# **Condensed Consolidated**
# Interim Financial Statements

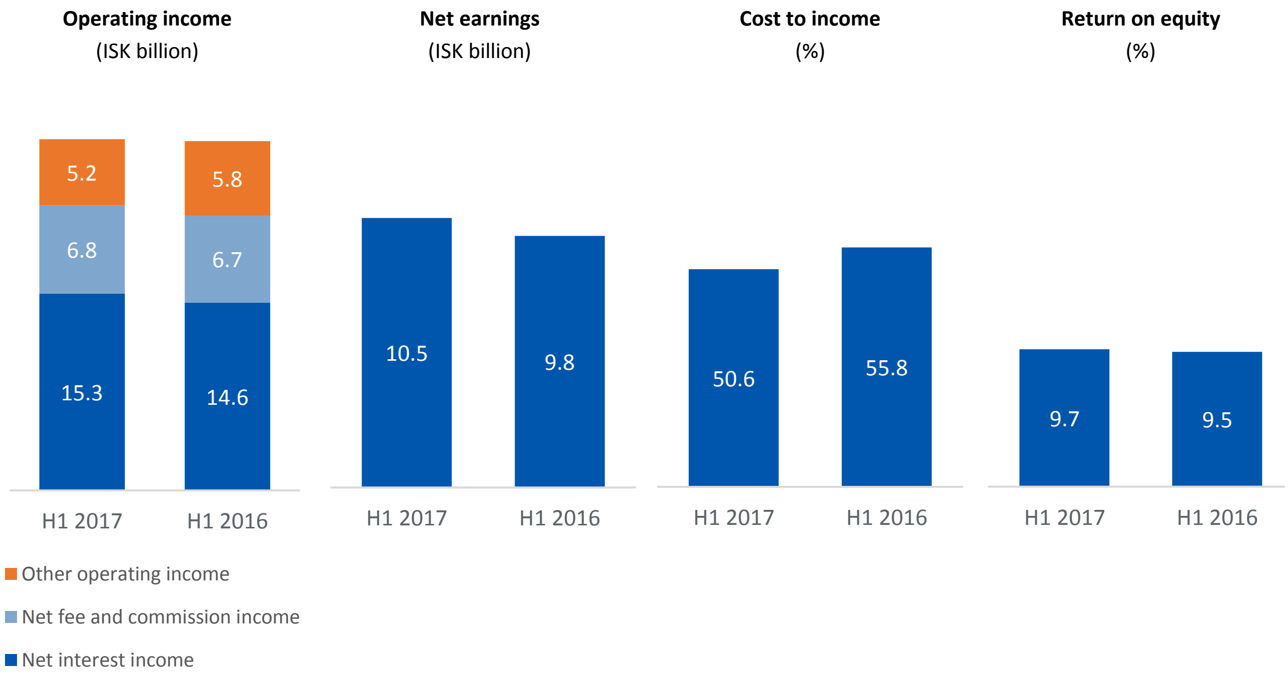
1 January - 30 June 2017

Arion Bank

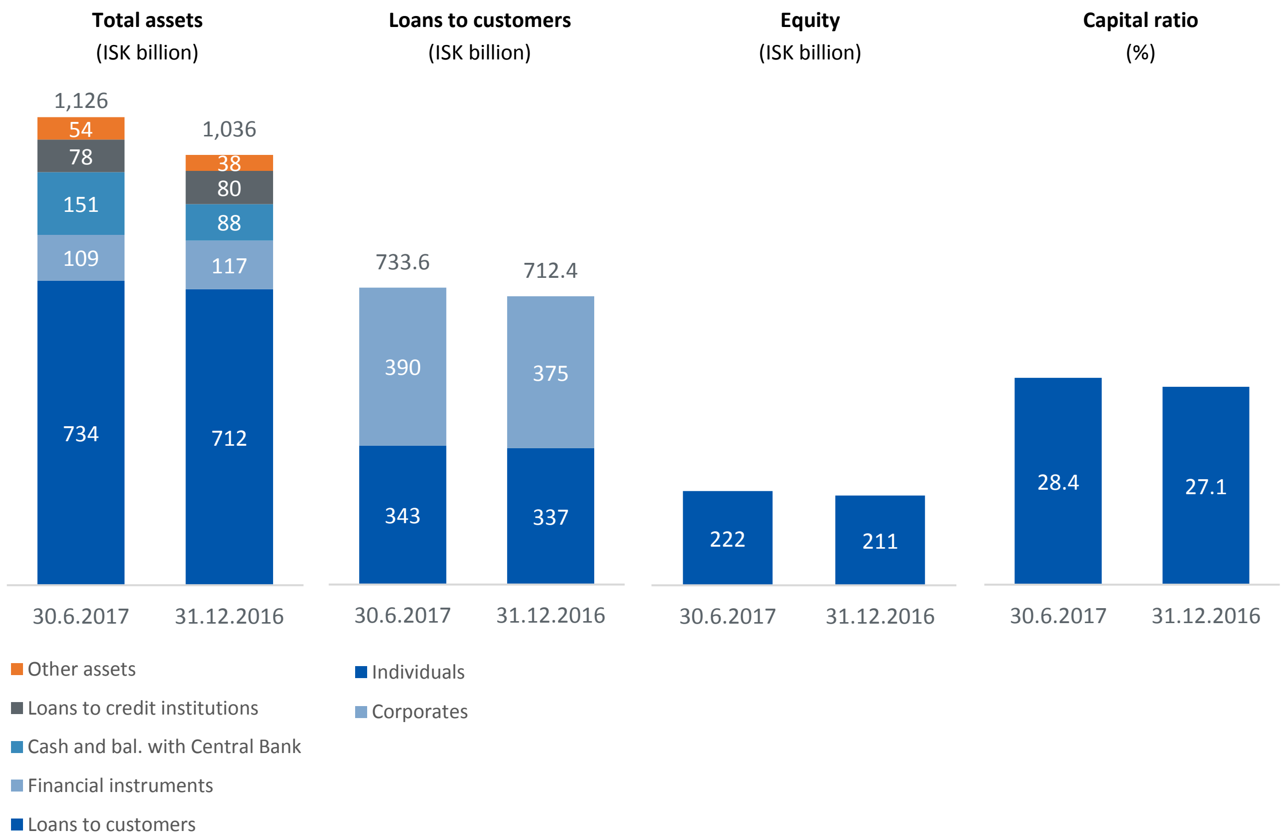
# Contents

# Key figures

## Condensed Consolidated Interim Statement of Comprehensive Income




## Condensed Consolidated Interim Statement of Financial Position



# Endorsement and statement
## by the Board of Directors and the CEO

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period from 1 January to 30 June 2017 include the Condensed Consolidated Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

**Outlook**

The Icelandic economy continues to perform strongly and GDP grew by 5.0% in the first quarter of 2017. Private consumption, low unemployment and a flourishing tourism sector continue to fuel GDP growth. However, signs of a slowdown have emerged, although analysts expect it to be a soft landing. Industrial and housing investments constituted the majority of investment growth in 2016 and will continue to do so in 2017, albeit at a slower pace. Inflation remains below the Central Bank's inflation target and the underlying inflationary pressure is low. The Icelandic króna remained strong after the removal of nearly all capital controls in March. However, short-term fluctuations have become more frequent. The economic outlook is favorable and Arion Research predicts strong economic growth, low unemployment and low inflation throughout the year. Research expects GDP growth to slow down to 2.7% in 2018 and inflation to rise to 2.8%, still remaining within the Central Bank's tolerance level.

Arion Bank is financially robust, as demonstrated by a leverage ratio of 17.4% (see Note 43). The Bank's liquidity position is strong, with a liquidity coverage ratio of 266% (see Note 41). All the ingredients are in place to enable Arion Bank to continue to offer its customers quality services in the areas which are important to them, whether in Retail Banking, Corporate Banking, Asset Management or Investment Banking. The Bank's financial strength enables it to grow alongside its customers and to pay competitive dividends to its owners.

**Operations during the period**

Net earnings amounted to ISK 10,466 million for the period ended 30 June 2017, and the total equity amounted to ISK 221,767 million at the end of the period. Return on equity was 9.7% for the period. The capital ratio of the Group, according to the Financial Undertakings Act No. 161/2002, was 28.4% and the corresponding Tier 1 ratio was 27.8%. The liquidity position was also strong at period end and well above the regulatory minimum.

On 1 January Vörður tryggingar hf. acquired the Bank's 100% shareholding in Okkar líftryggingar hf. Following the acquisition, the life insurance operations of Vörður and Okkar líftryggingar hf. were merged.

The main changes on the Balance Sheet from year-end 2016 relate to Cash and balance with the Central Bank, which have increased by ISK 63,720 million, or 72.7%, during the period. Deposits increased by ISK 25,430 million and borrowings by ISK 40,585 million during the period. The main reasons for this change are increased deposits in Retail Banking during the period and new borrowings. Loans to customers increased by ISK 21,227 million or 3.0%, and new lending is mainly to corporates in real estate and fishing industry.

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 1.3%.

In the first week of January, Arion Bank tapped its outstanding five-year senior unsecured EUR 300 million (ISK 34 billion) bond issue in November 2016 for a further EUR 200 million (ISK 23 billion). The bonds have a fixed coupon of 1.625% and were sold at rates corresponding to a 1.55% margin over interbank rates. The proceeds of the tap were partially used to repay the resettable EMTN held by Kaupthing. The resettable notes were issued in January 2016 to Kaupthing, in relation to the agreement made between Kaupthing and the Icelandic authorities in June 2015. The resettable notes were originally USD 747 million.

On 20 June, Arion Bank issued new three-year senior unsecured bonds for a total of EUR 300 million (ISK 35 billion). Orders were received from 80 investors with total demand in excess of EUR 750 million, meaning the issue was more than two times oversubscribed. The bonds have a fixed coupon of 0.75% and were sold at rates corresponding to a 0.88% margin over interbank rates. The proceeds from this transaction were used to buy back the outstanding amount of the Kaupthing notes.

Arion Bank issued a couple of EMTN private placements during the period, amounting to NOK 600 million (ISK 7.3 billion) and SEK 550 million (ISK 6.6 billion).

The Bank has continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. The Bank issued a total of ISK 12 billion of covered bonds during the first half of 2017. The Bank has also continued to issue commercial paper on the domestic market and that has further diversified the Bank's funding. Commercial paper amounting to ISK 13 billion was issued during the first half of 2017.

The Group had 1,223 full-time equivalent positions at the end of the period, compared with 1,239 at the end of 2016; 817 of these positions were at Arion Bank, compared with 869 at the end of 2016.

# Endorsement and statement
## by the Board of Directors and the CEO

Sameinað Sílikon hf. (“United Silicon”), a borrower and associate of the Bank, was on 14 August 2017 granted an authorisation for a moratorium, with the goal of reaching agreements with creditors regarding outstanding debts. The request was due to operational difficulties of United Silicon's silicon factory in Iceland, which can be traced to recurrent equipment failures since the operation started in November 2016. A recent ruling of an arbitral tribunal in the United Silicon's dispute with the construction company ÍAV hf. has increased its level of indebtedness.

