit of associates .....	-	-	3,017	-	-	414	3,525	6,956
Other operating income .....	8	44	420	16	-	1,495	249	2,232
<b>Operating income .....</b>	<b>3,245</b>	<b>5,208</b>	<b>12,203</b>	<b>12,528</b>	<b>4,995</b>	<b>6,051</b>	<b>6,147</b>	<b>50,377</b>
Operating expense .....	(1,033)	(386)	(746)	(4,302)	(184)	(4,276)	(8,409)	(19,336)
Bank levy .....	-	-	-	-	-	-	(2,168)	(2,168)
Net impairment .....	-	1,435	1,492	(2,733)	407	(762)	47	(114)
<b>Earnings before tax .....</b>	<b>2,212</b>	<b>6,257</b>	<b>12,949</b>	<b>5,493</b>	<b>5,218</b>	<b>1,013</b>	<b>(4,383)</b>	<b>28,759</b>
Net seg. rev. from ext. customers .....	1,261	10,885	12,773	22,371	(9,266)	6,245	6,100	50,377
Net seg. rev. from other segments .....	1,984	(5,677)	(570)	(9,843)	14,261	(194)	39	-
<b>Operating income .....</b>	<b>3,245</b>	<b>5,208</b>	<b>12,203</b>	<b>12,528</b>	<b>4,995</b>	<b>6,051</b>	<b>6,139</b>	<b>50,377</b>
Depreciation and amortisation .....	-	-	-	217	-	419	582	1,218
30.9.2015								
<b>Total assets .....</b>	<b>5,492</b>	<b>238,439</b>	<b>43,943</b>	<b>440,274</b>	<b>212,676</b>	<b>49,857</b>	<b>18,795</b>	<b>1,009,476</b>
<b>Total liabilities .....</b>	<b>1,166</b>	<b>182,968</b>	<b>31,660</b>	<b>386,929</b>	<b>192,964</b>	<b>30,149</b>	<b>8,845</b>	<b>834,681</b>
<b>Allocated equity .....</b>	<b>4,326</b>	<b>55,471</b>	<b>12,283</b>	<b>53,345</b>	<b>19,712</b>	<b>19,708</b>	<b>9,950</b>	<b>174,795</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 4. Operating segments, continued

#### Geographic information

	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
1.1.-30.9.2016							
Net interest income .....	23,746	845	89	(3,232)	582	28	22,058
Net fee and commission income .....	8,681	50	440	957	81	4	10,213
Net financial income .....	(966)	(12)	4,996	308	13	-	4,339
Share of profit of associates .....	212	-	498	-	-	-	710
Other income .....	2,642	-	-	-	-	-	2,642
<b>Operating income .....</b>	<b>34,315</b>	<b>883</b>	<b>6,023</b>	<b>(1,967)</b>	<b>676</b>	<b>32</b>	<b>39,962</b>
1.1.-30.9.2015							
Net interest income .....	20,028	545	23	(507)	176	22	20,287
Net fee and commission income .....	9,420	165	415	679	44	3	10,726
Net financial income .....	7,727	(44)	(17)	2,482	31	(3)	10,176
Share of profit of associates .....	6,956	-	-	-	-	-	6,956
Other income .....	2,232	-	-	-	-	-	2,232
<b>Operating income .....</b>	<b>46,363</b>	<b>666</b>	<b>421</b>	<b>2,654</b>	<b>251</b>	<b>22</b>	<b>50,377</b>

Discontinued operations are excluded from the profit and loss segment information.



## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 5. Operations by quarters

2016	Q3	Q2	Q1	Total
Net interest income .....	7,432	7,353	7,273	22,058
Net fee and commission income .....	3,466	3,528	3,219	10,213
Net financial income .....	844	3,796	(301)	4,339
Share of profit of associates .....	16	17	677	710
Other operating income .....	781	626	1,235	2,642
<b>Operating income .....</b>	<b>12,539</b>	<b>15,320</b>	<b>12,103</b>	<b>39,962</b>
Salaries and related expense .....	(3,826)	(4,318)	(4,108)	(12,252)
Other operating expense .....	(3,423)	(3,736)	(3,234)	(10,393)
Bank levy .....	(705)	(743)	(742)	(2,190)
Net impairment .....	5,882	1,448	(503)	6,827
<b>Earnings before tax .....</b>	<b>10,467</b>	<b>7,971</b>	<b>3,516</b>	<b>21,954</b>
Income tax expense .....	(3,170)	(1,354)	(737)	(5,261)
<b>Net earnings from continuing operations .....</b>	<b>7,297</b>	<b>6,617</b>	<b>2,779</b>	<b>16,693</b>
Net gain from discontinued operations, net of tax .....	206	259	104	569
<b>Net earnings .....</b>	<b>7,503</b>	<b>6,876</b>	<b>2,883</b>	<b>17,262</b>
2015				
Net interest income .....	7,112	7,392	5,783	20,287
Net fee and commission income .....	3,292	3,677	3,757	10,726
Net financial income .....	453	2,184	7,539	10,176
Share of profit of associates .....	2,739	6	4,211	6,956
Other operating income .....	709	1,032	491	2,232
<b>Operating income .....</b>	<b>14,305</b>	<b>14,291</b>	<b>21,781</b>	<b>50,377</b>
Salaries and related expense .....	(3,153)	(3,675)	(3,492)	(10,320)
Other operating expense .....	(3,012)	(3,108)	(2,896)	(9,016)
Bank levy .....	(779)	(659)	(730)	(2,168)
Net impairment .....	(33)	(1,863)	1,782	(114)
<b>Earnings before tax .....</b>	<b>7,328</b>	<b>4,986</b>	<b>16,445</b>	<b>28,759</b>
Income tax expense .....	(1,272)	(647)	(1,720)	(3,639)
<b>Net earnings from continuing operations .....</b>	<b>6,056</b>	<b>4,339</b>	<b>14,725</b>	<b>25,120</b>
Net gain from discontinued operations, net of tax .....	15	79	183	277
<b>Net earnings .....</b>	<b>6,071</b>	<b>4,418</b>	<b>14,908</b>	<b>25,397</b>

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

### 6. Net interest income

	2016 1.1.-30.9.	2015 1.1.-30.9.	2016 1.7.-30.9.	2015 1.7.-30.9.
<i>Interest income</i>				
Cash and balances with Central Bank .....	3,249	1,779	1,220	821
Loans .....	39,097	37,790	12,312	13,163
Securities .....	3,401	2,593	1,164	984
Other .....	499	646	155	180
<b>Interest income</b> .....	<b>46,246</b>	<b>42,808</b>	<b>14,851</b>	<b>15,148</b>
<i>Interest expense</i>				
Deposits .....	(12,515)	(11,968)	(3,771)	(4,508)
Borrowings .....	(11,061)	(9,855)	(3,251)	(3,361)
Subordinated liabilities .....	(529)	(603)	(343)	(100)
Other .....	(83)	(95)	(54)	(67)
<b>Interest expense</b> .....	<b>(24,188)</b>	<b>(22,521)</b>	<b>(7,419)</b>	<b>(8,036)</b>
<b>Net interest income</b> .....	<b>22,058</b>	<b>20,287</b>	<b>7,432</b>	<b>7,112</b>
Net interest income from assets and liabilities at fair value .....	3,401	2,593	1,164	942
Interest income from assets not at fair value .....	42,845	40,215	13,687	14,165
Interest expense from liabilities not at fair value .....	(24,188)	(22,521)	(7,419)	(7,995)
<b>Net interest income</b> .....	<b>22,058</b>	<b>20,287</b>	<b>7,432</b>	<b>7,112</b>
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets) .....	3.1%	3.0%	3.1%	3.1%

Interest income from money market loans is classified as Cash and balances with Central Bank. Priorly it was classified as Loans. Comparative figures have been adjusted accordingly.

### 7. Net fee and commission income

	Income		Expense		Net income	
	1.1.-30.9.2016		1.1.-30.9.2015		1.1.-30.9.2015	
Asset management .....	3,101	(201)	2,900	3,099	(210)	2,889
Cards .....	10,559	(6,515)	4,044	8,545	(4,384)	4,161
Collection and payment services .....	1,123	(59)	1,064	991	(63)	928
Investment banking .....	732	(36)	696	1,274	(36)	1,238
Lending and guarantees .....	1,180	-	1,180	1,070	-	1,070
Other .....	741	(412)	329	630	(190)	440
<b>Net fee and commission income</b> .....	<b>17,436</b>	<b>(7,223)</b>	<b>10,213</b>	<b>15,609</b>	<b>(4,883)</b>	<b>10,726</b>
	1.7.-30.9.2016		1.7.-30.9.2015		1.7.-30.9.2015	
Asset management .....	1,063	(61)	1,002	1,028	(87)	941
Cards .....	3,833	(2,492)	1,341	3,239	(1,885)	1,354
Collection and payment services .....	401	(22)	379	330	(21)	309
Investment banking .....	178	(12)	166	180	(15)	165
Lending and guarantees .....	403	-	403	388	-	388
Other .....	313	(138)	175	208	(73)	135
<b>Net fee and commission income</b> .....	<b>6,191</b>	<b>(2,725)</b>	<b>3,466</b>	<b>5,373</b>	<b>(2,081)</b>	<b>3,292</b>

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.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

<b>8. Net financial income</b>	2016 1.1.-30.9.	2015 1.1.-30.9.	2016 1.7.-30.9.	2015 1.7.-30.9.
Dividend income .....	603	6,798	3	-
Net gain on financial assets and financial liabilities classified as held for trading .....	(141)	740	(20)	654
Net gain on financial assets and financial liabilities designated at fair value through profit or loss .....	(585)	3,031	1,004	814
Realised gain on financial assets available-for-sale .....	5,291	-	-	-
Net foreign exchange loss .....	(829)	(393)	(143)	(1,015)
<b>Net financial income</b> .....	<b>4,339</b>	<b>10,176</b>	<b>844</b>	<b>453</b>

### *Net gain on financial assets and financial liabilities designated at fair value through profit or loss*

Equity instruments designated at fair value .....	(613)	2,818	636	700
Interest rate instruments designated at fair value .....	28	213	368	114
<b>Net gain on financial assets and financial liabilities designated at fair value through profit or loss</b> .....	<b>(585)</b>	<b>3,031</b>	<b>1,004</b>	<b>814</b>

In November 2015 Visa Inc. and Visa Europe Ltd. announced a definitive agreement on the acquisition by Visa Inc. of Visa Europe Ltd. Arion Bank was a member of Visa Europe Ltd. through its subsidiary Valitor Holding hf. In June 2016 the sale was formally completed, resulting in a total profit of ISK 5,291 million after taking into account conditional payments to Landsbankinn hf. and two savings funds, which formed part of the agreement when Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014. The shareholding in Visa Europe Ltd. was classified as Financial assets available for sale.

<b>9. Other operating income</b>	2016 1.1.-30.9.	2015 1.1.-30.9.	2016 1.7.-30.9.	2015 1.7.-30.9.
Fair value changes on investment property .....	25	555	-	129
Realised gain on investment property .....	429	207	-	81
Earned premiums, net of reinsurance .....	977	810	346	280
Other income .....	1,211	660	435	219
<b>Other operating income</b> .....	<b>2,642</b>	<b>2,232</b>	<b>781</b>	<b>709</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 10. Personnel and salaries

	2016 1.1.-30.9.	2015 1.1.-30.9.	2016 1.7.-30.9.	2015 1.7.-30.9.
<i>Number of employees</i>				
Average number of full time equivalent positions during the period .....	1,185	1,131	1,205	1,147
Full time equivalent positions at the end of the period .....	1,189	1,151	1,189	1,151
<i>The Bank's number of employees</i>				
Average number of full time equivalent positions during the period .....	893	849	901	843
Full time equivalent positions at the end of the period .....	887	850	887	850
<i>Salaries and related expense</i>				
Salaries .....	9,811	8,201	3,047	2,535
Defined contribution pension plans .....	1,391	1,138	456	349
Salary related expense .....	1,336	1,179	412	331
Capitalisation of salaries .....	(286)	(198)	(89)	(62)
<b>Salaries and related expense .....</b>	<b>12,252</b>	<b>10,320</b>	<b>3,826</b>	<b>3,153</b>
<i>Salaries and related expense for the Bank</i>				
Salaries .....	7,307	5,882	2,342	1,808
Defined contribution pension plans .....	1,036	876	329	288
Salary related expense .....	1,101	868	348	246
<b>Salaries and related expense .....</b>	<b>9,444</b>	<b>7,626</b>	<b>3,019</b>	<b>2,342</b>

During the period the Group made a provision of ISK 294 million (9M 2015: ISK 164 million) for performance plan payments, including salary related expense, thereof the Bank made a provision of ISK 264 million (9M 2015: ISK 111 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for financial undertakings. At the end of the period the Group's accrual for performance plan payments amounts to ISK 975 million (31.12.2015: ISK 1,056 million), thereof the Bank's accrual amounts to ISK 826 million (31.12.2015: ISK 852 million).