United Silicon intends to use the moratorium period in order to seek agreements with its creditors and other stakeholders for a financial restructuring. Furthermore, it is foreseen that new capital is required in order to make improvements to the equipment and facilities that are necessary for the factory to produce both the quantity and the quality of product as originally intended.

The Bank is the largest creditor of United Silicon, with a total credit exposure of ISK 8 billion (including loan commitments and guarantees). The Bank also holds 16.3% of the share capital, with 23.9% of the voting rights, which has been fully impaired. Further impairment requirements of the Bank's exposure are currently highly uncertain and will be subject to any financial restructuring agreement reached between United Silicon, the Bank and other stakeholders. The Bank is in discussions with United Silicon to minimize any potential further losses.

**Group ownership**

Kaupthing ehf., through its subsidiary Kaupskil ehf., holds 57.87% of the shares in Arion Bank hf. The remaining shareholding is held by the Icelandic State Financial Investments which holds 13.00% on behalf of the Icelandic government, Attestor Capital LLP through Trinity Investment Designated Activity Company holds 9.99%, Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. holds 9.99%, Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group holds 6.58%, and Goldman Sachs International through ELQ Investors II Ltd. holds 2.57%. In addition, the investors have options on 21.9% of issued shares of Arion Bank, but this option expires prior to any potential offering of Arion Banks's shares to the public.

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 the Icelandic State Financial Investments. On 10 May 2017 the chairman of the Board of Directors, Monica Caneman decided to step down from the Board of Directors of Arion Bank. The vice-chairman of the Board, Guðrún Johnsen, took over the responsibilities of chairman of the Board of Directors. On 23 June 2017 Eva Cederbalk was elected as a new director of Arion Bank and on 26 June 2017 Eva Cederbalk was elected chairman of the Board of Directors of Arion Bank.

# Endorsement and statement
## by the Board of Directors and the CEO

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

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 30 June 2017 have been prepared in accordance with International Accounting Standard 34 "Interim Financial Reporting" (IAS 34) 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 Condensed Consolidated Interim Financial Statements give a true and fair view of the financial performance of the Group for the period ended 30 June 2017 and its financial position as at 30 June 2017.

Furthermore, in our opinion the Condensed Consolidated 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 Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 30 June 2017 and confirm them by means of their signatures.

Reykjavík, 23 August 2017

**Board of Directors**

Eva Cederbalk
Chairman

Brynjólfur Bjarnason

Guðrún Johnsen

Jakob Már Ásmundsson

John P. Madden

Kirstín Þ. Flygenring

Måns Höglund

Þóra Hallgrímsdóttir

**Chief Executive Officer**

Höskuldur H. Ólafsson

# Review Report
## on the Condensed Consolidated Interim Financial Statements

To the Board of Directors and shareholders of Arion Bank.

We have reviewed the accompanying Condensed Consolidated Interim Statement of Financial Position of Arion Bank (the "Group") as of 30 June 2017 and the related Condensed Consolidated Interim Statement of Comprehensive Income, Condensed Consolidated Interim Statement of Changes in Equity and Condensed Consolidated Interim Statement of Cash Flows for the six months then ended and a summary of significant accounting policies and other explanatory notes.

**The Board of Directors and Management's Responsibility for the Consolidated Financial Statements**

The Board of Directors and management are responsible for the preparation and fair presentation of this Condensed Consolidated Interim Financial Statements in accordance with International Financial Reporting Standards for Interim Financial Reporting, IAS 34, as adopted by the EU.

**Auditor's Responsibility**

Our responsibility is to express a conclusion on this Condensed Consolidated Interim Financial Statements based on our review.

**Scope of Review**

We conducted our review in accordance with International Standard on Review Engagements, ISRE 2410. A review of Condensed Consolidated Interim Financial Statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

**Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that the accompanying Condensed Consolidated Interim Financial Statements do not give a true and fair view of the financial position of the Group as at 30 June 2017, and of its financial performance and its cash flows for the six month period then ended in accordance with International Accounting Standard 34 "Interim Financial Reporting" (IAS 34) as adopted by the EU and additional requirements in the Icelandic Act on Annual Accounts.

**Confirmation of Endorsement and Statement by the Board of Directors and the CEO**

Pursuant to the requirement of Paragraph 2 Article 104 of the Icelandic Act on Annual Accounts No. 3/2006, we confirm to the best of our knowledge that the accompanying Endorsement and Statement by the Board of Directors and the CEO includes all information required by the Icelandic Act on Annual Accounts that is not disclosed elsewhere in the Condensed Consolidated Interim Financial Statements.

Kópavogur, 23 August 2017

**Deloitte ehf.**

Páll Grétar Steingrímsson
State Authorized Public Accountant

Gunnar Þorvarðarson
State Authorized Public Accountant

# Condensed Consolidated Interim Statement of Comprehensive Income
## for the period from 1 January to 30 June 2017

| Income Statement | Notes | 2017 1.1.-30.6. | 2016 1.1.-30.6 | 2017 1.4.-30.6.* | 2016 1.4.-30.6.* |
|---|---|---|---|---|---|
| Interest income | | 29,840 | 31,395 | 16,117 | 16,525 |
| Interest expense | | (14,520) | (16,769) | (7,957) | (9,172) |
| **Net interest income** | 6 | 15,320 | 14,626 | 8,160 | 7,353 |
| Fee and commission income | | 13,019 | 11,245 | 6,928 | 6,005 |
| Fee and commission expense | | (6,181) | (4,498) | (3,420) | (2,477) |
| **Net fee and commission income** | 7 | 6,838 | 6,747 | 3,508 | 3,528 |
| Net financial income | 8 | 3,205 | 3,495 | 1,975 | 3,796 |
| Net insurance income | 9 | 1,053 | 391 | 606 | 246 |
| Share of profit of associates and net impairment | 25 | (934) | 694 | (900) | 17 |
| Other operating income | 10 | 1,850 | 1,230 | 1,470 | 284 |
| **Operating income** | | 27,332 | 27,183 | 14,819 | 15,224 |
| Salaries and related expense | 11 | (8,783) | (8,426) | (4,561) | (4,318) |
| Other operating expense | 12 | (5,057) | (6,730) | (1,223) | (3,640) |
| Bank levy | 13 | (1,574) | (1,485) | (777) | (743) |
| Net impairment | 14 | 1,289 | 945 | 409 | 1,448 |
| **Earnings before tax** | | 13,207 | 11,487 | 8,667 | 7,971 |
| Income tax expense | 15 | (3,161) | (2,091) | (1,827) | (1,354) |
| **Net earnings from continuing operations** | | 10,046 | 9,396 | 6,840 | 6,617 |
| Net gain from assets held for sale, net of tax | 16 | 420 | 363 | 273 | 259 |
| **Net earnings** | | 10,466 | 9,759 | 7,113 | 6,876 |
| ***Attributable to*** | | | | | |
| Shareholders of Arion Bank | | 10,464 | 9,262 | 7,112 | 6,854 |
| Non-controlling interest | 25 | 2 | 497 | 1 | 22 |
| **Net earnings** | | 10,466 | 9,759 | 7,113 | 6,876 |
| **Earnings per share from continuing operations** | | | | | |
| Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK) | 17 | 5.02 | 4.45 | 3.42 | 3.30 |

## Other Comprehensive Income

| | Notes | 2017 1.1.-30.6. | 2016 1.1.-30.6 | 2017 1.4.-30.6.* | 2016 1.4.-30.6.* |
|---|---|---|---|---|---|
| **Net earnings** | | 10,466 | 9,759 | 7,113 | 6,876 |
| Net gain on AFS financial assets, net of tax | | - | (2,903) | - | (2,715) |
| Exchange difference on translating foreign subsidiaries | 32 | (83) | 94 | (127) | 22 |
| **Net other comprehensive income to be reclassified to profit or loss in subsequent periods** | | (83) | (2,809) | (127) | (2,693) |
| **Total comprehensive income** | | 10,383 | 6,950 | 6,986 | 4,183 |
| ***Attributable to*** | | | | | |
| Shareholders of Arion Bank | | 10,381 | 6,453 | 6,984 | 4,085 |
| Non-controlling interest | | 2 | 497 | 2 | 98 |
| **Total comprehensive income** | | 10,383 | 6,950 | 6,986 | 4,183 |

*The Interim Condensed Consolidated statements of comprehensive income for the three month periods ended 30 June 2017 and 30 June 2016 have not been reviewed by the Bank's auditors.

*The Notes on pages 13 to 61 are an integral part of these Condensed Consolidated Interim Financial Statements.*

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# Condensed Consolidated Interim Statement of Financial Position

## as at 30 June 2017

| Assets | Notes | 30.06.2017 | 31.12.2016 |
|---|---|---|---|
| Cash and balances with Central Bank | 18 | 151,354 | 87,634 |
| Loans to credit institutions | 19 | 78,250 | 80,116 |
| Loans to customers | 20 | 733,649 | 712,422 |
| Financial instruments | 21-23 | 109,353 | 117,456 |
| Investment property | 23 | 7,166 | 5,358 |
| Investments in associates | 25 | 825 | 839 |
| Intangible assets | 26 | 11,639 | 11,057 |
| Tax assets | 27 | 413 | 288 |
| Other assets | 28 | 33,762 | 20,854 |
| **Total Assets** | | 1,126,411 | 1,036,024 |
| **Liabilities** | | | |
| Due to credit institutions and Central Bank | 22 | 7,644 | 7,987 |
| Deposits | 22 | 437,494 | 412,064 |
| Financial liabilities at fair value | 22 | 5,029 | 3,726 |
| Tax liabilities | 27 | 9,342 | 7,293 |
| Other liabilities | 29 | 65,074 | 54,094 |
| Borrowings | 22, 30 | 380,061 | 339,476 |
| **Total Liabilities** | | 904,644 | 824,640 |
| **Equity** | | | |
| Share capital and share premium | 32 | 75,861 | 75,861 |
| Other reserves | 32 | 13,565 | 19,761 |
| Retained earnings | | 132,167 | 115,590 |
| **Total Shareholders' Equity** | | 221,593 | 211,212 |
| Non-controlling interest | | 174 | 172 |
| **Total Equity** | | 221,767 | 211,384 |
| **Total Liabilities and Equity** | | 1,126,411 | 1,036,024 |

*The Notes on pages 13 to 61 are an integral part of these Condensed Consolidated Interim Financial Statements.*

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# Condensed Consolidated Interim Statement of Changes in Equity
## for the period from 1 January to 30 June 2017

| | Share capital and share premium | Other reserves | Retained earnings | **Total share-holders' equity** | Non-controlling interest | **Total equity** |
|---|---|---|---|---|---|---|
| **Equity 1 January 2017** | 75,861 | 19,761 | 115,590 | 211,212 | 172 | 211,384 |
| Net earnings | - | - | 10,464 | 10,464 | 2 | 10,466 |
| Translation difference | - | (83) | - | (83) | - | (83) |
| **Total comprehensive income** | - | (83) | 10,464 | 10,381 | 2 | 10,383 |
| Reserve for investments in subsidiaries | - | (5,642) | 5,642 | - | - | - |
| Reserve for investments in associates | - | 7 | (7) | - | - | - |
| Reserve for investments in securities | - | (477) | 477 | - | - | - |
| **Equity 30 June 2017** | 75,861 | 13,565 | 132,167 | 221,593 | 174 | 221,767 |
| | | | | | | |
| **Equity 1 January 2016** | 75,861 | 4,548 | 112,377 | 192,786 | 9,108 | 201,894 |
| Net earnings | - | - | 9,262 | 9,262 | 497 | 9,759 |
| Net gain on AFS financial assets | - | (2,903) | - | (2,903) | - | (2,903) |
| Translation difference | - | 94 | - | 94 | - | 94 |
| **Total comprehensive income** | - | (2,809) | 9,262 | 6,453 | 497 | 6,950 |
| **Equity 30 June 2016** | 75,861 | 1,739 | 121,639 | 199,239 | 9,605 | 208,844 |

In June 2016 the Icelandic Parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank, see Note 32.

*The Notes on pages 13 to 61 are an integral part of these Condensed Consolidated Interim Financial Statements.*

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# Condensed Consolidated Interim Statement of Cash flows

## for the period from 1 January to 30 June 2017

| | 2017 | 2016 |
|---|---|---|
| **Operating activities** | 1.1.-30.6. | 1.1.-30.6. |
| Net earnings | 10,466 | 9,759 |
| Non-cash items included in net earnings | (17,417) | (15,573) |
| Changes in operating assets and liabilities | 78,796 | (3,703) |
| Interest received | 20,957 | 23,810 |
| Interest paid | (5,285) | (8,422) |
| Dividend received | 190 | 600 |
| Income tax paid | (1,342) | (2,136) |
| Net cash from operating activities | 86,365 | 4,335 |
| **Investing activities** | | |
| Acquisition of associates | (961) | (13) |
| Acquisition of subsidiary | (237) | - |
| Proceeds from sale of associates | - | 27,102 |
| Dividend received from associates | 41 | - |
| Acquisition of intangible assets | (1,125) | (530) |
| Acquisition of property and equipment | (395) | (694) |
| Proceeds from sale of property and equipment | 85 | 209 |
| Net cash (to) from investing activities | (2,592) | 26,074 |
| Net increase in cash and cash equivalents | 83,773 | 30,409 |
| Cash and cash equivalents at beginning of the year | 123,933 | 110,000 |
| Effect of exchange rate changes on cash and cash equivalents | (2,316) | (2,299) |
| **Cash and cash equivalents** | 205,390 | 138,110 |
| **Non-cash investing transactions** | | |
| Assets acquired through foreclosure on collateral from customers with view to resale | 467 | 957 |
| Settlement of loans through foreclosure on collateral from customers with view to resale | (467) | (957) |
| **Non-cash changes due to funding agreement with Kaupthing** | | |
| Deposits | - | 41,409 |
| Borrowings | - | (41,409) |

*The Notes on pages 13 to 61 are an integral part of these Condensed Consolidated Interim Financial Statements.*

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# Notes to the Condensed Consolidated Interim Statement of Cash flows
## for the period from 1 January to 30 June 2017

| | 2017 | 2016 |
|---|---|---|
| **Non-cash items included in net earnings** | 1.1.-30.6. | 1.1.-30.6. |
| Net interest income | (15,320) | (14,626) |
| Net impairment | (1,289) | (945) |
| Income tax expense | 3,161 | 2,091 |
| Bank levy | 1,574 | 1,485 |
| Net foreign exchange gain | 1 | 687 |
| Net gain on financial instruments | (3,016) | (3,582) |
| Depreciation and amortization | 1,023 | 862 |
| Share of profit of associates and net impairment | 934 | (694) |
| Investment property, fair value change | (1,362) | (25) |
| Revised Depositors' and Investors' Guarantee Fund expense | (2,669) | - |
| Net gain from assets held for sale, net of tax | (420) | (363) |
| Other changes | (34) | (463) |
| **Non-cash items included in net earnings** | (17,417) | (15,573) |

| | | |
|---|---|---|
| **Changes in operating assets and liabilities** | | |
| Mandatory reserve with Central Bank | (202) | 2,976 |
| Loans to credit institutions, excluding bank accounts | 18,170 | (2,180) |
| Loans to customers | (17,803) | (30,912) |
| Financial instruments and financial liabilities at fair value | 13,045 | 5,207 |
| Investment property | (435) | 1,509 |
| Other assets | 1,611 | 452 |
| Due to credit institutions and Central Bank | (527) | (3,412) |
| Deposits | 23,270 | (8,130) |
| Borrowings | 41,652 | 35,112 |
| Other liabilities | 15 | (4,325) |
| **Changes in operating assets and liabilities** | 78,796 | (3,703) |

| | | |
|---|---|---|
| **Cash and cash equivalents** | | |
| Cash and balances with Central Bank | 151,354 | 77,108 |
| Bank accounts | 63,570 | 70,661 |
| Mandatory reserve deposit with Central Bank | (9,534) | (9,659) |
| **Cash and cash equivalents** | 205,390 | 138,110 |

*The Notes on pages 13 to 61 are an integral part of these Condensed Consolidated Interim Financial Statements.*

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# Notes to the Condensed Consolidated Interim Financial Statements
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# Notes to the Condensed Consolidated Interim Financial Statements

## 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 Condensed Consolidated Interim Financial Statements 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 ended 31 December 2016. The Consolidated Financial Statements are available at Arion Bank's website www.arionbanki.is.

The Interim Financial Statements were approved and authorized for issue by the Board of Directors of Arion Bank on 23 August 2017.

The same accounting policies, presentation and methods of computation are followed in these Condensed Consolidated Interim Financial Statements as were applied in the presentation of the Bank's consolidated financial statements for the year ended 31 December 2016. Amendments to IFRSs effective for 2017 have not had a material effect on the results for the half year ended 30 June 2017.

*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
- assets 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 USD was 101.98 and 116.35 for EUR (31.12.2016: USD 112.90 and EUR 119.18).

*Comparison figures*

In the Interim Financial Statements 30 June 2016 earned premium of the subsidiary Okkar líftrygginar hf. was classified as Other operating income and claims incurred as Other operating expense. After the acquisition of the subsidiary Vörður tryggingar hf. 30 June 2016 net insurance income was presented separately in the Statement of Comprehansive Income, due to increased weight in the operation of the Group. Comparison figures have been changed accordingly.

### 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. The estimates and associated assumptions area based on historical experience and other factors that are considered to be relevant. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimate is revised if the revision affects only that period or in the period of revision and future periods in the revision affects both current and future periods.

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

# Notes to the Condensed Consolidated Interim Financial Statements

### 3. The Group

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

| | | | Equity interest | |
|---|---|---|---|---|
| | Operating activity | Currency | 30.6.2017 | 31.12.2016 |
| 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% |
| Okkar líftryggingar hf., Borgartún 25, Reykjavík, Iceland .................................... | Life insurance | ISK | - | 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% | 100.0% |

On 1 January Vörður tryggingar hf. acquired the Bank's 100% shareholding in Okkar líftryggingar hf. Following the acquisition the life insurance operation was merged under the name of Vörður líftryggingar hf.

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# Notes to the Condensed Consolidated Interim Financial Statements

## 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 Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Asset Management also administers pension funds. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

**Corporate Banking** provides comprehensive financial services and integrated solutions across the Bank's divisions, to larger corporate clients in Iceland. Corporate Banking provides a full range of lending products, deposit accounts, payment solutions 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 such as financial restructuring, IPO's and stock market listings. Capital Markets buys and sells securities and FX on behalf of Arion Bank's clients. Capital Markets manages securities issuance for clients and advises on hedges used in business operations often in co-operation with Corporate Finance. Research is an independent research team covering the Icelandic economy and financial markets.

**Retail Banking**, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of services in it's 24 branches and also through leading digital solutions featured in both an app and internet bank. This includes deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into six regions clusters, with the smaller branches capitalizing on the strength of larger units within each region. Retail Banking's 24 branches all around Iceland have a total of more than 100,000 customers.

**Treasury** is responsible 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 Valitor Holding hf., Vörður tryggingar hf., Okkar líftryggingar hf. (in 2016), Eignarhaldsfélagið Landey ehf., EAB 1 ehf., BG12 slhf. and other smaller entities of the Group.

In addition to the above operating segments, the Group presents information for the corporate **Headquarters** carrying out support functions such as Overhead, Risk Management, Finance (excluding Treasury and Market Making), Legal and IT. The Headquarters information presented do not represents an operating segment.