### 11. Other operating expense

	2016 1.1.-30.9.	2015 1.1.-30.9.	2016 1.7.-30.9.	2015 1.7.-30.9.
Administration expense .....	8,096	6,841	2,680	2,267
Depositors' and investors' guarantee fund .....	602	631	181	211
Depreciation of property and equipment .....	707	672	265	213
Amortisation of intangible assets .....	639	546	219	172
Claims incurred, net of reinsurance .....	314	265	74	123
Other expense .....	35	61	4	26
<b>Other operating expense .....</b>	<b>10,393</b>	<b>9,016</b>	<b>3,423</b>	<b>3,012</b>

### 12. Bank levy

The Bank levy is 0.376% on total debt excluding tax liabilities, in excess of ISK 50 billions. Non-financial subsidiaries are exempt from this tax. The tax is assessed on financial institutions to meet the funding of a special index and interest relief provided to individual tax payers.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 13. Net impairment

	2016 1.1.-30.9.	2015 1.1.-30.9.	2016 1.7.-30.9.	2015 1.7.-30.9.
Increase in book value of loans to corporates .....	2,129	2,111	301	87
Increase in book value of loans to individuals .....	8,525	1,667	6,948	679
Net change in impairment of loans to corporates .....	(1,973)	767	(1,427)	248
Net change in impairment of loans to individuals .....	(2,205)	(3,148)	(185)	(861)
Net change in collective impairment on loans .....	351	(1,486)	245	(186)
Impairment of intangible assets .....	-	(25)	-	-
<b>Net impairment</b> .....	<b>6,827</b>	<b>(114)</b>	<b>5,882</b>	<b>(33)</b>

### 14. Income tax expense

Current tax expense .....	5,318	3,844	3,035	1,424
Deferred tax expense .....	(57)	(205)	135	(152)
<b>Income tax expense</b> .....	<b>5,261</b>	<b>3,639</b>	<b>3,170</b>	<b>1,272</b>

#### Reconciliation of effective tax rate

	1.1.-30.9.2016		1.1.-30.9.2015	
Earnings before tax .....		21,954		28,759
Income tax using the Icelandic corporation tax rate .....	20.0%	4,391	20.0%	5,752
Additional 6% tax on financial institutions .....	5.2%	1,132	3.0%	877
Non-deductible expenses .....	0.4%	91	2.1%	602
Tax exempt revenue .....	(3.6%)	(781)	(12.8%)	(3,675)
Non-deductible taxes .....	2.0%	438	0.0%	-
Other changes .....	(0.0%)	(10)	0.3%	83
<b>Effective tax rate</b> .....	<b>24.0%</b>	<b>5,261</b>	<b>12.7%</b>	<b>3,639</b>

Financial institutions pay 6% additional tax on taxable profit exceeding ISK 1 billion.

Tax exempt revenues consist mainly of profit from equity positions.

### 15. Net gain from discontinued operations, net of tax

	2016 1.1.-30.9.	2015 1.1.-30.9.	2016 1.7.-30.9.	2015 1.7.-30.9.
Income from real estates and other assets .....	925	529	326	151
Expense related to real estates and other assets .....	(356)	(252)	(120)	(136)
<b>Net gain from discontinued operations, net of tax</b> .....	<b>569</b>	<b>277</b>	<b>206</b>	<b>15</b>

### 16. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2016 1.1.-30.9.	2015 1.1.-30.9.	2016 1.1.-30.9.	2015 1.1.-30.9.
Net earnings attributable to the shareholders of Arion Bank .....	16,207	25,282	16,776	25,559
Weighted average number of outstanding shares for the period, million .....	2,000	2,000	2,000	2,000
<b>Basic earnings per share</b> .....	<b>8.10</b>	<b>12.64</b>	<b>8.39</b>	<b>12.78</b>

There were no instruments at the end of the period that could potentially dilute basic earnings per share (31.12.2015: none).

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION

17. Cash and balances with Central Bank	30.9.2016	31.12.2015
Cash on hand .....	7,483	4,921
Cash with Central Bank .....	68,767	30,546
Mandatory reserve deposit with Central Bank .....	9,395	12,635
<b>Cash and balances with Central Bank .....</b>	<b>85,645</b>	<b>48,102</b>

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

## 18. Loans to credit institutions

Bank accounts .....	48,429	74,533
Money market loans .....	10,700	7,976
Other loans .....	9,128	4,982
<b>Loans to credit institutions .....</b>	<b>68,257</b>	<b>87,491</b>

## 19. Loans to customers

	Individuals		Corporates		Total	
	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
30.9.2016						
Overdrafts .....	15,603	13,730	22,015	20,223	37,618	33,953
Credit cards .....	10,852	10,567	1,243	1,214	12,095	11,781
Mortgage loans .....	283,423	280,455	14,729	14,499	298,152	294,954
Other loans .....	35,314	29,895	358,004	345,324	393,318	375,219
<b>Loans to customers .....</b>	<b>345,192</b>	<b>334,647</b>	<b>395,991</b>	<b>381,260</b>	<b>741,183</b>	<b>715,907</b>
31.12.2015						
Overdrafts .....	16,840	14,833	24,248	22,387	41,088	37,220
Credit cards .....	10,842	10,560	1,054	997	11,896	11,557
Mortgage loans .....	271,895	268,048	12,889	12,601	284,784	280,649
Other loans .....	38,058	31,178	334,849	319,746	372,907	350,924
<b>Loans to customers .....</b>	<b>337,635</b>	<b>324,619</b>	<b>373,040</b>	<b>355,731</b>	<b>710,675</b>	<b>680,350</b>

The total book value of pledged loans that were pledged against amounts borrowed was ISK 158 billion at the end of the period (31.12.2015: ISK 199 billion). At the end of the period pledged loans comprised mortgage loans to individuals. At year end 2015 pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies.

Further analysis of loans is provided in Risk Management Disclosures.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 19. Loans to customers, continued

#### *Changes in the provision for losses on loans to customers*

1.1.-30.9.2016	Specific	Collective	Total
Balance at the beginning of the year .....	25,341	4,984	30,325
Provision for losses .....	4,178	(351)	3,827
Write-offs .....	(9,063)	-	(9,063)
Payment of loans previously written off .....	187	-	187
<b>Balance at the end of the period .....</b>	<b>20,643</b>	<b>4,633</b>	<b>25,276</b>
1.1.-30.9.2015			
Balance at the beginning of the year .....	22,214	4,467	26,681
Provision for losses .....	2,381	1,486	3,867
Write-offs .....	(4,443)	-	(4,443)
Payment of loans previously written off .....	264	-	264
<b>Balance at the end of the period .....</b>	<b>20,416</b>	<b>5,953</b>	<b>26,369</b>

#### *Significant accounting estimates and judgements*

Key sources of estimation uncertainty are impairment losses on loans.

The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 54 in the Annual Financial Statements for 2015. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the Credit Risk function.

### 20. Financial instruments

	30.9.2016	31.12.2015
Bonds and debt instruments .....	74,993	78,794
Shares and equity instruments with variable income .....	32,197	35,504
Derivatives .....	4,953	2,401
Securities used for hedging .....	16,214	16,492
<b>Financial instruments .....</b>	<b>128,357</b>	<b>133,191</b>

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## 21. Financial assets and financial liabilities

30.9.2016	Amortised cost	Trading	Designated at fair value	Total
<i>Loans</i>				
Cash and balances with Central Bank .....	85,645	-	-	85,645
Loans to credit institutions .....	68,257	-	-	68,257
Loans to customers .....	715,907	-	-	715,907
<b>Loans</b> .....	<b>869,809</b>	<b>-</b>	<b>-</b>	<b>869,809</b>
<i>Bonds and debt instruments</i>				
Listed .....	-	4,880	66,132	71,012
Unlisted .....	-	105	3,876	3,981
<b>Bonds and debt instruments</b> .....	<b>-</b>	<b>4,985</b>	<b>70,008</b>	<b>74,993</b>
<i>Shares and equity instruments with variable income</i>				
Listed .....	-	3,480	11,246	14,726
Unlisted .....	-	1,336	12,799	14,135
Bond funds with variable income, unlisted .....	-	655	2,681	3,336
<b>Shares and equity instruments with variable income</b> .....	<b>-</b>	<b>5,471</b>	<b>26,726</b>	<b>32,197</b>
<i>Derivatives</i>				
OTC derivatives .....	-	4,953	-	4,953
<b>Derivatives</b> .....	<b>-</b>	<b>4,953</b>	<b>-</b>	<b>4,953</b>
<i>Securities used for hedging</i>				
Bonds and debt instruments, listed .....	-	6,252	-	6,252
Shares and equity instruments with variable income, listed .....	-	9,853	-	9,853
Shares and equity instruments with variable income, unlisted .....	-	109	-	109
<b>Securities used for hedging</b> .....	<b>-</b>	<b>16,214</b>	<b>-</b>	<b>16,214</b>
Other financial assets .....	10,091	-	-	10,091
<b>Financial assets</b> .....	<b>879,900</b>	<b>31,623</b>	<b>96,734</b>	<b>1,008,257</b>
<i>Liabilities at amortised cost</i>				
Due to credit institutions and Central Bank .....	9,375	-	-	9,375
Deposits .....	431,929	-	-	431,929
Borrowings .....	326,754	-	-	326,754
<b>Liabilities at amortised cost</b> .....	<b>768,058</b>	<b>-</b>	<b>-</b>	<b>768,058</b>
<i>Financial liabilities at fair value</i>				
Short position in bonds .....	-	2,805	-	2,805
Short position in equity .....	-	32	-	32
Derivatives .....	-	2,260	-	2,260
<b>Financial liabilities at fair value</b> .....	<b>-</b>	<b>5,097</b>	<b>-</b>	<b>5,097</b>
Other financial liabilities .....	34,826	-	-	34,826
<b>Financial liabilities</b> .....	<b>802,884</b>	<b>5,097</b>	<b>-</b>	<b>807,981</b>

Financial assets classified as available for sale at year-end 2015 were sold in June 2016, see Note 8.



## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 21. Financial assets and financial liabilities, continued

31.12.2015	Amortised cost	Trading	Designated at fair value	Available for sale	Total
<i>Loans</i>					
Cash and balances with Central Bank .....	48,102	-	-	-	48,102
Loans to credit institutions .....	87,491	-	-	-	87,491
Loans to customers .....	680,350	-	-	-	680,350
<b>Loans</b> .....	<b>815,943</b>	-	-	-	<b>815,943</b>
<i>Bonds and debt instruments</i>					
Listed .....	-	2,526	74,757	-	77,283
Unlisted .....	-	99	1,412	-	1,511
<b>Bonds and debt instruments</b> .....	-	<b>2,625</b>	<b>76,169</b>	-	<b>78,794</b>
<i>Shares and equity instruments with variable income</i>					
Listed .....	-	2,138	13,869	-	16,007
Unlisted .....	-	1,668	10,665	5,852	18,185
Bond funds with variable income, unlisted .....	-	1,090	222	-	1,312
<b>Shares and equity instruments with variable income</b> .....	-	<b>4,896</b>	<b>24,756</b>	<b>5,852</b>	<b>35,504</b>
<i>Derivatives</i>					
OTC derivatives .....	-	2,401	-	-	2,401
<b>Derivatives</b> .....	-	<b>2,401</b>	-	-	<b>2,401</b>
<i>Securities used for hedging</i>					
Bonds and debt instruments, listed .....	-	1,519	-	-	1,519
Shares and equity instruments with variable income, listed .....	-	14,276	-	-	14,276
Shares and equity instruments with variable income, unlisted .....	-	697	-	-	697
<b>Securities used for hedging</b> .....	-	<b>16,492</b>	-	-	<b>16,492</b>
Other financial assets .....	4,581	-	-	-	4,581
<b>Financial assets</b> .....	<b>820,524</b>	<b>26,414</b>	<b>100,925</b>	<b>5,852</b>	<b>953,715</b>
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank .....	11,387	-	-	-	11,387
Deposits .....	469,347	-	-	-	469,347
Borrowings .....	256,058	-	-	-	256,058
Subordinated liabilities .....	10,365	-	-	-	10,365
<b>Liabilities at amortised cost</b> .....	<b>747,157</b>	-	-	-	<b>747,157</b>
<i>Financial liabilities at fair value</i>					
Short position in bonds .....	-	4,616	-	-	4,616
Derivatives .....	-	2,993	-	-	2,993
<b>Financial liabilities at fair value</b> .....	-	<b>7,609</b>	-	-	<b>7,609</b>
Other financial liabilities .....	38,667	-	-	-	38,667
<b>Financial liabilities</b> .....	<b>785,824</b>	<b>7,609</b>	-	-	<b>793,433</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 21. Financial assets and financial liabilities, continued

<i>Bonds and debt instruments designated at fair value specified by issuer</i>	30.9.2016	31.12.2015
Financial and insurance activities .....	8,080	9,258
Public sector .....	55,071	59,246
Corporates .....	6,857	7,665
<b>Bonds and debt instruments designated at fair value .....</b>	<b>70,008</b>	<b>76,169</b>

The total amount of pledged bonds was ISK 18.2 billion at the end of the period (31.12.2015: ISK 21.5 billion). Pledged bonds comprise Icelandic and foreign Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

### 22. Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of assets and liabilities 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.

For assets and liabilities that are recognised at fair value on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorisation (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting period.

#### *Assets and liabilities recorded at fair value by level of the fair value hierarchy*

30.9.2016	Level 1	Level 2	Level 3	Total
<i>Assets at fair value</i>				
Bonds and debt instruments .....	27,398	47,506	89	74,993
Shares and equity instruments with variable income .....	13,477	18,694	26	32,197
Derivatives .....	-	4,953	-	4,953
Securities used for hedging .....	16,073	141	-	16,214
Investment property .....	-	-	5,113	5,113
<b>Assets at fair value .....</b>	<b>56,948</b>	<b>71,294</b>	<b>5,228</b>	<b>133,470</b>
<i>Liabilities at fair value</i>				
Short position in bonds .....	2,805	-	-	2,805
Short position in equity .....	32	-	-	32
Derivatives .....	-	2,260	-	2,260
<b>Liabilities at fair value .....</b>	<b>2,837</b>	<b>2,260</b>	<b>-</b>	<b>5,097</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 22. Fair value hierarchy, continued

31.12.2015	Level 1	Level 2	Level 3	Total
<i>Assets at fair value</i>				
Bonds and debt instruments .....	32,813	45,799	182	78,794
Shares and equity instruments with variable income .....	14,331	15,299	5,874	35,504
Derivatives .....	-	2,401	-	2,401
Securities used for hedging .....	15,706	786	-	16,492
Investment property .....	-	-	7,542	7,542
<b>Assets at fair value .....</b>	<b>62,850</b>	<b>64,285</b>	<b>13,598</b>	<b>140,733</b>
<i>Liabilities at fair value</i>				
Short position in bonds .....	4,616	-	-	4,616
Derivatives .....	-	2,993	-	2,993
<b>Liabilities at fair value .....</b>	<b>4,616</b>	<b>2,993</b>	<b>-</b>	<b>7,609</b>

Transfers from Level 2 to Level 1 amounted to ISK 69 million during the period (2015: ISK 8,106 million). There have been no transfers from Level 1 to Level 2 during the period (2015: none).

The level of the fair value hierarchy of assets is determined at the end of each reporting period.

<i>Movements in Level 3 assets measured at fair value</i>	Investment property		Financial assets		Total	
	30.9.2016	31.12.2015	30.9.2016	31.12.2015	30.9.2016	31.12.2015
Balance at the beginning of the year .....	7,542	6,842	6,056	1,276	13,598	8,118
Net fair value changes .....	25	422	2,822	5,857	2,847	6,279
Additions .....	618	1,026	-	77	618	1,103
Disposal .....	(1,664)	(843)	(8,764)	(1,154)	(10,428)	(1,997)
Disposals through the sale of a subsidiary .....	(1,408)	-	-	-	(1,408)	-
Transfers into Level 3 .....	-	95	13	-	13	95
Transfers out of Level 3 .....	-	-	(12)	-	(12)	-
<b>Balance at the end of the period .....</b>	<b>5,113</b>	<b>7,542</b>	<b>115</b>	<b>6,056</b>	<b>5,228</b>	<b>13,598</b>

<i>Line items where effects of Level 3 assets are recognised in the Interim Statement of Comprehensive Income</i>	2016		2015	
	1.1.-30.9.	1.1.-30.9.	1.1.-30.9.	1.1.-30.9.
Net interest income .....	2	21		
Net financial income .....	5,250	(17)		
Other operating income .....	454	762		
Net loss on AFS financial assets, net of tax .....	(2,903)	-		
<b>Effects recognised in the Statement of Comprehensive Income .....</b>	<b>2,803</b>	<b>766</b>		

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 22. Fair value hierarchy, continued

*Carrying values and fair values of financial assets and financial liabilities not carried at fair value*

30.9.2016	Carrying value	Fair value	Unrealised gain (loss)
<i>Financial assets not carried at fair value</i>			
Cash and balances with Central bank .....	85,645	85,645	-
Loans to credit institutions .....	68,257	68,257	-
Loans to customers .....	715,907	719,666	3,759
Other financial assets .....	10,091	10,091	-
<b>Financial assets not carried at fair value .....</b>	<b>879,900</b>	<b>883,659</b>	<b>3,759</b>
<i>Financial liabilities not carried at fair value</i>			
Due to credit institutions and Central bank .....	9,375	9,375	-
Deposits .....	431,929	431,929	-
Borrowings .....	326,754	341,049	(14,295)
Other financial liabilities .....	34,826	34,826	-
<b>Financial liabilities not carried at fair value .....</b>	<b>802,884</b>	<b>817,179</b>	<b>(14,295)</b>
31.12.2015			
<i>Financial assets not carried at fair value</i>			
Cash and balances with Central bank .....	48,102	48,102	-
Loans to credit institutions .....	87,491	87,491	-
Loans to customers .....	680,350	688,196	7,846
Other financial assets .....	4,581	4,581	-
<b>Financial assets not carried at fair value .....</b>	<b>820,524</b>	<b>828,370</b>	<b>7,846</b>
<i>Financial liabilities not carried at fair value</i>			
Due to credit institutions and Central bank .....	11,387	11,387	-
Deposits .....	469,347	469,347	-
Borrowings .....	256,058	264,839	(8,781)
Subordinated liabilities .....	10,365	10,365	-
Other financial liabilities .....	38,667	38,667	-
<b>Financial liabilities not carried at fair value .....</b>	<b>785,824</b>	<b>794,605</b>	<b>(8,781)</b>

Financial assets and financial liabilities predominantly bear interest at floating rates. For assets and liabilities not at floating rates fair value is determined by Level 2 methods for which the valuation input is market observable interest rates.

Retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account mortgaging. Defaulted loans are presented at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value. Other loans, including corporate loans, are presented at book value as they are generally of a shorter duration than retail mortgages and the interest rate risk on them is therefore limited.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 22. Fair value hierarchy, continued

<i>Derivatives</i>	Notional value	Fair value	
		Assets	Liabilities
30.9.2016			
Forward exchange rate agreements, unlisted .....	46,540	224	495
Interest rate and exchange rate agreements, unlisted .....	148,093	3,418	1,126
Bond swap agreements, unlisted .....	2,451	16	9
Share swap agreements, unlisted .....	9,727	1,273	522
Options - purchased agreements, unlisted .....	88	22	108
<b>Derivatives</b> .....	<b>206,899</b>	<b>4,953</b>	<b>2,260</b>
31.12.2015			
Forward exchange rate agreements, unlisted .....	49,435	231	287
Interest rate and exchange rate agreements, unlisted .....	103,369	1,948	710
Bond swap agreements, unlisted .....	3,811	43	28
Share swap agreements, unlisted .....	13,099	178	1,934
Options - purchased agreements, unlisted .....	66	1	34
<b>Derivatives</b> .....	<b>169,780</b>	<b>2,401</b>	<b>2,993</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 23. Offsetting financial assets and financial liabilities

*Financial assets subject to enforceable master netting arrangements and similar arrangements*

	Assets subject to netting arrangements			Netting potential not recognized in the balance sheet		Assets after consideration of netting potential	Assets not subject to enforceable netting arrangements	Total assets recognised on balance sheet
	Gross assets before balance sheet	Balance sheet nettings with gross	Assets recognised on balance	Financial	Collateral received			
30.9.2016								
Reverse repurchase agreements .....	18,784	(540)	18,244	(2,926)	-	15,318	-	18,244
Derivatives .....	2,832	-	2,832	(662)	-	2,170	2,121	4,953
<b>Total assets .....</b>	<b>21,616</b>	<b>(540)</b>	<b>21,076</b>	<b>(3,588)</b>	<b>-</b>	<b>17,488</b>	<b>2,121</b>	<b>23,197</b>
31.12.2015								
Reverse repurchase agreements .....	22,100	(490)	21,610	(4,929)	-	16,681	-	21,610
Derivatives .....	964	-	964	(400)	-	564	1,437	2,401
<b>Total assets .....</b>	<b>23,064</b>	<b>(490)</b>	<b>22,574</b>	<b>(5,329)</b>	<b>-</b>	<b>17,245</b>	<b>1,437</b>	<b>24,011</b>

*Financial liabilities subject to enforceable master netting arrangements and similar arrangements*

	Liabilities subject to netting arrangements			Netting potential not recognized in the balance sheet		Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arrangements	Total liabilities recognised on balance sheet
	Gross liabilities before balance sheet	Balance sheet nettings with gross	Liabilities recognised on balance	Financial	Collateral pledged			
30.9.2016								
Repurchase agreements .....	2,926	-	2,926	(2,926)	-	-	-	2,926
Derivatives .....	2,491	-	2,491	(662)	-	1,829	(231)	2,260
<b>Total liabilities .....</b>	<b>5,417</b>	<b>-</b>	<b>5,417</b>	<b>(3,588)</b>	<b>-</b>	<b>1,829</b>	<b>(231)</b>	<b>5,186</b>
31.12.2015								
Repurchase agreements .....	4,929	-	4,929	(4,929)	-	-	-	4,929
Derivatives .....	400	-	400	(400)	-	-	2,593	2,993
<b>Total liabilities .....</b>	<b>5,329</b>	<b>-</b>	<b>5,329</b>	<b>(5,329)</b>	<b>-</b>	<b>-</b>	<b>2,593</b>	<b>7,922</b>

Accounting policies for offsetting are provided in Note 54 in the Annual Financial Statements for 2015.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 24. Investments in associates

<i>The Group's interest in its principal associates</i>	30.9.2016	31.12.2015
Auðkenni hf., Borgartún 31, Reykjavík, Iceland .....	22.4%	22.4%
Bakkavor Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom .....	-	46.0%
Farice ehf., Smáratorg 3, Kópavogur, Iceland .....	39.3%	39.3%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland .....	23.0%	23.0%
Urriðaland ehf., Laugavegur 182, Reykjavík, Iceland .....	41.4%	41.4%
220 Fjörður ehf., Fjarðargötu 13-15, Hafnarfjörður, Iceland .....	38.5%	38.5%
<i>Investments in associates</i>		
Carrying amount at the beginning of the year .....	27,299	21,966
Acquisitions .....	13	262
Dividend received .....	(41)	(611)
Transfers .....	-	(6,458)
Disposals .....	(27,112)	(17,148)
Exchange difference .....	-	(178)
Share of profit of associates and reversal of impairment .....	710	29,466
<b>Investment in associates</b> .....	<b>869</b>	<b>27,299</b>

In January 2016 the Bank's subsidiary BG12 slhf. sold its entire shareholding in Bakkavor Group Ltd. The main effect related to the sale was a valuation change recognised in the Statement of Comprehensive Income in 2015. During the period the total effects from the sale through the Statement of Comprehensive Income was ISK 498 million.