# Notes to the Condensed Consolidated Interim Financial Statements

## 4. Operating segments

| 1.1.-30.6.2017 | Asset Manage-ment | Corporate Banking | Investment Banking | Retail Banking | Treasury | Other divisions and Sub-sidiaries | Head-quarters and Elimination | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 275 | 3,195 | 132 | 7,899 | 3,326 | 635 | (142) | 15,320 |
| Net fee and commission income | 1,776 | 457 | 637 | 2,148 | (157) | 1,764 | 213 | 6,838 |
| Net financial income | 54 | 165 | (38) | 19 | (322) | 3,057 | 270 | 3,205 |
| Net insurance income | - | - | - | - | - | 1,073 | (20) | 1,053 |
| Share of profit of associates and net impairment | - | - | - | - | - | - | (934) | (934) |
| Other operating income | 14 | 1,091 | - | 7 | 5 | 501 | 232 | 1,850 |
| **Operating income (loss)** | 2,119 | 4,908 | 731 | 10,073 | 2,852 | 7,030 | (381) | 27,332 |
| Operating expense | (434) | (156) | (402) | (1,637) | 280 | (4,487) | (7,004) | (13,840) |
| Bank levy | - | - | - | - | - | - | (1,574) | (1,574) |
| Net impairment | - | 832 | 21 | 402 | 55 | (19) | (2) | 1,289 |
| **Earnings (loss) before tax** | 1,685 | 5,584 | 350 | 8,838 | 3,187 | 2,524 | (8,961) | 13,207 |
| Net seg. rev. from ext. customers | 978 | 8,630 | 457 | 15,499 | (5,379) | 7,398 | (251) | 27,332 |
| Net seg. rev. from other segments | 1,141 | (3,722) | 274 | (5,426) | 8,231 | (368) | (130) | - |
| **Operating income (loss)** | 2,119 | 4,908 | 731 | 10,073 | 2,852 | 7,030 | (381) | 27,332 |
| Depreciation and amortization | - | - | - | 176 | - | 445 | 402 | 1,023 |
| 30.6.2017 | | | | | | | | |
| **Total assets** | 86,026 | 260,571 | 18,723 | 517,956 | 585,970 | 83,226 | (426,061) | 1,126,411 |
| **Total liabilities** | 80,296 | 201,308 | 14,823 | 452,802 | 536,759 | 52,583 | (433,927) | 904,644 |
| **Allocated equity** | 5,730 | 59,263 | 3,900 | 65,154 | 49,211 | 30,643 | 7,866 | 221,767 |
| 1.1.-30.6.2016 | | | | | | | | |
| Net interest income | 300 | 3,151 | 940 | 7,731 | 2,301 | 512 | (309) | 14,626 |
| Net fee and commission income | 1,865 | 497 | 771 | 1,562 | (190) | 1,949 | 293 | 6,747 |
| Net financial income | (8) | (113) | (115) | 69 | (403) | 4,920 | (855) | 3,495 |
| Net insurance income | - | - | - | - | - | 391 | - | 391 |
| Share of profit of associates and net impairment | - | - | 498 | - | - | 238 | (42) | 694 |
| Other operating income | 10 | 69 | 321 | 10 | 7 | 745 | 68 | 1,230 |
| **Operating income (loss)** | 2,167 | 3,604 | 2,415 | 9,372 | 1,715 | 8,755 | (845) | 27,183 |
| Operating expense | (752) | (330) | (583) | (3,043) | (113) | (3,367) | (6,968) | (15,156) |
| Bank levy | - | - | - | - | - | - | (1,485) | (1,485) |
| Net impairment | - | 1,405 | 1,446 | (1,858) | 3 | (53) | 2 | 945 |
| **Earnings (loss) before tax** | 1,415 | 4,679 | 3,278 | 4,471 | 1,605 | 5,335 | (9,296) | 11,487 |
| Net seg. rev. from ext. customers | 733 | 7,837 | 2,159 | 15,282 | (7,301) | 9,086 | (613) | 27,183 |
| Net seg. rev. from other segments | 1,434 | (4,233) | 256 | (5,910) | 9,016 | (331) | (232) | - |
| **Operating income (loss)** | 2,167 | 3,604 | 2,415 | 9,372 | 1,715 | 8,755 | (845) | 27,183 |
| Depreciation and amortization | - | - | - | 158 | - | 328 | 376 | 862 |
| 30.6.2016 | | | | | | | | |
| **Total assets** | 83,934 | 258,649 | 20,407 | 495,406 | 553,229 | 85,411 | (462,033) | 1,035,003 |
| **Total liabilities** | 79,240 | 204,380 | 17,474 | 436,084 | 527,989 | 32,971 | (471,979) | 826,159 |
| **Allocated equity** | 4,694 | 54,269 | 2,933 | 59,322 | 25,240 | 52,440 | 9,946 | 208,844 |

Following the acquisition of Vörður tryggingar hf. at 30 September 2016 the presentation of insurance income in the Statement of Comprehensive income was changed, see Note 1.

Assets held for sale are excluded from the profit and loss segment information.

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# Notes to the Condensed Consolidated Interim Financial Statements

### 4. Operating segments, continued

*Geographic information*

| 1.1.-30.6.2017 | Iceland | Nordic | United Kingdom | Other Europe | North America | Other | Total |
|---|---|---|---|---|---|---|---|
| Net interest income | 16,831 | 208 | 125 | (2,092) | 223 | 25 | 15,320 |
| Net fee and commission income | 5,641 | 127 | 67 | 996 | 3 | 4 | 6,838 |
| Net financial income | 2,121 | (14) | 194 | 221 | 704 | (21) | 3,205 |
| Net insurance income | 1,053 | - | - | - | - | - | 1,053 |
| Share of profit of associates and net impairment | (934) | - | - | - | - | - | (934) |
| Other operating income | 1,535 | - | 315 | - | - | - | 1,850 |
| **Operating income (loss)** | 26,247 | 321 | 701 | (875) | 930 | 8 | 27,332 |

| 1.1.-30.6.2016 | Iceland | Nordic | United Kingdom | Other Europe | North America | Other | Total |
|---|---|---|---|---|---|---|---|
| Net interest income | 15,636 | 433 | 67 | (1,855) | 329 | 16 | 14,626 |
| Net fee and commission income | 5,912 | 61 | 33 | 719 | 19 | 3 | 6,747 |
| Net financial income | (1,520) | (5) | 5,009 | 19 | 5 | (13) | 3,495 |
| Net insurance income | 391 | - | - | - | - | - | 391 |
| Share of profit of associates and net impairment | 196 | - | 498 | - | - | - | 694 |
| Other operating income | 1,230 | - | - | - | - | - | 1,230 |
| **Operating income (loss)** | 21,845 | 489 | 5,607 | (1,117) | 353 | 6 | 27,183 |

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# Notes to the Condensed Consolidated Interim Financial Statements

## Quarterly statements

### 5. Operations by quarters, unaudited

| 2017 | Q2 | Q1 | Total |
|---|---|---|---|
| Net interest income | 8,160 | 7,160 | 15,320 |
| Net fee and commission income | 3,508 | 3,330 | 6,838 |
| Net financial income | 1,975 | 1,230 | 3,205 |
| Net insurance income | 606 | 447 | 1,053 |
| Share of profit of associates and net impairment | (900) | (34) | (934) |
| Other operating income | 1,470 | 380 | 1,850 |
| **Operating income** | 14,819 | 12,513 | 27,332 |
| Salaries and related expense | (4,561) | (4,222) | (8,783) |
| Other operating expense | (1,223) | (3,834) | (5,057) |
| Bank levy | (777) | (797) | (1,574) |
| Net impairment | 409 | 880 | 1,289 |
| **Earnings before tax** | 8,667 | 4,540 | 13,207 |
| Income tax expense | (1,827) | (1,334) | (3,161) |
| **Net earnings from continuing operations** | 6,840 | 3,206 | 10,046 |
| Net gain from assets held for sale, net of tax | 273 | 147 | 420 |
| **Net earnings** | 7,113 | 3,353 | 10,466 |

| 2016 | Q2 | Q1 | Total |
|---|---|---|---|
| Net interest income | 7,353 | 7,273 | 14,626 |
| Net fee and commission income | 3,528 | 3,219 | 6,747 |
| Net financial income | 3,796 | (301) | 3,495 |
| Net insurance income | 246 | 145 | 391 |
| Share of profit of associates and net impairment | 17 | 677 | 694 |
| Other operating income | 283 | 947 | 1,230 |
| **Operating income** | 15,223 | 11,960 | 27,183 |
| Salaries and related expense | (4,318) | (4,108) | (8,426) |
| Other operating expense | (3,640) | (3,090) | (6,730) |
| Bank levy | (743) | (742) | (1,485) |
| Net impairment | 1,448 | (503) | 945 |
| **Earnings before tax** | 7,970 | 3,517 | 11,487 |
| Income tax expense | (1,354) | (737) | (2,091) |
| **Net earnings from continuing operations** | 6,616 | 2,780 | 9,396 |
| Net gain from assets held for sale, net of tax | 259 | 104 | 363 |
| **Net earnings** | 6,875 | 2,884 | 9,759 |

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# Notes to the Condensed Consolidated Interim Financial Statements

## Notes to the Consolidated Statement of Comprehensive Income

### 6. Net interest income

| | 2017 | 2016 | 2017 | 2016 |
|---|---|---|---|---|
| *Interest income* | 1.1.-30.6 | 1.1.-30.6 | 1.4.-30.6 | 1.4.-30.6 |
| Cash and balances with Central Bank | 3,406 | 2,029 | 2,024 | 1,764 |
| Loans | 24,808 | 26,785 | 13,373 | 13,675 |
| Securities | 1,197 | 2,237 | 515 | 909 |
| Other | 429 | 344 | 205 | 177 |
| **Interest income** | 29,840 | 31,395 | 16,117 | 16,525 |
| *Interest expense* | | | | |
| Deposits | (6,942) | (8,744) | (3,819) | (4,605) |
| Borrowings | (7,533) | (7,810) | (4,120) | (4,461) |
| Subordinated liabilities | - | (186) | - | (91) |
| Other | (45) | (29) | (18) | (15) |
| **Interest expense** | (14,520) | (16,769) | (7,957) | (9,172) |
| **Net interest income** | 15,320 | 14,626 | 8,160 | 7,353 |
| Net interest income from assets and liabilities at fair value | 1,197 | 2,237 | 515 | 909 |
| Interest income from assets not at fair value | 28,643 | 29,158 | 15,602 | 15,616 |
| Interest expense from liabilities not at fair value | (14,520) | (16,769) | (7,957) | (9,172) |
| **Net interest income** | 15,320 | 14,626 | 8,160 | 7,353 |
| Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets) | 3.0% | 3.1% | 3.1% | 3.1% |

### 7. Net fee and commission income

| | 1.1.-30.6.2017 | | | 1.1.-30.6.2016 | | |
|---|---|---|---|---|---|---|
| | Income | Expense | Net income | Income | Expense | Net income |
| Asset management | 2,053 | (209) | 1,844 | 2,038 | (140) | 1,898 |
| Cards and payment solution | 8,219 | (5,549) | 2,670 | 6,726 | (4,023) | 2,703 |
| Collection and payment services | 748 | (49) | 699 | 722 | (37) | 685 |
| Investment banking | 428 | (24) | 404 | 554 | (24) | 530 |
| Lending and guarantees | 947 | - | 947 | 777 | - | 777 |
| Other | 624 | (350) | 274 | 428 | (274) | 154 |
| **Net fee and commission income** | 13,019 | (6,181) | 6,838 | 11,245 | (4,498) | 6,747 |

| | 1.4.-30.6.2017 | | | 1.4.-30.6.2016 | | |
|---|---|---|---|---|---|---|
| Asset management | 1,062 | (96) | 966 | 1,017 | (67) | 950 |
| Cards | 4,371 | (3,061) | 1,310 | 3,585 | (2,191) | 1,394 |
| Collection and payment services | 409 | (22) | 387 | 387 | (22) | 365 |
| Investment banking | 210 | (11) | 199 | 373 | (12) | 361 |
| Lending and guarantees | 538 | - | 538 | 390 | - | 390 |
| Other | 338 | (230) | 108 | 253 | (185) | 68 |
| **Net fee and commission income** | 6,928 | (3,420) | 3,508 | 6,005 | (2,477) | 3,528 |

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.