The Group accounts for investments in associates based on the equity method less applicable impairment. The impairment testing uses management valuation techniques and assumptions such as EBITDA multiples. Alternative assumptions could potentially result in significantly different carrying values but the management is of the opinion that the impaired value is based on the most probable outcomes under current market conditions.

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## 25. Intangible assets

Intangible assets comprise four categories: Goodwill, Infrastructure, Customer relationships and related agreements and Software. Goodwill arises on the acquisition of subsidiaries. Infrastructure and Customer relationships and related agreements originate as a premium in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Group's operations.

	Goodwill	Infra-structure	Customer relationship and related agreements	Software	Total
30.9.2016					
Balance at the beginning of the year .....	2,407	3,021	854	3,003	9,285
Acquisition through business combination .....	33	-	-	33	66
Additions and transfers .....	1,943	-	110	480	2,533
Additions, internally developed .....	-	-	-	286	286
Exchange difference .....	(322)	-	(20)	(112)	(454)
Amortisation .....	-	-	(165)	(474)	(639)
<b>Intangible assets .....</b>	<b>4,061</b>	<b>3,021</b>	<b>779</b>	<b>3,216</b>	<b>11,077</b>
31.12.2015					
Balance at the beginning of the year .....	2,171	3,046	1,539	2,840	9,596
Additions and transfers .....	506	-	(435)	530	601
Additions, internally developed .....	-	-	-	289	289
Exchange difference .....	(270)	-	(40)	(57)	(367)
Impairment .....	-	(25)	(2)	-	(27)
Amortisation .....	-	-	(208)	(599)	(807)
<b>Intangible assets .....</b>	<b>2,407</b>	<b>3,021</b>	<b>854</b>	<b>3,003</b>	<b>9,285</b>

## 26. Tax assets and tax liabilities

	30.9.2016		31.12.2015	
	Assets	Liabilities	Assets	Liabilities
Current tax .....	-	5,443	-	3,272
Deferred tax .....	241	311	205	1,650
<b>Tax assets and tax liabilities .....</b>	<b>241</b>	<b>5,754</b>	<b>205</b>	<b>4,922</b>

## 27. Other assets

	30.9.2016	31.12.2015
Non-current assets and disposal groups held for sale .....	4,773	5,082
Property and equipment .....	6,856	6,766
Accounts receivable .....	5,333	2,433
Unsettled securities trading .....	1,982	685
Sundry assets .....	4,070	2,612
<b>Other assets .....</b>	<b>23,014</b>	<b>17,578</b>

Vast majority of the Non-current assets and disposal groups held for sale consist of real estates that are generally the result of foreclosures on companies and individuals.



## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

28. Other liabilities	30.9.2016	31.12.2015
Accounts payable .....	18,068	23,296
Provision for settled FX loans .....	-	2,882
Unsettled securities trading .....	727	754
Depositors' and investors' guarantee fund .....	2,866	2,873
Insurance claim .....	11,495	2,574
Withholding tax .....	517	1,643
Bank levy .....	5,007	2,811
Sundry liabilities .....	13,885	12,628
<b>Other liabilities</b> .....	<b>52,565</b>	<b>49,461</b>

29. Borrowings	First issued	Maturity	Maturity type	Terms of interest		
Covered bond in ISK .....	2013	2019	At maturity	Fixed, CPI linked, 2.50% .....	4,451	4,483
Covered bond in ISK .....	2014	2021	At maturity	Fixed, CPI linked, 3.50% .....	9,256	5,096
Covered bond in ISK .....	2015	2022	At maturity	Fixed, 6.50% .....	17,424	7,737
Covered bond in ISK .....	2014	2029	At maturity	Fixed, CPI linked, 3.50% .....	22,936	15,279
Covered bond in ISK .....	2006	2033	Amortizing	Fixed, CPI linked, 3.75% .....	16,836	17,108
Covered bond in ISK .....	2012	2034	Amortizing	Fixed, CPI linked, 3.60% .....	2,177	2,249
Covered bond in ISK .....	2008	2045	Amortizing	Fixed, CPI linked, 4.00% .....	6,199	6,182
Covered bond in ISK .....	2006	2048	Amortizing	Fixed, CPI linked, 3.75% .....	78,200	77,916
<b>Covered bonds</b> .....					<b>157,479</b>	<b>136,050</b>
Senior unsecured bond in NOK .....	2013	2016	At maturity	Floating, NIBOR +5.00% .....	-	1,547
Senior unsecured bond in USD .....	2016	2017	At maturity	Floating, 3 month LIBOR +1.93% ....	3,431	-
Senior unsecured bond in EUR .....	2009	2018	Amortizing	Floating, EURIBOR +1.00% .....	897	1,177
Senior unsecured bond in ISK .....	2010	2018	Amortizing	Floating, REIBOR +1.00% .....	1,365	1,600
Senior unsecured bond in EUR .....	2015	2018	At maturity	Fixed, 3.125% .....	38,980	43,350
Senior unsecured bond in EUR .....	2016	2019	At maturity	Fixed, 2.50% .....	38,718	-
Senior unsecured bond in RON .....	2016	2019	At maturity	Fixed, 3.80% .....	1,032	-
Senior unsecured bond in SEK .....	2016	2019	At maturity	Floating, 3 month STIBOR +2.65% ..	3,652	-
Senior unsecured bond in NOK .....	2015	2020	At maturity	Floating, NIBOR +2.95% .....	11,531	11,900
Senior unsecured bond in USD .....	2016	2023	At maturity	Floating, 3 month LIBOR +2.60% ....	56,723	-
<b>Bonds issued</b> .....					<b>156,329</b>	<b>59,574</b>
Central Bank, secured, various curr. ..	2010	2022	At maturity	Floating, LIBOR + 3.00% .....	-	56,024
Bills issued .....					12,616	4,081
Other .....					330	329
<b>Other loans/bills</b> .....					<b>12,946</b>	<b>60,434</b>
<b>Borrowings</b> .....					<b>326,754</b>	<b>256,058</b>

Book value of listed bonds was ISK 262,976 million at the end of the period (31.12.2015: ISK 196,927 million). Market value of those bonds was ISK 272,695 million (31.12.2015: ISK 205,720 million).

The Group did not repurchase own debts during the period (2015: ISK 10 billion).

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 30. Subordinated liabilities

	Issued	Maturity	Maturity type	Terms of interest	30.9.2016	31.12.2015
Tier II capital in various currencies ....	2010	2020	At maturity	Floating, EURIBOR/LIBOR + 5.00%	-	10,365
<b>Subordinated liabilities</b> .....					-	10,365

Arion Bank settled the subordinated liabilities with the Ministry of Finance with a prepayment in September.

### 31. Pledged assets

#### *Pledged assets against liabilities*

Assets, pledged as collateral against borrowings .....	192,225	222,046
Assets, pledged as collateral against loans from credit institutions and short positions .....	18,244	21,611
<b>Pledged assets against liabilities</b> .....	210,469	243,657

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 192 billion at the end of the period (31.12.2015: ISK 222 billion). At the end of the period those assets were pool of mortgage loans to individuals but at year end 2015 pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies. The book value of those borrowings was ISK 157 billion at the end of the period (31.12.2015: ISK 192 billion).

The Group has pledged bonds against short term lending from the Central Bank of Iceland and against short positions, related to swap agreements, to hedge market risk of those assets.

### 32. Equity

#### *Share capital and share premium*

According to the Bank'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 approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	30.9.2016	Number (million)	31.12.2015
Issued share capital .....	2,000	75,861	2,000	75,861

Share premium represents excess of payment above nominal value that Shareholders have paid for shares issued by Arion Bank hf.

<i>Other reserves</i>	30.9.2016	31.12.2015
Statutory reserve .....	1,637	1,637
Available-for-sale reserve .....	-	2,903
Foreign currency translation reserve .....	289	8
<b>Other reserves</b> .....	1,926	4,548

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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## OTHER INFORMATION

### 33. Legal matters

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, if appropriate, to account for any adverse effects which the claims may have on its financial standing. When the Group is of the opinion that it is to the detriment of the Group's case to disclose potential amounts relating to legal claims, it elects not to do so. At the end of the period, the Group had several unresolved legal claims.

#### Contingent liabilities

##### *Investigation and legal proceedings regarding alleged breaches of competition law*

The Icelandic Competition Authority (ICA) has opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including Arion Bank. The investigation was initiated by separate complaints from BYR hf. and MP Banki hf. made in 2010. The complaints from BYR hf. and MP Banki 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 ICA has sent the bank a letter proposing concluding the matter with an agreement. The Bank is looking into the conditions of the proposed agreement.

With a writ issued in June 2013, Kortabjónustan ehf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and Valitor hf. to the amount of ISK 1.2 billion plus interest, due to damage Kortabjónustan hf. contends the five parties caused the company due to violations of the Competition Act. The Bank has put forward its arguments in the case and has demanded the rejection of Kortabjónustan's claims. Kortabjónustan's court-appointed evaluator has given a report on Kortabjónustan's alleged loss. The Bank and other defendants in the case have demanded that a reassessment be carried out.

##### *Legal proceedings regarding damages*

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., have filed two cases against the Bank claiming damages in the amount of more than ISK 4 billion plus interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagið Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. The Bank believes it likely that it will be acquitted of the plaintiffs' claims in both cases and has not therefore made any provision.

In its judgment in case No. 612/2012, pronounced on 24 April 2013, the Supreme Court ruled that Valitor hf. had not been authorized to rescind an agreement between the company and Datacell ehf. In January 2015 Datacell ehf. and Sunshine Press Productions ehf. brought legal action against Valitor hf. for the payment of compensation relating to damage which the companies considered they had sustained on account of the aforementioned rescinding by Valitor hf. of the agreement. Court-appointed assessors were subsequently asked to assess the damage in question at the request of the plaintiffs. The assessors announced their conclusions in March 2016. Valitor hf. has filed a motion for dismissal of the case. If the district court will not approve of that motion then Valitor request for other court-appointed appraisers to gain a second opinion.

#### Other legal matters

##### *Mortgage documents*

Courts cases are being prosecuted against the Bank in which it is demanded that the mortgaging of part of a property be invalidated on the basis that the signature of the mortgagor on the mortgage documents was not correct. Recently the district court, in respect of a case which did not involve the Bank, invalidated a mortgage under similar circumstances to these. The Bank is assessing the possible impact of a negative outcome on the Bank's loan portfolio.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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### 33. Legal matters, continued

#### *The uncertainty regarding the book value of foreign currency loans*

Some uncertainty over the legality of FX loans has continued in 2016 and the Group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans. Although there is much more clarity in the matters of FX loans there still remains uncertainty regarding foreign currency linked loans in certain respects, such as regarding the recalculation of particular loans. Nevertheless, the Group considers its portfolio of foreign currency linked loans to be fully provisioned for the most likely outcome.

#### **Legal matters concluded**

In April 2013 the ICA imposed an ISK 500 million fine on Valitor hf. for abusing its dominant position on the payment card market and violating conditions set out in an earlier decision of the ICA. The Supreme Court ruled in April 2016 on upholding the ICA's decision from April 2013. Valitor paid the fine in 2013.