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# Notes to the Condensed Consolidated Interim Financial Statements

## 8. Net financial income

| | 2017<br>1.1.-30.6. | 2016<br>1.1.-30.6. | 2017<br>1.4.-30.6. | 2016<br>1.4.-30.6. |
|---|---|---|---|---|
| Dividend income | 190 | 600 | 106 | 397 |
| Net gain on financial assets and financial liabilities classified as held for trading | 40 | (121) | 28 | (482) |
| Net gain on fair value hedge of interest rate swap | 55 | - | (4) | - |
| Net gain on financial assets and financial liabilities designated through profit or loss at fair value | 2,921 | (1,588) | 1,814 | (865) |
| Realised gain on financial assets available-for-sale | - | 5,291 | - | 5,291 |
| Net foreign exchange income | (1) | (687) | 31 | (545) |
| **Net financial income** | 3,205 | 3,495 | 1,975 | 3,796 |

*Net gain on fair value hedge of interest rate swap*

| | | | | |
|---|---|---|---|---|
| Fair value change of interest rate swaps designated as hedging instruments | (512) | - | (256) | - |
| Fair value change on bonds issued by the Group attributable to interest rate risk | 567 | - | 252 | - |
| **Net gain on fair value hedge of interest rate swap** | 55 | - | (4) | - |

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

| | | | | |
|---|---|---|---|---|
| Equity instruments designated at fair value | 2,499 | (1,248) | 1,747 | (712) |
| Interest rate instruments designated at fair value | 422 | (340) | 67 | (153) |
| **Net gain on financial assets and financial liabilities designated at fair value through profit or loss** | 2,921 | (1,588) | 1,814 | (865) |

## 9. Net insurance income

*Earned premiums, net of reinsurers' share*

| | | | | |
|---|---|---|---|---|
| Premiums written | 6,264 | 793 | 2,622 | 356 |
| Premiums written, reinsurers' shares | (204) | (50) | (102) | (20) |
| Change in provision for unearned premiums | (1,652) | (115) | (252) | 8 |
| Change in provision for unearned premiums, reinsurers' share | 1 | 3 | 4 | (1) |
| **Earned premiums, net of reinsurers' share** | 4,408 | 631 | 2,272 | 343 |

*Claims incurre, net of reinsurers' share*

| | | | | |
|---|---|---|---|---|
| Claims paid | (2,908) | (230) | (1,438) | (109) |
| Claims paid, reinsurers' share | 54 | 23 | 37 | 9 |
| Change in provision for claims | (503) | (69) | (250) | (26) |
| Changes in provision for claims, reinsurers' share | 2 | 36 | (15) | 29 |
| **Claims incurred, net of reinsurers' share** | (3,355) | (240) | (1,666) | (97) |
| **Net insurance income** | 1,053 | 391 | 606 | 246 |

Prior the acquisition of Vörður tryggingar hf. at 30 September 2016 earned premiums of Okkar líftryggingar hf. was classified as Other operating income and claims incurred as Other operating expense, see Note 1.

## 10. Other operating income

| | 2017<br>1.1.-30.6. | 2016<br>1.1.-30.6. | 2017<br>1.4.-30.6. | 2016<br>1.4.-30.6. |
|---|---|---|---|---|
| Fair value changes on investment property | 1,362 | 25 | 1,269 | - |
| Realized gain on investment property | 11 | 429 | 11 | 81 |
| Other income | 477 | 776 | 190 | 203 |
| **Other operating income** | 1,850 | 1,230 | 1,470 | 284 |

Prior to the acquisition of Vörður tryggingar hf. at 30 September 2016 earned premium of Okkar líftryggingar hf. was classified as Other operating income, see Note 1.

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## 11. Personnel and salaries

| | 2017 | 2016 | 2017 | 2016 |
|---|---|---|---|---|
| *Number of employees* | 1.1.-30.6. | 1.1.-30.6. | 1.4.-30.6. | 1.4.-30.6. |
| Average number of full-time equivalent positions during the period | 1,214 | 1,171 | 1,222 | 1,184 |
| Full-time equivalent positions at the end of the period | 1,223 | 1,199 | 1,223 | 1,199 |
| *Number of employees at Arion Bank* | | | | |
| Average number of full-time equivalent positions during the period | 826 | 885 | 820 | 891 |
| Full-time equivalent positions at the end of the period | 817 | 896 | 817 | 896 |
| *Salaries and related expense* | | | | |
| Salaries | 7,069 | 6,765 | 3,678 | 3,481 |
| Defined contribution pension plans | 1,010 | 935 | 523 | 477 |
| Salary-related expense | 882 | 923 | 452 | 471 |
| Capitalization of salaries, due to internally developed software | (178) | (197) | (92) | (111) |
| **Salaries and related expense** | 8,783 | 8,426 | 4,561 | 4,318 |
| *Salaries and related expense for Arion Bank* | | | | |
| Salaries | 4,769 | 4,965 | 2,452 | 2,568 |
| Defined contribution pension plans | 682 | 707 | 349 | 364 |
| Salary-related expense | 697 | 752 | 363 | 388 |
| **Salaries and related expense** | 6,148 | 6,424 | 3,164 | 3,320 |

During the period the Group made a provision of ISK 252 million (H1 2016: ISK 213 million) for performance plan payments, including salary-related expense, of which the Bank made a provision of ISK 232 million (H1 2016: ISK 195 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 amounted to ISK 923 million (31.12.2016: ISK 1,453 million), of which the Bank's accrual amounts to ISK 776 million (31.12.2016: ISK 1,177 million).

## 12. Other operating expense

| | 2017 | 2016 | 2017 | 2016 |
|---|---|---|---|---|
| | 1.1.-30.6. | 1.1.-30.6. | 1.4.-30.6. | 1.4.-30.6. |
| Administration expense | 6,242 | 5,416 | 3,141 | 2,984 |
| Depositors' and Investors' Guarantee Fund | (2,258) | 421 | (2,463) | 202 |
| Depreciation of property and equipment | 413 | 442 | 202 | 227 |
| Amortization of intangible assets | 610 | 420 | 313 | 212 |
| Other expense | 50 | 31 | 30 | 15 |
| **Other operating expense** | 5,057 | 6,730 | 1,223 | 3,640 |

Prior to the acquisition of Vörður tryggingar hf. claims incurred of Okkar líftryggingar hf. was classified as Other operating expense, see Note 1.

The Bank had recognized a liability of ISK 2,669 million against the Depositors' and Investors' Guarantee Fund. At the end of June 2017 the Bank received confirmation from the Fund stating that the claim would not be collected, see Note 34.

## 13. Bank levy

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

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## 14. Net impairment

| | 2017 1.1.-30.6. | 2016 1.1.-30.6. | 2017 1.4.-30.6. | 2016 1.4.-30.6. |
|---|---|---|---|---|
| Net change in impairment of loans to corporates | 304 | (546) | (365) | 281 |
| Net change in impairment of loans to individuals | (181) | (2,020) | (146) | (174) |
| Net change in collective impairment on loans | 85 | 106 | 512 | 136 |
| **Provision for losses** | 208 | (2,460) | 1 | 243 |
| Increase in book value of loans to corporates | 338 | 1,828 | 49 | 271 |
| Increase in book value of loans to individuals | 743 | 1,577 | 359 | 934 |
| **Net impairment** | 1,289 | 945 | 409 | 1,448 |

## 15. Income tax expense

| | 2017 1.1.-30.6. | 2016 1.1.-30.6. | 2017 1.4.-30.6. | 2016 1.4.-30.6. |
|---|---|---|---|---|
| Current tax expense | 3,598 | 2,283 | 2,111 | 1,354 |
| Deferred tax expense | (437) | (192) | (284) | - |
| **Income tax expense** | 3,161 | 2,091 | 1,827 | 1,354 |

| *Reconciliation of effective tax rate* | 1.1.-30.6.2017 | | 1.1.-30.6.2016 | |
|---|---|---|---|---|
| Earnings before tax | | 13,207 | | 11,487 |
| Income tax using the Icelandic corporate tax rate | 20.0% | 2,641 | 20.0% | 2,297 |
| Additional 6% tax on Financial Undertakings | 5.8% | 770 | 4.2% | 487 |
| Non-deductible expenses | 0.0% | 5 | 0.5% | 62 |
| Tax exempt revenue | (4.4%) | (584) | (8.1%) | (929) |
| Non-deductible taxes | 2.4% | 315 | 2.6% | 297 |
| Tax incentives not recognized in the Statement of Comprehensive Income | (0.0%) | (5) | (0.7%) | (82) |
| Other changes | 0.1% | 19 | (0.4%) | (41) |
| **Effective tax rate** | 23.9% | 3,161 | 18.2% | 2,091 |

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

Tax exempt revenues consist mainly of profit from equity positions.

## 16. Net gain from assets held for sale, net of tax

| | 2017 1.1.-30.6. | 2016 1.1.-30.6. | 2017 1.4.-30.6. | 2016 1.4.-30.6. |
|---|---|---|---|---|
| Income from real estates and other assets | 655 | 600 | 388 | 401 |
| Expense related to real estates and other assets | (130) | (146) | (47) | (77) |
| **Net gain from assets held for sale** | 525 | 454 | 341 | 324 |
| Income tax expense | (105) | (91) | (68) | (65) |
| **Net gain from assets held for sale, net of tax** | 420 | 363 | 273 | 259 |

## 17. Earnings per share

| | Net gain from assets held for sale Excluded | | Included | |
|---|---|---|---|---|
| | 2017 1.1.-30.6. | 2016 1.1.-30.6. | 2017 1.4.-30.6. | 2016 1.4.-30.6. |
| Net earnings attributable to the shareholders of Arion Bank | 10,044 | 8,899 | 10,464 | 9,262 |
| Weighted average number of outstanding shares for the period, million | 2,000 | 2,000 | 2,000 | 2,000 |
| **Basic earnings per share** | 5.02 | 4.45 | 5.23 | 4.63 |

There were no instruments at the end of the period that could potentially dilute basic earnings per share (1.1.-30.6.2016: none).

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# Notes to the Condensed Consolidated Interim Financial Statements

## Notes to the Consolidated Statement of Finanacial Position

### 18. Cash and balances with Central Bank

| | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Cash on hand | 9,197 | 7,448 |
| Cash with Central Bank | 132,623 | 70,854 |
| Mandatory reserve deposit with Central Bank | 9,534 | 9,332 |
| **Cash and balances with Central Bank** | 151,354 | 87,634 |

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

### 19. Loans to credit institutions

| | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Bank accounts | 63,570 | 45,631 |
| Money market loans | 13,023 | 32,267 |
| Other loans | 1,657 | 2,218 |
| **Loans to credit institutions** | 78,250 | 80,116 |

### 20. Loans to customers

| | Individuals | | Corporates | | Total | |
|---|---|---|---|---|---|---|
| 30.6.2017 | Gross carrying amount | Book value | Gross carrying amount | Book value | Gross carrying amount | Book value |
| Overdrafts | 13,855 | 12,418 | 22,174 | 20,649 | 36,029 | 33,067 |
| Credit cards | 10,245 | 10,083 | 1,199 | 1,098 | 11,444 | 11,181 |
| Mortgage loans | 294,273 | 291,796 | 17,810 | 17,543 | 312,083 | 309,339 |
| Other loans | 32,609 | 29,105 | 357,882 | 350,957 | 390,491 | 380,062 |
| **Loans to customers** | 350,982 | 343,402 | 399,065 | 390,247 | 750,047 | 733,649 |
| 31.12.2016 | | | | | | |
| Overdrafts | 14,805 | 13,381 | 19,314 | 17,630 | 34,119 | 31,011 |
| Credit cards | 11,363 | 11,099 | 1,180 | 1,151 | 12,543 | 12,250 |
| Mortgage loans | 285,784 | 282,996 | 16,298 | 15,975 | 302,082 | 298,971 |
| Other loans | 34,777 | 29,940 | 351,739 | 340,250 | 386,516 | 370,190 |
| **Loans to customers** | 346,729 | 337,416 | 388,531 | 375,006 | 735,260 | 712,422 |

The total book value of pledged loans that were pledged against amounts borrowed was ISK 171 billion at the end of the period (31.12.2016: ISK 165 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk Management Disclosures.