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## OFF BALANCE SHEET INFORMATION

### 34. Obligations

<i>Financial guarantees, unused overdraft and loan commitments the Group has granted its customers</i>	30.9.2016	31.12.2015
Financial guarantees .....	22,128	19,162
Unused overdrafts .....	46,311	42,100
Loan commitments .....	72,205	126,068

#### *Depositors' and Investors' Guarantee fund*

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. Even though the law has not been amended Icelandic bank's have made quarterly payments to a separate division within the fund since 2010. Despite this change in execution and due to uncertainty of the shape of future legislation the liability brought forward from previous years is not changed from the balance of ISK 2,669 million. The Group has granted the Fund a guarantee for obligations amounting to ISK 3,210 million.

### 35. Assets under management and under custody

30.9.2016 31.12.2015

Assets under management .....	1,008,543	996,648
Assets under custody .....	1,378,987	1,427,269

Assets under management represent the total market value of the financial assets which the Group manages on behalf of its customers.

The Group, acting as custodian, is responsible for safeguarding a firm's or individual's financial assets, hold in safekeeping securities such as stocks, bonds and securities funds, arrange the settlement of trades and movements of securities, process corporate actions such as income on bonds and dividends on shares; and pricing on securities.

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## RELATED PARTY

### 36. Related party

The Group has a related party relationship with Kaupskil ehf., being the ultimate controlling party with 87% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., being the parent company of Kaupskil ehf.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13% stake in Arion Bank and thus has influence over the Group. ISFI and related entities are defined as related parties.

The Board of Directors of Arion Bank and key Management personnel of the Bank are defined as related parties, as well as close family members of individuals referred to above and legal entities controlled by them. The Group's associates are also defined as related parties.

No unusual transactions took place with related parties during the period. Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

30.9.2016

	Assets	Liabilities	Net balance
<i>Balances with related parties</i>			
Shareholders with control over the Group .....	178	(7,814)	(7,636)
Board of Directors and key Management personnel .....	297	(65)	232
Associates and other related parties .....	164	(138)	26
<b>Balances with related parties .....</b>	<b>639</b>	<b>(8,017)</b>	<b>(7,378)</b>

31.12.2015

<i>Balances with related parties</i>			
Shareholders with control over the Group .....	212	(50,158)	(49,946)
Board of Directors and key Management personnel .....	232	(59)	173
Associates and other related parties .....	2,132	(241)	1,891
<b>Balances with related parties .....</b>	<b>2,576</b>	<b>(50,458)</b>	<b>(47,882)</b>

Through the ownership of ISFI the Group has a related party relationship with Landsbankinn hf. Landsbankinn hf. provides banking services to the Bank's subsidiary Valitor hf. and has a traditional bank to bank relationship with Arion Bank hf. The Group holds assets amounting to ISK 8,575 million (31.12.2015: ISK 14,038 million) by Landsbankinn hf. and liabilities amounting to ISK 1,677 million at the end of the period (31.12.2015: ISK 1,499 million). Those amounts are not included in the table above.

Kaupthing hf. holds senior unsecured bonds, issued by Arion Bank in January 2016, for the amount of ISK 56,723 million at the end of the period. This amount is not included in the table above.

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## RISK MANAGEMENT DISCLOSURES

The Group faces various risks arising from its day to day operations. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels.

Further information regarding risk management is available in the Annual Financial Statements for 2015 and in the Pillar 3 Risk Disclosures for 2015, published on the Bank's website, [www.arionbanki.is](http://www.arionbanki.is). The Pillar 3 Risk Disclosures are not audited.

### 37. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off-balance sheet items such as commitments and financial guarantees.

#### Exposure to credit risk

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

<i>Maximum exposure to credit risk related to on-balance sheet items</i>	30.9.2016	31.12.2015
Cash and balances with Central Bank .....	85,645	48,102
Loans to credit institutions .....	68,257	87,491
Loans to corporates .....	381,260	355,731
Loans to individuals .....	334,647	324,619
Financial instruments .....	93,032	86,770
Other assets with credit risk .....	10,091	4,581
<b>Total on-balance sheet maximum exposure to credit risk .....</b>	<b>972,932</b>	<b>907,294</b>
 <i>Maximum exposure to credit risk related to off-balance sheet items</i>		
Financial guarantees .....	22,128	19,162
Unused overdrafts .....	46,311	42,100
Loan commitments .....	72,205	126,068
<b>Total off-balance sheet maximum exposure to credit risk .....</b>	<b>140,644</b>	<b>187,330</b>
<b>Maximum exposure to credit risk .....</b>	<b>1,113,576</b>	<b>1,094,624</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 37. Credit risk, continued

<i>Loans to customers specified by sectors</i>	30.9.2016	31.12.2015
Individuals .....	46.7%	47.7%
Real estate activities and construction .....	15.8%	15.1%
Fishing industry .....	11.1%	11.1%
Information and communication technology .....	4.1%	4.7%
Wholesale and retail trade .....	8.0%	7.6%
Financial and insurance activities .....	4.9%	4.9%
Industry, energy and manufacturing .....	4.0%	3.1%
Transportation .....	0.8%	0.9%
Services .....	2.5%	2.9%
Public sector .....	1.3%	1.2%
Agriculture and forestry .....	0.8%	0.8%
	100.0%	100.0%

#### Collateral and other credit enhancements

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- Retail loans to individuals: Mortgages on residential properties.
- Corporate loans: Real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

The value of collateral is based on estimated market value. The valuation of real estate is built on market price, official valuation of the Icelandic Property Registry, or the opinion of internal or external specialists. The valuation of fishing vessels takes into account related fishing quota.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses.

The collateral value in the table below is capped by the exposure amount.

#### *Collateral held against different types of financial assets*

	Cash and securities	Real estate	Fishing vessels	Other collateral	Total
30.9.2016					
Cash and balances with Central Bank .....	-	-	-	-	-
Loans to credit institutions .....	-	-	-	-	-
Loans to customers					
Individuals .....	574	294,608	8	5,598	300,788
Real estate activities and construction .....	519	104,872	28	1,066	106,485
Fishing industry .....	69	8,068	60,280	6,242	74,659
Information and communication technology .....	189	2,397	-	18,770	21,356
Wholesale and retail trade .....	346	24,378	2	20,564	45,290
Financial and insurance activities .....	15,478	6,662	203	770	23,113
Industry, energy and manufacturing .....	3,442	15,215	-	6,594	25,251
Transportation .....	46	850	218	1,332	2,446
Services .....	35	5,516	39	3,246	8,836
Public sector .....	65	3,911	-	84	4,060
Agriculture and forestry .....	5	4,823	-	165	4,993
Financial instruments .....	6,298	-	-	-	6,298
Financial guarantees .....	1,161	3,754	1,114	2,872	8,901
<b>Collateral held against different types of financial assets .....</b>	<b>28,227</b>	<b>475,054</b>	<b>61,892</b>	<b>67,303</b>	<b>632,476</b>



## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 37. Credit risk, continued

	Cash and securities	Real estates	Fishing vessels	Other collateral	Total
31.12.2015					
Cash and balances with Central Bank .....	-	-	-	-	-
Loans to credit institutions .....	-	-	-	-	-
Loans to customers					
Individuals .....	428	289,862	24	4,107	294,421
Real estate activities and construction .....	1,032	89,039	8	1,025	91,104
Fishing industry .....	53	7,956	57,945	7,037	72,991
Information and communication technology .....	76	2,369	-	18,630	21,075
Wholesale and retail trade .....	210	20,424	7	22,912	43,553
Financial and insurance activities .....	15,947	4,367	-	1,577	21,891
Industry, energy and manufacturing .....	461	12,792	3	4,416	17,672
Transportation .....	91	875	173	3,891	5,030
Services .....	13	4,847	40	2,623	7,523
Public sector .....	73	3,732	-	99	3,904
Agriculture and forestry .....	5	3,493	-	112	3,610
Financial instruments .....	7,474	-	-	-	7,474
Financial guarantees .....	885	4,232	623	1,445	7,185
<b>Collateral held against different types of financial assets .....</b>	<b>26,748</b>	<b>443,988</b>	<b>58,823</b>	<b>67,874</b>	<b>597,433</b>

#### Collateral repossessed

During the period the Group took possession of assets due to foreclosures. The total amount of real estates the Group took possession of during the period and still holds at period end amount to ISK 1,289 million (31.12.2015: ISK 2,761 million) and other assets ISK 8 million (31.12.2015: ISK 7 million). The assets are held for sale, see Note 27.

#### Credit quality

	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
30.9.2016				
Cash and balances with Central Bank .....	85,645	-	-	85,645
Loans to credit institutions .....	68,257	-	-	68,257
Loans to customers				
Loans to corporates .....	362,102	17,475	1,683	381,260
Loans to individuals .....	305,461	25,092	4,094	334,647
Financial instruments .....	86,198	-	-	86,198
Other assets with credit risk .....	10,091	-	-	10,091
<b>Credit quality by class of financial assets .....</b>	<b>917,754</b>	<b>42,567</b>	<b>5,777</b>	<b>966,098</b>
31.12.2015				
Cash and balances with Central Bank .....	48,102	-	-	48,102
Loans to credit institutions .....	87,491	-	-	87,491
Loans to customers				
Loans to corporates .....	337,153	17,302	1,276	355,731
Loans to individuals .....	291,277	26,532	6,810	324,619
Financial instruments .....	82,714	-	-	82,714
Other assets with credit risk .....	4,581	-	-	4,581
<b>Credit quality by class of financial assets .....</b>	<b>851,318</b>	<b>43,834</b>	<b>8,086</b>	<b>903,238</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 37. Credit risk, continued

#### *Neither past due nor impaired loans*

The Bank uses internal credit rating models to monitor the development of credit risk and to estimate customers' probability of default (PD). The Bank rates customers with one of three models. For large corporates the Bank uses quantitative information based on financial statements as well as qualitative data. Credit ratings of individuals and SMEs are based on statistical models using historical information which has been found to be predictive. The models are updated annually and recalibrated with current data with the aim of improving their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement.

The table below shows loans to customers that are neither past due nor impaired, broken down by the Bank's classification scale, where 5 denotes the highest risk.