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## 20. Loans to customers, continued

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

| 1.1.-30.6.2017 | Specific | Collective | Total |
|---|---|---|---|
| Balance at the beginning of the year | 18,281 | 4,557 | 22,838 |
| Provision for losses | (123) | (85) | (208) |
| Write-offs | (6,057) | - | (6,057) |
| Exchange difference | (235) | - | (235) |
| Payment of loans previously written off | 60 | - | 60 |
| **Balance at the end of the period** | 11,926 | 4,472 | 16,398 |

| 1.1.-30.6.2016 | | | |
|---|---|---|---|
| Balance at the beginning of the year | 25,341 | 4,984 | 30,325 |
| Provision for losses | 2,566 | (106) | 2,460 |
| Write-offs | (7,693) | - | (7,693) |
| Exchange difference | 369 | - | 369 |
| Payment of loans previously written off | 153 | - | 153 |
| **Balance at the end of the period** | 20,736 | 4,878 | 25,614 |

*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 53 in the Annual Financial Statements for 2016. 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 realizable 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.

## 21. Financial instruments

| | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Bonds and debt instruments | 60,003 | 69,565 |
| Shares and equity instruments with variable income | 25,567 | 27,035 |
| Derivatives | 6,217 | 5,159 |
| Securities used for hedging | 17,566 | 15,697 |
| **Financial instruments** | 109,353 | 117,456 |

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# Notes to the Condensed Consolidated Interim Financial Statements

### 22. Financial assets and financial liabilities

| 30.6.2017 | Amortized cost | Trading | Designated at fair value | Total |
|---|---|---|---|---|
| *Loans* | | | | |
| Cash and balances with Central Bank | 151,354 | - | - | 151,354 |
| Loans to credit institutions | 78,250 | - | - | 78,250 |
| Loans to customers | 733,649 | - | - | 733,649 |
| **Loans** | 963,253 | - | - | 963,253 |
| *Bonds and debt instruments* | | | | |
| Listed | - | 5,407 | 51,451 | 56,858 |
| Unlisted | - | 20 | 3,125 | 3,145 |
| **Bonds and debt instruments** | - | 5,427 | 54,576 | 60,003 |
| *Shares and equity instruments with variable income* | | | | |
| Listed | - | 2,075 | 6,406 | 8,481 |
| Unlisted | - | 1,216 | 10,437 | 11,653 |
| Bond funds with variable income, unlisted | - | 2,229 | 3,204 | 5,433 |
| **Shares and equity instruments with variable income** | - | 5,520 | 20,047 | 25,567 |
| *Derivatives* | | | | |
| OTC derivatives | - | 6,217 | - | 6,217 |
| **Derivatives** | - | 6,217 | - | 6,217 |
| *Securities used for hedging* | | | | |
| Bonds and debt instruments, listed | - | 6,857 | - | 6,857 |
| Shares and equity instruments with variable income, listed | - | 10,627 | - | 10,627 |
| Shares and equity instruments with variable income, unlisted | - | 82 | - | 82 |
| **Securities used for hedging** | - | 17,566 | - | 17,566 |
| Other financial assets | 21,890 | - | - | 21,890 |
| **Financial assets** | 985,143 | 34,730 | 74,623 | 1,094,496 |
| *Liabilities at amortized cost* | | | | |
| Due to credit institutions and Central Bank | 7,644 | - | - | 7,644 |
| Deposits | 437,494 | - | - | 437,494 |
| Borrowings | 380,061 | - | - | 380,061 |
| **Liabilities at amortized cost** | 825,199 | - | - | 825,199 |
| *Financial liabilities at fair value* | | | | |
| Short position in bonds | - | 1,736 | - | 1,736 |
| Derivatives | - | 3,271 | - | 3,271 |
| Derivatives used for hedge accounting | - | 22 | - | 22 |
| **Financial liabilities at fair value** | - | 5,029 | - | 5,029 |
| Other financial liabilities | 41,005 | - | - | 41,005 |
| **Financial liabilities** | 866,204 | 5,029 | - | 871,233 |

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# Notes to the Condensed Consolidated Interim Financial Statements

## 22. Financial assets and financial liabilities, continued

| 31.12.2016 | Amortized cost | Trading | Designated at fair value | Total |
|---|---|---|---|---|
| *Loans* | | | | |
| Cash and balances with Central Bank | 87,634 | - | - | 87,634 |
| Loans to credit institutions | 80,116 | - | - | 80,116 |
| Loans to customers | 712,422 | - | - | 712,422 |
| **Loans** | 880,172 | - | - | 880,172 |
| *Bonds and debt instruments* | | | | |
| Listed | - | 5,284 | 61,055 | 66,339 |
| Unlisted | - | 102 | 3,124 | 3,226 |
| **Bonds and debt instruments** | - | 5,386 | 64,179 | 69,565 |
| *Shares and equity instruments with variable income* | | | | |
| Listed | - | 2,949 | 9,125 | 12,074 |
| Unlisted | - | 1,348 | 10,579 | 11,927 |
| Bond funds with variable income, unlisted | - | 1,027 | 2,007 | 3,034 |
| **Shares and equity instruments with variable income** | - | 5,324 | 21,711 | 27,035 |
| *Derivatives* | | | | |
| OTC derivatives | - | 5,159 | - | 5,159 |
| **Derivatives** | - | 5,159 | - | 5,159 |
| *Securities used for hedging* | | | | |
| Bonds and debt instruments, listed | - | 7,318 | - | 7,318 |
| Shares and equity instruments with variable income, listed | - | 8,365 | - | 8,365 |
| Shares and equity instruments with variable income, unlisted | - | 14 | - | 14 |
| **Securities used for hedging** | - | 15,697 | - | 15,697 |
| Other financial assets | 8,617 | - | - | 8,617 |
| **Financial assets** | 888,789 | 31,566 | 85,890 | 1,006,245 |
| *Liabilities at amortized cost* | | | | |
| Due to credit institutions and Central Bank | 7,987 | - | - | 7,987 |
| Deposits | 412,064 | - | - | 412,064 |
| Borrowings | 339,476 | - | - | 339,476 |
| **Liabilities at amortized cost** | 759,527 | - | - | 759,527 |
| *Financial liabilities at fair value* | | | | |
| Short position in bonds | - | 1,884 | - | 1,884 |
| Derivatives | - | 1,842 | - | 1,842 |
| **Financial liabilities at fair value** | - | 3,726 | - | 3,726 |
| Other financial liabilities | 36,350 | - | - | 36,350 |
| **Financial liabilities** | 795,877 | 3,726 | - | 799,603 |

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

| *Bonds and debt instruments designated at fair value, specified by issuer* | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Financial and insurance activities | 4,678 | 5,564 |
| Public sector | 43,638 | 51,860 |
| Corporates | 6,260 | 6,755 |
| **Bonds and debt instruments designated at fair value** | 54,576 | 64,179 |

The total amount of pledged bonds was ISK 15.5 billion at the end of the period (31.12.2016: ISK 15.6 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.

### 23. 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 recognized at fair value on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorization (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**

30.6.2017

| *Assets at fair value* | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 23,016 | 36,307 | 680 | 60,003 |
| Shares and equity instruments with variable income | 5,917 | 18,616 | 1,034 | 25,567 |
| Derivatives | - | 6,217 | - | 6,217 |
| Securities used for hedging | 17,456 | 110 | - | 17,566 |
| Investment property | - | - | 7,166 | 7,166 |
| **Assets at fair value** | 46,389 | 61,250 | 8,880 | 116,519 |
| | | | | |
| *Liabilities at fair value* | | | | |
| Short position in bonds | 1,736 | - | - | 1,736 |
| Derivatives | - | 3,271 | - | 3,271 |
| Derivatives used for hedge accounting | - | 22 | - | 22 |
| **Liabilities at fair value** | 1,736 | 3,293 | - | 5,029 |

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# Notes to the Condensed Consolidated Interim Financial Statements

### 23. Fair value hierarchy, continued

31.12.2016

| *Assets at fair value* | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 22,787 | 46,689 | 89 | 69,565 |
| Shares and equity instruments with variable income | 11,863 | 15,154 | 18 | 27,035 |
| Derivatives | - | 5,159 | - | 5,159 |
| Securities used for hedging | 15,659 | 38 | - | 15,697 |
| Investment property | - | - | 5,358 | 5,358 |
| **Assets at fair value** | 50,309 | 67,040 | 5,465 | 122,814 |

| *Liabilities at fair value* | | | | |
|---|---|---|---|---|
| Short position in bonds | 1,884 | - | - | 1,884 |
| Derivatives | - | 1,842 | - | 1,842 |
| **Liabilities at fair value** | 1,884 | 1,842 | - | 3,726 |

There was no transfer between Level 1 and Level 2 during the period (2016: No transfers).

*Fair value of assets and liabilities*

The fair value of asset and liabilities is the amount at which the asset and liability could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Group to measure assets and liabilities. If quoted prices for an asset fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

**Methods for establishing fair value**

The best evidence of the fair value of an asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

*Level 1: Fair value established from quoted market prices*

In some cases, the carrying value of an asset in Note 22 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from quoted market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

*Level 2: Fair value established using valuation techniques with observable market information*

For assets and liabilities, for which the market is not active, the Group applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable and willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

For assets and liabilities for which quoted prices on active markets are not available, the fair value is derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

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### 23. Fair value hierarchy, continued

In most cases the valuation is based on theoretical financial models, such as the Black Scholes model or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

The fair value for deposits with stated maturities is calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Statement of Financial Position.