30.9.2016	Risk classification					Not rated	Total
	1	2	3	4	5		
Individuals .....	62,281	162,100	55,677	17,190	4,580	3,633	305,461
Real estate activities and construction .....	41,249	30,765	23,690	5,416	389	4,958	106,467
Fishing industry .....	25,940	37,434	9,702	3,429	716	-	77,221
Information and communication technology .....	18,550	3,683	970	5,337	1	11	28,552
Wholesale and retail trade .....	11,005	20,048	18,544	2,419	192	1,733	53,941
Financial and insurance activities .....	11,475	3,143	8,566	221	-	10,966	34,371
Industry, energy and manufacturing .....	8,291	8,564	9,517	521	83	-	26,976
Transportation .....	985	3,447	537	(7)	20	533	5,515
Services .....	2,015	5,210	4,810	1,058	2,549	3	15,645
Public sector .....	357	4,561	2,016	1,040	55	679	8,708
Agriculture and forestry .....	478	1,124	2,173	608	21	302	4,706
<b>Neither past due nor impaired loans .....</b>	<b>182,626</b>	<b>280,079</b>	<b>136,202</b>	<b>37,232</b>	<b>8,606</b>	<b>22,818</b>	<b>667,563</b>
31.12.2015							
Individuals .....	54,822	148,472	63,027	18,553	4,693	1,710	291,277
Real estate activities and construction .....	36,550	23,792	29,776	3,790	154	3,279	97,341
Fishing industry .....	21,807	33,232	7,657	5,415	1,249	1,341	70,701
Information and communication technology .....	17,346	4,252	8,949	126	-	-	30,673
Wholesale and retail trade .....	9,447	18,356	18,260	2,064	198	33	48,358
Financial and insurance activities .....	3,012	17,784	11,308	223	-	456	32,783
Industry, energy and manufacturing .....	3,088	14,256	2,930	324	135	-	20,733
Transportation .....	3,320	1,094	1,040	274	28	-	5,756
Services .....	2,326	4,805	9,918	539	19	-	17,607
Public sector .....	357	3,396	2,342	1,038	133	545	7,811
Agriculture and forestry .....	336	1,558	2,887	609	-	-	5,390
<b>Neither past due nor impaired loans .....</b>	<b>152,411</b>	<b>270,997</b>	<b>158,094</b>	<b>32,955</b>	<b>6,609</b>	<b>7,364</b>	<b>628,430</b>

Exposures that are 'Not rated' are typically due to newly formed entities and entities for which the Bank's rating models are not applicable.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 37. Credit risk, continued

#### *Past due but not impaired loans by class of loans*

	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
30.9.2016						
Loans to corporates .....	4,428	7,549	2,169	839	2,490	17,475
Loans to individuals .....	3,193	9,845	5,767	591	5,696	25,092
<b>Past due but not impaired loans .....</b>	<b>7,621</b>	<b>17,394</b>	<b>7,936</b>	<b>1,430</b>	<b>8,186</b>	<b>42,567</b>
31.12.2015						
Loans to corporates .....	9,638	3,779	1,681	662	1,542	17,302
Loans to individuals .....	3,706	9,437	5,237	554	7,598	26,532
<b>Past due but not impaired loans .....</b>	<b>13,344</b>	<b>13,216</b>	<b>6,918</b>	<b>1,216</b>	<b>9,140</b>	<b>43,834</b>

Loans past due up to three days are mainly overdrafts that were not renewed in time. The majority of the past due but not impaired loans are considered fully secured with collateral or have been acquired at discount. Loans acquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

<i>Impaired loans to customers specified by sector</i>	30.9.2016		31.12.2015	
	Impair- ment amount	Gross carrying amount	Impair- ment amount	Gross carrying amount
Individuals .....	8,195	12,289	10,593	17,403
Real estate activities and construction .....	1,521	1,964	1,515	1,867
Fishing industry .....	515	614	257	373
Information and communication technology .....	377	392	308	332
Wholesale and retail trade .....	619	932	681	893
Financial and insurance activities .....	176	212	5,953	6,011
Industry, energy and manufacturing .....	1,267	1,384	828	1,025
Transportation .....	4,567	4,575	4,433	4,440
Services .....	3,167	3,710	504	682
Public sector .....	64	64	143	215
Agriculture and forestry .....	175	284	126	186
<b>Impaired loans to customers specified by sector .....</b>	<b>20,643</b>	<b>26,420</b>	<b>25,341</b>	<b>33,427</b>

#### **Large exposure**

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's capital base according to FME rule No. 625/2013. The legal maximum for individual large exposures is 25% of the capital base, net of eligible collateral.

The Group has no large exposure at the end of the period before taking account of eligible collateral (31.12.2015: One large exposure of ISK 22 billion without eligible collateral).

No.	30.9.2016		31.12.2015	
	Gross	Net	Gross	Net
1 .....	<10%	<10%	11%	11%
<b>Sum of large exposure gross and net &gt; 10% .....</b>	<b>0%</b>	<b>0%</b>	<b>11%</b>	<b>11%</b>

No large exposure exceeds the legal limit of 25% of the Group's capital base at the end of the period.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 38. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments.

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

#### Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair value of financial instruments. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities. This mismatch is characterised by a gap between the interest fixing period of assets and liabilities, with a large amount of liabilities being demand deposits while the interest rates of assets are predominantly fixed to some extent, resulting in a repricing risk for the Group. The Group also faces interest basis risk between interest bearing assets and interest bearing liabilities due to different types of floating rate indices in different currencies.

#### Interest rate risk in the banking book

The following table shows the Group's interest bearing assets and liabilities by interest fixing periods. The figures for loans to customers and borrowings are shown on a fair value basis, see Note 22, and are therefore different from the amounts shown in these Interim Financial Statements. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category.

30.9.2016	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
<b>Assets</b>						
Balances with Central Bank .....	78,162	-	-	-	-	78,162
Loans to credit institutions .....	68,257	-	-	-	-	68,257
Loans to customers .....	388,982	60,646	134,838	3,835	131,365	719,666
Financial instruments .....	46,195	1,942	6,213	6,496	2,591	63,437
<b>Assets</b> .....	<b>581,596</b>	<b>62,588</b>	<b>141,051</b>	<b>10,331</b>	<b>133,956</b>	<b>929,522</b>
<b>Liabilities</b>						
Due to credit institutions and Central Bank .....	9,344	-	31	-	-	9,375
Deposits .....	378,046	39,417	12,315	1,348	803	431,929
Borrowings .....	86,106	8,430	85,768	27,906	132,839	341,049
<b>Liabilities</b> .....	<b>473,496</b>	<b>47,847</b>	<b>98,114</b>	<b>29,254</b>	<b>133,642</b>	<b>782,353</b>
Derivatives and other off-balance sheet items (net position) ..	(81,495)	-	83,694	-	-	2,199
<b>Net interest gap</b> .....	<b>26,605</b>	<b>14,741</b>	<b>126,631</b>	<b>(18,923)</b>	<b>314</b>	<b>149,368</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 38. Market risk, continued

31.12.2015	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
<i>Assets</i>						
Balances with Central Bank .....	43,181	-	-	-	-	43,181
Loans to credit institutions .....	87,491	-	-	-	-	87,491
Loans to customers .....	347,571	64,594	127,907	5,255	142,869	688,196
Financial instruments .....	43,925	10,002	8,556	7,786	242	70,511
<b>Assets .....</b>	<b>522,168</b>	<b>74,596</b>	<b>136,463</b>	<b>13,041</b>	<b>143,111</b>	<b>889,379</b>
<i>Liabilities</i>						
Due to credit institutions and Central Bank .....	11,387	-	-	-	-	11,387
Deposits .....	464,998	3,501	848	-	-	469,347
Borrowings .....	72,010	4,509	48,705	12,982	126,633	264,839
Subordinated liabilities .....	10,365	-	-	-	-	10,365
<b>Liabilities .....</b>	<b>558,760</b>	<b>8,010</b>	<b>49,553</b>	<b>12,982</b>	<b>126,633</b>	<b>755,938</b>
Derivatives and other off-balance sheet items (net position) ..	(46,330)	(1,802)	49,346	-	-	1,214
<b>Net interest gap .....</b>	<b>(82,922)</b>	<b>64,784</b>	<b>136,256</b>	<b>59</b>	<b>16,478</b>	<b>134,655</b>

#### Interest rate risk in the trading book

The following table shows the total basis point value (BPV) of the Group's bond and derivatives in the trading book at market value (MV). BPV denotes the change in value given a basis point (0.01%) yield change.

<i>Trading financial instruments, long positions</i>	30.9.2016			31.12.2015		
	MV	Duration	BPV	MV	Duration	BPV
ISK, CPI Indexed linked .....	4,757	2.9	(1.4)	4,544	3.6	(1.6)
ISK, Non Indexed linked .....	9,818	(0.5)	0.5	5,849	(1.8)	1.1
FX .....	83,327	(0.5)	4.3	64,226	(0.6)	3.9
<b>Total .....</b>	<b>97,902</b>	<b>(0.3)</b>	<b>3.4</b>	<b>74,619</b>	<b>(0.5)</b>	<b>3.4</b>
<i>Trading financial instruments, short positions</i>						
ISK, CPI Indexed linked .....	439	4.1	(0.2)	393	9.7	(0.4)
ISK, Non Indexed linked .....	10,198	0.3	(0.3)	7,953	0.3	(0.3)
FX .....	80,697	(0.4)	3.6	64,172	(0.5)	2.9
<b>Total .....</b>	<b>91,334</b>	<b>(0.3)</b>	<b>3.1</b>	<b>72,518</b>	<b>(0.3)</b>	<b>2.3</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 38. Market risk, continued

#### Indexation risk

The Group is exposed to indexation risk when there is a mismatch between index-linked assets and liabilities.

Transaction maturity profile of indexed assets and liabilities

30.9.2016	Up to 1 year	1 to 5 years	Over 5 years	Total
<i>Assets, CPI indexed linked</i>				
Loans to customers .....	13,508	96,302	213,824	323,634
Financial instruments .....	6,399	-	-	6,399
Off-balance sheet position .....	852	6,543	-	7,395
<b>Assets, CPI indexed linked .....</b>	<b>20,759</b>	<b>102,845</b>	<b>213,824</b>	<b>337,428</b>
<i>Liabilities, CPI indexed linked</i>				
Deposits .....	71,617	12,026	2,114	85,757
Borrowings .....	2,222	14,547	123,616	140,385
Other .....	395	686	798	1,879
<b>Liabilities, CPI indexed linked .....</b>	<b>74,234</b>	<b>27,259</b>	<b>126,528</b>	<b>228,021</b>
Net on-balance sheet position .....	(54,327)	69,043	87,296	102,012
Net off-balance sheet position .....	852	6,543	-	7,395
<b>CPI Balance .....</b>	<b>(53,475)</b>	<b>75,586</b>	<b>87,296</b>	<b>109,407</b>
31.12.2015				
<i>Assets, CPI indexed linked</i>				
Loans to customers .....	13,629	76,393	209,485	299,507
Financial instruments .....	3,412	-	-	3,412
Off-balance sheet position .....	749	7,940	-	8,689
<b>Assets, CPI indexed linked .....</b>	<b>17,790</b>	<b>84,333</b>	<b>209,485</b>	<b>311,608</b>
<i>Liabilities, CPI indexed linked</i>				
Deposits .....	72,352	12,899	1,916	87,167
Borrowings .....	2,128	14,164	112,350	128,642
Off-balance sheet position .....	-	-	782	782
<b>Liabilities, CPI indexed linked .....</b>	<b>74,480</b>	<b>27,063</b>	<b>115,048</b>	<b>216,591</b>
Net on-balance sheet position .....	(57,439)	49,330	94,437	86,328
Net off-balance sheet position .....	749	7,940	-	8,689
<b>CPI Balance .....</b>	<b>(56,690)</b>	<b>57,270</b>	<b>94,437</b>	<b>95,017</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 38. Market risk, continued

#### Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Group is exposed to currency risk through a currency mismatch between assets and liabilities. ISK denominated deposits are a primary source of funding for the Group whereas a substantial part of the Group's assets consists of foreign currency denominated loans to customers. Net exposures per currency are monitored centrally in the Bank.