*Level 3: Fair value established using valuation techniques with significant unobservable market information*

In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of assets with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organizations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

The Group applies management valuation for determining fair value of investment properties. Management valuation is either based on recent transactions and offers for similar assets or present value calculations which involve estimation of future cash flow and the assessment of appropriate discount rate.

| **Movements in Level 3 assets measured at fair value** | Investment property | | Financial assets | | Total | |
|---|---|---|---|---|---|---|
| | 30.6.2017 | 31.12.2016 | 30.6.2017 | 31.12.2016 | 30.6.2017 | 31.12.2016 |
| Balance at the beginning of the year | 5,358 | 7,542 | 107 | 6,056 | 5,465 | 13,598 |
| Net fair value changes | 1,362 | 290 | (9) | 2,828 | 1,353 | 3,118 |
| Additions | 730 | 618 | 111 | - | 841 | 618 |
| Disposal | (284) | (1,684) | (79) | (8,778) | (363) | (10,462) |
| Disposals through the sale of a subsidiary | - | (1,408) | - | - | - | (1,408) |
| Transfers into Level 3 | - | - | 1,584 | 13 | 1,584 | 13 |
| Transfers out of Level 3 | - | - | - | (12) | - | (12) |
| **Balance at the end of the period** | 7,166 | 5,358 | 1,714 | 107 | 8,880 | 5,465 |

| **Line items where effects of Level 3 assets are recognized in the Statement of Comprehensive Income** | 2017 | 2016 |
|---|---|---|
| | 1.1.-30.6. | 1.1.-30.6. |
| Net interest income | 16 | 2 |
| Net financial income | (25) | 5,270 |
| Other operating income | 1,373 | 454 |
| **Effects recognized in the Income Statement** | 1,364 | 5,726 |
| Net loss on AFS financial assets, net of tax | - | (2,903) |
| **Effects recognized in the Statement of Comprehensive Income** | 1,364 | 2,823 |

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### 23. Fair value hierarchy, continued

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

| 30.6.2017 | Carrying value | Fair value | Unrealized gain (loss) |
|---|---|---|---|
| *Financial assets not carried at fair value* | | | |
| Cash and balances with Central Bank | 151,354 | 151,354 | - |
| Loans to credit institutions | 78,250 | 78,250 | - |
| Loans to customers | 733,649 | 739,470 | 5,821 |
| Other financial assets | 21,890 | 21,890 | - |
| **Financial assets not carried at fair value** | 985,143 | 990,964 | 5,821 |
| *Financial liabilities not carried at fair value* | | | |
| Due to credit institutions and Central Bank | 7,644 | 7,644 | - |
| Deposits | 437,494 | 437,494 | - |
| Borrowings | 380,061 | 405,098 | (25,037) |
| Other financial liabilities | 41,005 | 41,005 | - |
| **Financial liabilities not carried at fair value** | 866,204 | 891,241 | (25,037) |

| 31.12.2016 | | | |
|---|---|---|---|
| *Financial assets not carried at fair value* | | | |
| Cash and balances with Central Bank | 87,634 | 87,634 | - |
| Loans to credit institutions | 80,116 | 80,116 | - |
| Loans to customers | 712,422 | 717,220 | 4,798 |
| Other financial assets | 8,617 | 8,617 | - |
| **Financial assets not carried at fair value** | 888,789 | 893,587 | 4,798 |
| *Financial liabilities not carried at fair value* | | | |
| Due to credit institutions and Central Bank | 7,987 | 7,987 | - |
| Deposits | 412,064 | 412,064 | - |
| Borrowings | 339,476 | 348,412 | (8,936) |
| Other financial liabilities | 36,350 | 36,350 | - |
| **Financial liabilities not carried at fair value** | 795,877 | 804,813 | (8,936) |

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 a part of Loans to Customers, 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.

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### 23. Fair value hierarchy, continued

| *Derivatives* | Notional | Fair value | |
|---|---|---|---|
| 30.6.2017 | value | Assets | Liabilities |
| Forward exchange rate agreements | 56,838 | 528 | 1,337 |
| Fair value hedge of interest rate swap | 93,080 | 73 | 89 |
| Interest rate and exchange rate agreements | 200,599 | 4,911 | 1,452 |
| Bond swap agreements | 2,470 | 18 | 5 |
| Share swap agreements | 9,997 | 687 | 309 |
| Options - purchased agreements | 146 | - | 101 |
| **Derivatives** | 363,130 | 6,217 | 3,293 |

| 31.12.2016 | | | |
|---|---|---|---|
| Forward exchange rate agreements | 31,921 | 266 | 247 |
| Interest rate and exchange rate agreements | 210,143 | 4,288 | 1,104 |
| Bond swap agreements | 2,995 | 1 | 8 |
| Share swap agreements | 8,138 | 597 | 457 |
| Options - purchased agreements | 1,218 | 7 | 26 |
| **Derivatives** | 254,415 | 5,159 | 1,842 |

The Group applies hedge accounting only with respect to certain foreign currency denominated interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate foreign currency denominated bonds (see Note 30) arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. The Group applies fair value hedge accounting to the hedging relationships. The total fair value of the interest rate swaps at 30 June 2017 was negative and amounted to ISK 22 million. Their total notional values at period end amounted to ISK 93,080 million.

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### 24. 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 | | | | |
|---|---|---|---|---|---|---|---|---|
| 30.6.2017 | Gross assets before balance sheet nettings | Balance sheet nettings with gross liabilities | Assets recognized on balance sheet, net | Financial liabilities | Collateral received | Assets after consideration of netting potential | Assets not subject to enforceable netting arr-angements | Total assets recognized on balance sheet |
| Reverse repurchase agreements | 15,465 | (251) | 15,214 | (1,485) | - | 13,729 | - | 15,214 |
| Derivatives | 4,769 | - | 4,769 | (1,090) | - | 3,679 | 1,448 | 6,217 |
| **Total assets** | 20,234 | (251) | 19,983 | (2,575) | - | 17,408 | 1,448 | 21,431 |
| 31.12.2016 | | | | | | | | |
| Reverse repurchase agreements | 15,644 | (80) | 15,564 | (1,884) | - | 13,680 | - | 15,564 |
| Derivatives | 4,100 | - | 4,100 | (629) | - | 3,471 | 1,059 | 5,159 |
| **Total assets** | 19,744 | (80) | 19,664 | (2,513) | - | 17,151 | 1,059 | 20,723 |

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

| | Liabilities subject to netting arrangements | | | Netting potential not recognized in the balance sheet | | | | |
|---|---|---|---|---|---|---|---|---|
| 30.6.2017 | Gross liabilities before balance sheet nettings | Balance sheet nettings with gross assets | Liabilities recognized on balance sheet, net | Financial assets | Collateral pledged | Liabilities after consideration of netting potential | Liabilities not subject to enforceable netting arr-angements | Total liabilities recognized on balance sheet |
| Repurchase agreements | 1,736 | (251) | 1,485 | (1,485) | - | - | - | 1,485 |
| Derivatives | 1,141 | - | 1,141 | (1,090) | - | 51 | 2,152 | 3,293 |
| **Total liabilities** | 2,877 | (251) | 2,626 | (2,575) | - | 51 | 2,152 | 4,778 |
| 31.12.2016 | | | | | | | | |
| Repurchase agreements | 1,884 | (80) | 1,804 | (1,884) | - | (80) | - | 1,804 |
| Derivatives | 629 | - | 629 | (629) | - | - | 1,213 | 1,842 |
| **Total liabilities** | 2,513 | (80) | 2,433 | (2,513) | - | (80) | 1,213 | 3,646 |

Reserve repurchase agreements and repurchase agreements are recognized within the line items Financial instruments and Due to credit institutions and Central Bank respectively.

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### 25. Investments in associates

| *The Group's interest in its principal associates* | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Auðkenni hf., Borgartún 31, Reykjavík, Iceland | 25.44% | 25.4% |
| Farice ehf., Smáratorg 3, Kópavogur, Iceland | 35.80% | 35.8% |
| Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland | 22.99% | 23.0% |
| Urriðaland ehf., Laugavegur 182, Reykjavík, Iceland | 41.40% | 41.4% |
| 220 Fjörður ehf., Fjarðargötu 13-15, Hafnarfjörður, Iceland | 34.93% | 34.9% |
| Sameinað Sílikon hf. (United Silicon), Stakksbraut 9, Keflavík, Iceland | 23.90% | - |

| *Investments in associates* | | |
|---|---|---|
| Carrying amount at the beginning of the year | 839 | 27,299 |
| Additions | 961 | 76 |
| Dividend received | (41) | (153) |
| Disposals | - | (27,291) |
| Share of profit of associates and net impairment | (934) | 908 |
| **Investment in associates** | 825 | 839 |

In April and June 2017 Arion Bank participated in share capital increase of United Silicon, which operates a silicon production plant in Iceland. The Bank's investment in the company's share capital amounts to approximately ISK 1 billion and has been fully provisioned for in the Bank's accounts. On 30 June 2017 Arion Bank holds 16.3% of share capital but holds 23.9% of voting rights, based on different classes of share capital of United Silicon.

Arion Bank holds 38.4% of share capital in Farice ehf., but holds 35.8% of voting rights, based on different classes of share capital of Farice ehf.

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## 26. 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 are recognized upon acquisition 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.

Infrastructure, which is capitalized as an intangible asset, is related to the asset management operation, payment solution and credit card operation and branding of the insurance operation. The business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as described below.

Customer relationships and related agreements are connected to business relationships and agreements upon acquisition. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationships with individual customers through retail banking operation and the insurance operation. The customer relationship is tested for impairment and related agreements are amortized over a period of five years.

Acquired software and internally developed software is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

| 30.6.2017 | Goodwill | Infra-structure | Customer relation-ship and related agreements | Software | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year | 2,202 | 3,705 | 1,608 | 3,542 | 11,057 |
| Acquisition through business combination | - | - | - | 109 | 109 |
| Additions | 173 | - | 238 | 536 | 947 |
| Additions, internally developed | - | - | - | 178 | 178 |
| Exchange difference | (19) | - | (11) | (12) | (42) |
| Amortization | - | - | (145) | (465) | (610) |
| **Intangible assets** | 2,356 | 3,705 | 1,690 | 3,888 | 11,639 |

| 31.12.2016 | Goodwill | Infra-structure | Customer relation-ship and related agreements | Software | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year | 2,407 | 3,021 | 854 | 3,003 | 9,285 |
| Acquisition through business combination | 496 | 684 | 904 | 457 | 2,541 |
| Additions and transfers | (271) | - | 110 | 638 | 477 |
| Additions, internally developed | - | - | - | 384 | 384 |
| Exchange difference | (430) | - | (32) | (182) | (644) |
| Impairment | - | - | (9) | - | (9) |
| Amortization | - | - | (219) | (758) | (977) |
| **Intangible assets** | 2,202 | 3,705 | 1,608 | 3,542 | 11,057 |

Impairment is recognized in the line item Net impairment in the Statement of Comprehensive income.

Goodwill is recognized in the segment Other divisions and subsidiaries, see Note 4.