#### Breakdown of assets and liabilities by currency

30.9.2016

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	84,407	333	346	180	87	36	256	85,645
Loans to credit institutions .....	24,528	10,662	10,534	6,260	2,100	8,279	5,894	68,257
Loans to customers .....	589,563	66,275	36,896	3,227	7,831	5	12,110	715,907
Financial instruments .....	95,760	18,337	9,634	1,089	179	3,331	27	128,357
Investment property .....	5,113	-	-	-	-	-	-	5,113
Investments in associates .....	869	-	-	-	-	-	-	869
Intangible assets .....	7,849	-	-	-	3,228	-	-	11,077
Tax assets .....	241	-	-	-	-	-	-	241
Other assets .....	21,787	666	413	85	30	31	2	23,014
<b>Assets .....</b>	<b>830,117</b>	<b>96,273</b>	<b>57,823</b>	<b>10,841</b>	<b>13,455</b>	<b>11,682</b>	<b>18,289</b>	<b>1,038,480</b>
<i>Liabilities and equity</i>								
Due to credit inst. and Central Bank ..	7,022	2,211	64	3	-	1	74	9,375
Deposits .....	400,682	13,164	9,190	5,660	978	1,418	837	431,929
Financial liabilities at fair value .....	4,092	543	70	1	-	266	125	5,097
Tax liabilities .....	5,512	-	-	-	242	-	-	5,754
Other liabilities .....	42,312	4,785	2,233	1,986	572	245	432	52,565
Borrowings .....	172,822	78,595	60,154	-	-	11,531	3,652	326,754
Subordinated liabilities .....	-	-	-	-	-	-	-	-
Shareholders' equity .....	206,940	-	-	-	-	-	-	206,940
Non-controlling interest .....	66	-	-	-	-	-	-	66
<b>Liabilities and equity .....</b>	<b>839,448</b>	<b>99,298</b>	<b>71,711</b>	<b>7,650</b>	<b>1,792</b>	<b>13,461</b>	<b>5,120</b>	<b>1,038,480</b>
Net on-balance sheet position .....	(9,331)	(3,025)	(13,888)	3,191	11,663	(1,779)	13,169	
Net off-balance sheet position .....	8,125	3,309	13,825	(3,301)	(9,433)	1,541	(14,066)	
<b>Net position .....</b>	<b>(1,206)</b>	<b>284</b>	<b>(63)</b>	<b>(110)</b>	<b>2,230</b>	<b>(238)</b>	<b>(897)</b>	

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 38. Market risk, continued

31.12.2015

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	47,357	252	167	37	96	37	156	48,102
Loans to credit institutions .....	20,923	24,741	19,478	7,260	3,182	4,125	7,782	87,491
Loans to customers .....	568,196	44,532	37,395	6,487	11,357	9	12,374	680,350
Financial instruments .....	84,752	24,852	13,227	6,145	63	3,248	904	133,191
Investment property .....	7,542	-	-	-	-	-	-	7,542
Investments in associates .....	1,043	-	-	26,256	-	-	-	27,299
Intangible assets .....	5,575	-	-	-	3,710	-	-	9,285
Tax assets .....	205	-	-	-	-	-	-	205
Other assets .....	16,711	482	170	177	22	14	2	17,578
<b>Assets .....</b>	<b>752,304</b>	<b>94,859</b>	<b>70,437</b>	<b>46,362</b>	<b>18,430</b>	<b>7,433</b>	<b>21,218</b>	<b>1,011,043</b>
<i>Liabilities and equity</i>								
Due to credit inst. and Central Bank ..	9,471	381	74	6	1	-	1,454	11,387
Deposits .....	388,228	18,041	50,913	6,865	1,523	2,156	1,621	469,347
Financial liabilities at fair value .....	6,791	584	104	10	4	-	116	7,609
Tax liabilities .....	4,500	-	-	-	422	-	-	4,922
Other liabilities .....	41,098	2,648	1,484	1,432	832	347	1,620	49,461
Borrowings .....	142,060	44,526	33,442	8,511	-	13,447	14,072	256,058
Subordinated liabilities .....	-	3,942	2,603	3,820	-	-	-	10,365
Shareholders' equity .....	192,786	-	-	-	-	-	-	192,786
Non-controlling interest .....	9,108	-	-	-	-	-	-	9,108
<b>Liabilities and equity .....</b>	<b>794,042</b>	<b>70,122</b>	<b>88,620</b>	<b>20,644</b>	<b>2,782</b>	<b>15,950</b>	<b>18,883</b>	<b>1,011,043</b>
Net on-balance sheet position .....	(41,738)	24,737	(18,183)	25,718	15,648	(8,517)	2,335	
Net off-balance sheet position .....	9,619	(13,684)	20,273	(1,470)	(17,856)	5,481	(2,363)	
<b>Net position .....</b>	<b>(32,119)</b>	<b>11,053</b>	<b>2,090</b>	<b>24,248</b>	<b>(2,208)</b>	<b>(3,036)</b>	<b>(28)</b>	



## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 39. Liquidity and Funding risk

Liquidity risk is defined as the risk that the Group, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

#### Maturity gap analysis

Group's assets and liabilities at carrying amount by residual maturity

30.9.2016	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
<b>Assets</b>							
Cash and balances with Central Bank .....	85,645	76,250	-	9,395	-	-	-
Loans to credit institutions .....	68,257	33,013	31,688	3,556	-	-	-
Loans to customers .....	715,907	10,411	57,454	83,666	253,381	310,995	-
Financial instruments .....	128,357	11,237	5,812	3,936	51,741	13,471	42,160
<i>Derivatives - assets leg</i> .....	64,134	-	11,570	27,638	24,392	534	-
<i>Derivatives - liabilities leg</i> .....	(59,181)	-	(10,313)	(27,014)	(21,591)	(263)	-
Investment property .....	5,113	-	-	-	-	-	5,113
Investments in associates .....	869	-	-	-	-	-	869
Intangible assets .....	11,077	-	-	-	-	-	11,077
Tax assets .....	241	-	-	-	241	-	-
Other assets .....	23,014	2,296	5,885	1,199	711	-	12,923
<b>Assets</b> .....	<b>1,038,480</b>	<b>133,207</b>	<b>100,839</b>	<b>101,752</b>	<b>306,074</b>	<b>324,466</b>	<b>72,142</b>
<b>Liabilities</b>							
Due to credit institutions and Central Bank .....	9,375	9,316	-	34	25	-	-
Deposits .....	431,929	288,634	87,987	40,856	12,334	2,118	-
Financial liabilities at fair value .....	5,097	-	3,466	578	714	339	-
<i>Derivatives - assets leg</i> .....	(49,691)	-	(4,424)	(36,428)	(8,445)	(394)	-
<i>Derivatives - liabilities leg</i> .....	51,951	-	5,053	37,006	9,159	733	-
<i>Short position bonds and derivatives</i> .....	1,845	-	1,845	-	-	-	-
<i>Short position securities used for hedging</i> .....	992	-	992	-	-	-	-
Tax liabilities .....	5,754	-	349	5,094	311	-	-
Other liabilities .....	52,565	16,303	11,952	1,305	5,260	6	17,739
Borrowings .....	326,754	-	6,848	11,839	111,896	196,171	-
<b>Liabilities</b> .....	<b>831,474</b>	<b>314,253</b>	<b>110,602</b>	<b>59,706</b>	<b>130,540</b>	<b>198,634</b>	<b>17,739</b>
<b>Off-balance sheet items</b>							
Financial guarantees .....	22,128	2,863	2,225	7,410	2,648	6,982	-
Unused overdraft .....	46,311	937	9,439	17,834	18,101	-	-
Loan commitments .....	72,205	36	16,402	14,618	36,163	4,986	-
<b>Off-balance sheet items</b> .....	<b>140,644</b>	<b>3,836</b>	<b>28,066</b>	<b>39,862</b>	<b>56,912</b>	<b>11,968</b>	<b>-</b>
<b>Net assets (liabilities)</b> .....	<b>66,362</b>	<b>(184,882)</b>	<b>(37,829)</b>	<b>2,184</b>	<b>118,622</b>	<b>113,864</b>	<b>54,403</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 39. Liquidity and Funding risk, continued

31.12.2015	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
<b>Assets</b>							
Cash and balances with Central Bank .....	48,102	35,467	-	12,635	-	-	-
Loans to credit institutions .....	87,491	50,151	37,340	-	-	-	-
Loans to customers .....	680,350	3,984	42,429	90,014	234,035	309,888	-
Financial instruments .....	133,191	4,765	1,711	10,861	54,392	10,985	50,477
<i>Derivatives - assets leg</i> .....	56,171	-	24,671	1,478	29,509	513	-
<i>Derivatives - liabilities leg</i> .....	(53,770)	-	(24,262)	(1,421)	(27,688)	(399)	-
Investment property .....	7,542	-	-	-	-	-	7,542
Investments in associates .....	27,299	-	-	-	-	-	27,299
Intangible assets .....	9,285	-	-	-	-	-	9,285
Tax assets .....	205	-	-	-	205	-	-
Other assets .....	17,578	1,017	2,592	174	793	-	13,002
<b>Assets</b> .....	<b>1,011,043</b>	<b>95,384</b>	<b>84,072</b>	<b>113,684</b>	<b>289,425</b>	<b>320,873</b>	<b>107,605</b>
<b>Liabilities</b>							
Due to credit institutions and Central Bank .....	11,387	9,881	-	1,481	25	-	-
Deposits .....	469,347	268,727	95,191	89,937	13,575	1,917	-
Financial liabilities at fair value .....	7,609	-	6,346	536	631	96	-
<i>Derivatives - assets leg</i> .....	(49,199)	-	(36,552)	(5,662)	(6,518)	(467)	-
<i>Derivatives - liabilities leg</i> .....	52,192	-	38,282	6,198	7,149	563	-
<i>Short position bonds and derivatives</i> .....	1,309	-	1,309	-	-	-	-
<i>Short position bonds used for hedging</i> .....	3,307	-	3,307	-	-	-	-
Tax liabilities .....	4,922	-	-	3,274	1,648	-	-
Other liabilities .....	49,461	17,002	14,724	5,192	3,529	6	9,008
Borrowings .....	256,058	-	7,081	4,308	69,933	174,736	-
Subordinated liabilities .....	10,365	-	-	-	3,942	6,423	-
<b>Liabilities</b> .....	<b>809,149</b>	<b>295,610</b>	<b>123,342</b>	<b>104,728</b>	<b>93,283</b>	<b>183,178</b>	<b>9,008</b>
<b>Off-balance sheet items</b>							
Financial guarantees .....	19,162	3,402	2,371	7,589	3,954	1,846	-
Unused overdraft .....	42,100	842	10,071	14,984	15,768	435	-
Loan commitments .....	126,068	-	50,628	35,542	34,506	5,392	-
<b>Off-balance sheet items</b> .....	<b>187,330</b>	<b>4,244</b>	<b>63,070</b>	<b>58,115</b>	<b>54,228</b>	<b>7,673</b>	<b>-</b>
<b>Net assets (liabilities)</b> .....	<b>14,564</b>	<b>(204,470)</b>	<b>(102,340)</b>	<b>(49,159)</b>	<b>141,914</b>	<b>130,022</b>	<b>98,597</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 39. Liquidity and Funding risk, continued

#### Net Stable Funding Ratio

The net stable funding ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per the definition of the Central Bank of Iceland rules No. 1032. In general, RSF is determined by applying different weights to different asset classes depending on the level of liquidity. ASF however is calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness. In 2016, the ratio for foreign currency shall be at least 90% and from 2017 the ratio shall exceed 100%.

Calculations of the NSFR are based on consolidated figures for the Bank and Arion Bank Mortgages Institutional Investor Fund. When calculating the FX ratio, a negative FX imbalance is subtracted from the numerator and a positive FX imbalance is subtracted from the denominator. The FX imbalance discrepancy between the Group's official FX imbalance and the imbalance reported in the NSFR is due to the fact that the Bank's subsidiaries have a substantial positive FX imbalance but are settled in ISK.

	ISK	FX	Total
30.9.2016			
Available stable funding .....	609,285	167,542	776,827
Required stable funding .....	547,024	94,140	641,164
FX imbalance .....		1,293	
<b>Net stable funding ratio .....</b>	<b>111%</b>	<b>180%</b>	<b>121%</b>
31.12.2015			
Available stable funding .....	540,864	129,273	670,137
Required stable funding .....	539,841	95,511	635,352
FX imbalance .....		(11,363)	
<b>Net stable funding ratio .....</b>	<b>100%</b>	<b>123%</b>	<b>105%</b>

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## 39. Liquidity and Funding risk, continued

### Liquidity coverage ratio

The liquidity coverage ratio (LCR) is part of the standards introduced in the Basel III Accord. The LCR is the result of a stress test that is designed to ensure that banks have the necessary assets on hand to withstand short-term liquidity disruptions. More accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, assets must be non-pledged, liquid and easily priced on the market, repoable at the Central Bank and not issued by the Group or related entities.

The Central Bank has set rules for minimum LCR. In 2016 the LCR requirement is 100% in foreign currency and 90% in total (ISK and foreign currency). The latter requirement will be 100% from 2017.

The following table shows the breakdown for the Group's LCR calculations broken down on currencies; ISK, FX and total. All amounts are weighted by their respective LCR weights as defined by the Central Bank.

	ISK	FX	Total
30.9.2016			
Liquid assets level 1 *	140,685	15,706	156,391
Liquid assets level 2 **	-	4,971	4,971
<b>Liquid Assets</b>	<b>140,685</b>	<b>20,677</b>	<b>161,362</b>
Deposits	102,233	15,022	117,255
Market Borrowing	3,648	585	4,233
Other Cash outflows	12,312	6,599	18,911
<b>Cash outflows</b>	<b>118,193</b>	<b>22,206</b>	<b>140,399</b>
Short term deposits with other banks ***	16,464	33,562	50,026
Other Cash inflows	6,461	765	7,226
<b>Cash inflows</b>	<b>22,925</b>	<b>34,327</b>	<b>57,252</b>
<b>Liquidity coverage ratio (LCR) ****</b>	<b>148%</b>	<b>372%</b>	<b>194%</b>
31.12.2015			
Liquid assets level 1 *	99,483	24,088	123,571
Liquid assets level 2 **	-	5,869	5,869
<b>Liquid Assets</b>	<b>99,483</b>	<b>29,957</b>	<b>129,440</b>
Deposits	122,275	21,640	143,915
Market Borrowing	1,502	122	1,624
Other Cash outflows	16,296	34,749	51,045
<b>Cash outflows</b>	<b>140,073</b>	<b>56,511</b>	<b>196,584</b>
Short term deposits with other banks ***	3,768	57,881	61,649
Other Cash inflows	9,193	29,457	38,650
<b>Cash inflows</b>	<b>12,961</b>	<b>87,338</b>	<b>100,299</b>
<b>Liquidity coverage ratio (LCR) ****</b>	<b>78%</b>	<b>212%</b>	<b>134%</b>

\* Level 1 assets receive a 100% weight in LCR calculations and include the Group's Cash and balances with Central Bank, domestic bonds eligible as collateral at the Central Bank, foreign government bonds and the liquidity facility from the Icelandic government.

\*\* Level 2 assets include the Group's covered bonds with a minimum rating of AA- and receive a 85% weight in LCR calculations.

\*\*\* Short term deposits in other banks are defined as cash inflows in LCR calculations.

\*\*\*\* LCR is defined as:  $LCR = \text{Weighted liquid assets} / (\text{weighted cash outflows} - \text{weighted cash inflows})$  where weighted cash inflows are capped at 75% of weighted cash outflows.

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 39. Liquidity and Funding risk, continued

#### *Composition of liquid assets*

The following table shows the composition of the Bank's liquidity buffer. The Bank's liquidity facility with the Icelandic Government is set to expire at year-end 2016, which will affect the Bank's LCR.

	ISK	USD	EUR	Other	Total
30.9.2016					
Cash and balances with Central Bank .....	84,407	346	333	559	85,645
Short term deposits in other banks .....	16,464	8,510	7,508	17,544	50,026
Domestic bonds eligible as collateral at the Central Bank .....	26,766	-	-	-	26,766
Foreign government bonds .....	-	7,135	7,333	-	14,468
Government liquidity facility .....	29,512	-	-	-	29,512
Covered bonds with a minimum rating of AA- .....	-	-	1,945	3,903	5,848
<b>Liquidity reserve .....</b>	<b>157,149</b>	<b>15,991</b>	<b>17,119</b>	<b>22,006</b>	<b>212,265</b>
31.12.2015					
Cash and balances with Central Bank .....	47,357	167	252	326	48,102
Short term deposits in other banks .....	3,768	16,741	20,824	20,316	61,649
Domestic bonds eligible as collateral at the Central Bank .....	22,614	-	-	-	22,614
Foreign government bonds .....	-	10,658	8,700	3,984	23,342
Government liquidity facility .....	29,513	-	-	-	29,513
Covered bonds with a minimum rating of AA- .....	-	-	2,122	4,783	6,905
<b>Liquidity reserve .....</b>	<b>103,252</b>	<b>27,566</b>	<b>31,898</b>	<b>29,409</b>	<b>192,125</b>

## NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

### 39. Liquidity and Funding risk, continued

#### LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. Some similar categories are grouped together. The table contains deposits at the Bank and at banking subsidiaries. Thus, amounts due to Central Bank and amounts due to credit institutions at non-banking subsidiaries are excluded.

#### LCR categorization - amounts and LCR outflow weights

	Deposits maturing within 30 days				Term deposits*	Total deposits
	Less Stable	Weight (%)	Stable	Weight (%)		
30.9.2016						
Retail .....	95,232	10%	39,617	5%	58,594	193,443
SME .....	41,557	10%	4,225	5%	4,501	50,283
Corporations .....	52,991	40%	931	20%	5,369	59,291
Sovereigns, central-banks and PSE .....	18,729	40%	-	-	1,612	20,341
Financial entities being wound up .....	-	100%	-	-	-	-
Pension funds .....	31,857	100%	-	-	22,200	54,057
Domestic financial entities .....	27,041	100%	-	-	21,847	48,888
Foreign financial entities .....	2,312	100%	-	-	-	2,312
Other foreign parties .....	6,999	100%	3,309	25%	2,346	12,654
<b>Total .....</b>	<b>276,718</b>		<b>48,082</b>		<b>116,469</b>	<b>441,269</b>
31.12.2015						
Retail .....	86,095	10%	39,598	5%	53,599	179,292
SME .....	37,884	10%	3,928	5%	4,327	46,139
Corporations .....	36,300	40%	823	20%	4,945	42,068
Sovereigns, central-banks and PSE .....	11,900	40%	-	-	1,304	13,204
Financial entities being wound up .....	16,948	100%	-	-	47,062	64,010
Pension funds .....	41,609	100%	-	-	35,104	76,713
Domestic financial entities .....	32,727	100%	-	-	11,016	43,743
Foreign financial entities .....	5,193	100%	-	-	-	5,193
Other foreign parties .....	3,707	100%	3,260	25%	1,923	8,890
<b>Total .....</b>	<b>272,363</b>		<b>47,609</b>		<b>159,280</b>	<b>479,252</b>

\* Here term deposits refer to deposits with maturities greater than 30 days.

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## 40. Capital management

### Capital ratio

The focus of capital management at the Group is to optimize the capital structure in the medium term and consequently maintain the Group's capitalization comfortably above the regulatory minimum, including capital buffers, and SREP requirements.

The Group's capital ratios are calculated in accordance with Act No. 161/2002 on Financial Undertakings. In September 2016, amendments were made to the Act, effectively adopting parts of CRR into law. The regulation had not been fully implemented at 30 September 2016. As a result, the Act is not entirely aligned with CRR, see details in footnotes below. Capital ratios for 31 December 2015 are based on the the preceding Basel II definitions. The Group uses the standardised approach to calculate the capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

<i>Capital Base</i>	30.9.2016	31.12.2015
<b>Total equity</b> .....	207,006	201,894
Non-controlling interest not eligible for inclusion in CET1 capital .....	(66)	(9,108)
Intangible assets .....	(11,077)	(9,285)
Tax assets .....	(241)	(205)
Equity holdings in financial sector entities * .....	(1,699)	(3,151)
<b>Common equity Tier 1 capital**</b> .....	193,923	180,145
Non-controlling interest not eligible for inclusion in CET1 capital .....	66	9,108
<b>Tier 1 capital</b> .....	193,989	189,253
Subordinated liabilities .....	-	10,365
Regulatory adjustments to Tier 2 capital *** .....	-	(771)
Equity holdings in financial sector entities * .....	-	(3,118)
General credit risk adjustments .....	4,633	-
<b>Tier 2 capital</b> .....	4,633	6,476
<b>Total capital base</b> .....	198,622	195,729
<i>Risk weighted assets</i>		
Credit risk, loans .....	621,495	637,919
Credit risk, securities and other .....	42,408	43,115
Market risk FX .....	2,578	38,401
Market risk other .....	10,926	7,035
Credit valuation adjustment .....	815	-
Operational risk .....	81,441	81,441
<b>Total risk weighted assets</b> .....	759,663	807,911
Of which domestic .....	691,293	694,803
<i>Capital ratios</i>		
CET1 ratio .....	25.5%	22.3%
Tier 1 ratio .....	25.5%	23.4%
Capital adequacy ratio .....	26.1%	24.2%
CET1 ratio, based on reviewed retained earnings at 30 June .....	24.5%	22.3%
Tier 1 ratio, based on reviewed retained earnings at 30 June .....	24.5%	23.4%
Capital adequacy ratio, based on reviewed retained earnings at 30 June .....	25.2%	24.2%

\* The Act No 161/2002 on financial undertakings states that the Bank's CET 1 holdings of instruments in financial sector entities are to be deducted from CET1, while CRR specifies a 10% threshold for such deductions. Such deductions were previously split between Tier 1 and Tier 2 capital but now apply to the corresponding type of capital instrument.

\*\* The newly amended Act on Financial Undertakings does not specify all capital deductions as listed in CRR. A minor deduction due to additional value adjustments is expected to come into effect with the full implementation of the regulation.

\*\*\* Straight-line amortization for maturities within five years.

# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## 40. Capital management, continued

The following table outlines the implementation of the capital buffer requirements in accordance with the Act on financial undertakings, as prescribed by the Financial Stability Council and approved by FME.

<i>Capital buffer requirement, % of RWA</i>	1.6.2016	1.1.2017	1.3.2017	1.11.2017
Capital conservation buffer .....	1.75%	2.50%	2.50%	2.50%
Capital buffer for systematically important institutions .....	2.00%	2.00%	2.00%	2.00%
Systemic risk buffer * .....	3.00%	3.00%	3.00%	3.00%
Countercyclical capital buffer * .....	-	-	1.00%	1.25%
<b>Combined capital buffer requirement .....</b>	<b>6.75%</b>	<b>7.50%</b>	<b>8.50%</b>	<b>8.75%</b>

The Bank carries out an on-going process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Group's total risk exposure. The ICAAP is aimed at identifying and measuring the Group's risk across all risk types and ensure that the Group has sufficient capital in accordance to its risk profile. FME supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole following the Supervisory Review and Evaluation Process (SREP). The Group's capital base exceeds the FME's SREP requirements.

The Bank's Pillar 2A capital add-on, which is the result of the ICAAP/SREP, may be comprised of 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. With the current capital structure, the Pillar 2A requirement is solely met with CET1 capital.

30.9.2016	Current	Fully implemented 1.11.2017
<i>Total capital requirement, % of RWA</i>		
Pillar 1 capital requirement .....	8.0%	8.0%
Pillar 2A capital requirement .....	4.3%	4.3%
Combined buffer requirement .....	6.5%	8.4%
<b>Total regulatory capital requirement .....</b>	<b>18.8%</b>	<b>20.7%</b>
Available capital .....	26.1%	26.1%
<i>CET1 requirement, % of RWA</i>		
Pillar 1 CET1 requirement .....	4.5%	4.5%
Pillar 2A CET1 requirement .....	2.4%	2.4%
Combined buffer requirement .....	6.5%	8.4%
<b>CET1 regulatory capital requirement .....</b>	<b>13.4%</b>	<b>15.3%</b>
Available CET1 capital .....	25.5%	25.5%

\*The capital buffers for systemic risk and countercyclical effects only apply to domestic assets.

### Leverage ratio

The leverage ratio is seen as a complementary measure to the risk-based Capital adequacy ratio. The minimum leverage ratio requirement is 3% as stated in Act no. 161/2002 of financial undertakings.

	30.9.2016	31.12.2015
On-balance sheet exposures .....	1,010,192	982,348
Derivative exposures .....	7,298	3,789
Securities financing transaction exposures .....	12,683	16,287
Off-balance sheet exposures .....	83,711	127,675
<b>Total exposure .....</b>	<b>1,113,884</b>	<b>1,130,099</b>
<b>Tier 1 capital .....</b>	<b>193,989</b>	<b>189,253</b>
Leverage ratio .....	17.4%	16.7%



# NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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## SIGNIFICANT ACCOUNTING POLICIES

The accounting policies adopted in the preparation of these Interim Financial Statements are consistent with those followed in the preparation of the Annual Financial Statements for the year 2015.

### 43. 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. The Interim Financial Statements are prepared on a going concern basis.