## 27. Tax assets and tax liabilities

| | 30.6.2017 | | 31.12.2016 | |
|---|---|---|---|---|
| | Assets | Liabilities | Assets | Liabilities |
| Current tax | - | 8,991 | - | 6,630 |
| Deferred tax | 413 | 351 | 288 | 663 |
| **Tax assets and tax liabilities** | 413 | 9,342 | 288 | 7,293 |

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## 28. Other assets

| | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Assets held for sale | 3,443 | 4,418 |
| Property and equipment | 6,671 | 6,723 |
| Accounts receivable | 6,831 | 5,373 |
| Unsettled securities trading | 13,533 | 712 |
| Investment for life assurance policyholders where risk is held by policyholder | 807 | 820 |
| Sundry assets | 2,477 | 2,808 |
| **Other assets** | 33,762 | 20,854 |

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

## 29. Other liabilities

| | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Accounts payable | 22,622 | 22,627 |
| Unsettled securities trading | 12,062 | 668 |
| Depositors' and investors' Guarantee Fund* | 213 | 2,870 |
| Technical provision | 12,411 | 10,243 |
| Technical provision for life assurance policyholders were investment risk is held by policyholder | 807 | 820 |
| Withholding tax | 468 | 1,745 |
| Bank levy | 4,446 | 2,872 |
| Sundry liabilities | 12,045 | 12,249 |
| **Other liabilities** | 65,074 | 54,094 |

| *Technical provision* | Technical provision | Reinsurers' share | Total 30.6.2017 | Technical provision | Reinsurers' share | Total 31.12.2016 |
|---|---|---|---|---|---|---|
| Claims reported and loss adjustment expenses | 5,345 | (169) | 5,176 | 4,842 | (167) | 4,675 |
| Claims incurred but not reported | 1,352 | (99) | 1,253 | 1,352 | (99) | 1,253 |
| **Claims outstanding** | 6,697 | (268) | 6,429 | 6,194 | (266) | 5,928 |
| Provision for unearned premiums | 5,714 | (19) | 5,695 | 4,049 | (18) | 4,031 |
| **Own technical provision** | 12,411 | (287) | 12,124 | 10,243 | (284) | 9,959 |

Insurance claim consists of claims outstanding and provision for unearned premiums. Claims outstanding present unsettled claims incurred. Claims outstanding is the total of claims reported and actuarial estimation of claims incurred but not reported. Provision for unearned premiums presents the current insurance risk that will be conditional on future fiscal years.

The Bank had recognized a liability of ISK 2,669 million against the Depositors' and Investors' Guarantee Fund. At the end of June 2017 the Bank received confirmation from the Fund stating that the claim would not be collected, see Note 34.

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## 30. Borrowings

| Currency, original nominal value | First issued | Maturity | Maturity type | Terms of interest | 30.6.2017 | 31.12.2016 |
|---|---|---|---|---|---|---|
| ARION CBI 19 (ISK 4,500 million) ....... | 2013 | 2019 | At maturity | Fixed, CPI linked, 2.50% ................. | 4,552 | 4,502 |
| ARION CB 19 (ISK 2,540 million) ........ | 2016 | 2019 | At maturity | Fixed, 5.50% ................................. | 1,588 | 580 |
| ARION CBI 21 (ISK 10,220 million) ..... | 2014 | 2021 | At maturity | Fixed, CPI linked, 3.50% ................. | 9,785 | 9,696 |
| ARION CB 22 (ISK 23,040 million) ...... | 2015 | 2022 | At maturity | Fixed, 6.50% ................................. | 22,691 | 19,596 |
| ARION CBI 25 (ISK 5,620 million) ....... | 2017 | 2025 | At maturity | Fixed, CPI linked, 3.00% ................. | 4,714 | - |
| ARION CBI 29 (ISK 25,220 million) ..... | 2014 | 2029 | At maturity | Fixed, CPI linked, 3.50% ................. | 26,094 | 23,524 |
| ARION CBI 34 (ISK 2,500 million) ....... | 2012 | 2034 | Amortizing | Fixed, CPI linked, 3.60% ................. | 2,184 | 2,207 |
| **Statutory covered bonds** ........................................ | | | | | 71,608 | 60,105 |
| ARION CB 1 (ISK 21,877 million) ........ | 2006 | 2033 | Amortizing | Fixed, CPI linked, 3.75% ................. | 16,543 | 16,734 |
| ARION CB 4 (ISK 15,500 million) ........ | 2008 | 2045 | Amortizing | Fixed, CPI linked, 4.00% ................. | 6,205 | 6,199 |
| ARION CB 2 (ISK 51,125 million) ........ | 2006 | 2048 | Amortizing | Fixed, CPI linked, 3.75% ................. | 78,408 | 78,239 |
| **Structured Covered bonds** ........................................ | | | | | 101,156 | 101,172 |
| **Total Covered bonds** ........................................ | | | | | 172,764 | 161,277 |
| USD 30 million ................................. | 2016 | 2017 | At maturity | Floating, 3 month LIBOR +1.93% .... | 3,081 | 3,406 |
| EUR 21 million ................................. | 2009 | 2018 | Amortizing | Floating, EURIBOR +1.00% ............ | 485 | 662 |
| ISK 3,835 million ............................... | 2010 | 2018 | Amortizing | Floating, REIBOR +1.00% ............... | 797 | 1,063 |
| EUR 300 million ................................ | 2015 | 2018 | At maturity | Fixed, 3.125% ................................ | 23,229 | 36,610 |
| SEK 500 million ................................. | 2016 | 2018 | At maturity | Floating, 3 month STIBOR + 1.09% . | 6,056 | 3,113 |
| EUR 300 million ................................ | 2016 | 2019 | At maturity | Fixed, 2.50% ................................. | 35,015 | 36,307 |
| RON 35 million ................................. | 2016 | 2019 | At maturity | Fixed, 3.80% ................................. | 908 | 951 |
| SEK 275 million ................................. | 2016 | 2019 | At maturity | Floating, 3 month STIBOR +2.65% .. | 3,321 | 3,422 |
| NOK 800 million ............................... | 2015 | 2020 | At maturity | Floating, NIBOR +2.95% ................ | 9,834 | 10,617 |
| NOK 320 million ............................... | 2016 | 2020 | At maturity | Floating, NIBOR +1.95% ................ | 3,926 | 2,902 |
| EUR 300 million ................................ | 2017 | 2020 | At maturity | Fixed, 0.75% ................................ | 34,767 | - |
| SEK 300 million ................................. | 2017 | 2020 | At maturity | Floating, 3 month STIBOR + 1.35% . | 3,633 | - |
| EUR 500 million* .............................. | 2016 | 2021 | At maturity | Fixed, 1.625% .............................. | 57,897 | 35,639 |
| USD 747 million ................................ | 2016 | 2023 | At maturity | Floating, 3 month LIBOR +2.60% .... | - | 29,317 |
| NOK 250 million ............................... | 2017 | 2023 | At maturity | Fixed, 3.02% ................................ | 3,057 | - |
| NOK 250 million ............................... | 2017 | 2027 | At maturity | Fixed, 3.40% ................................ | 3,059 | - |
| **Senior unsecured bonds** ........................................ | | | | | 189,065 | 164,009 |
| Bills issued ........................................ | | | | | 15,467 | 13,854 |
| Other ........................................ | | | | | 2,765 | 336 |
| **Other loans/bills** ........................................ | | | | | 18,232 | 14,190 |
| **Borrowings** ........................................ | | | | | 380,061 | 339,476 |

The book value of listed bonds was ISK 337 billion at the end of the period (31.12.2016: ISK 284 billion). The market value of those bonds was ISK 362 billion (31.12.2016: ISK 290 billion).

The Group repurchased own debts during the period in the amount of ISK 20 billion (2016: nil) with minor effects on the Statement of Comprehensive Income.

In January 2016 the Bank reached an agreement with Kaupthing under which FX deposits held at Arion Bank would be converted into issued EMTN bond in USD and Kaupthing would prepay Arion Bank's Central Bank secured loan, in various currencies, of ISK 56 billion. The total issue was ISK 97 billion (USD 747 million) with mandatory prepayment requirement if the Bank should issue bonds in excess of USD 165 million. In 2016 Arion Bank's issue exceeded this benchmark twice and thus a prepayment of ISK 57 billion (USD 489 million) was made in 2016. The remaining outstanding amount of ISK 29 billion (USD 258 million) was prepaid during the first half of 2017.

*The Group applies hedge accounting to this bond issuance and uses certain foreign currency denominated interest rate swaps as hedging instruments (see Note 23). The interest rate swaps are hedging the exposure of the Group's changes in the fair value of this fixed-rate foreign currency denominated bond arising from changes in interest rates. The Group started to apply hedge accounting during the first quarter of 2017. The Group applies fair value hedge accounting to the hedging relationships. The total carrying amount of the bond issuance is ISK 57,897 million and included in the amount are fair value changes amounting to ISK 567 million (see Note 8).

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## 31. Pledged assets

| *Pledged assets against liabilities* | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Assets, pledged as collateral against borrowings | 201,607 | 196,901 |
| Assets, pledged as collateral against loans from credit institutions and short positions | 15,465 | 15,644 |
| **Pledged assets against liabilities** | 217,072 | 212,545 |

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 202 billion at the end of the period (31.12.2016: ISK 197 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 173 billion at the end of the period (31.12.2016: ISK 161 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) | 30.6.2017 | Number (million) | 31.12.2016 |
|---|---|---|---|---|
| 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.

| *Other reserves* | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Statutory reserve | 1,637 | 1,637 |
| Reserve for investments in subsidiaries | 11,370 | 17,012 |
| Reserve for investments in associates | 30 | 23 |
| Reserve for investments in securities | 422 | 899 |
| Foreign currency translation reserve | 106 | 190 |
| **Other reserves** | 13,565 | 19,761 |

In June 2016 the Icelandic parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank, see Note 65 in the Annual Financial Statements for 2016. There is some uncertainty over the interpretation and implementation of the amendments and thus the Note may be subject to change in the near term.

# Notes to the Condensed Consolidated Interim Financial Statements

## 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**

*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 that it will be acquitted of the plaintiffs' claims in both cases and has therefore not made any provision.

In January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed a suit against Valitor hf. for compensatory damages amounting to approximately ISK 8.1 billion relating to Valitor hf.'s termination of Datacell's vendor agreement. The Icelandic Supreme Court ruled on 24 April 2013 in case no. 612/2012 that Valitor hf. did not have the authority to terminate the agreement. The plaintiffs had court-appointed appraisers evaluate the plaintiffs' alleged losses and they returned their report in March 2016. Valitor hf. disagreed with the assessment stated in the report and filed a motion to appoint three court appraisers to re-evaluate the plaintiffs' alleged losses The district court agreed to Valitor hf.'s demand. The reassessment has been completed but it was not filed with the court. Valitor hf. has requested a new assessment, which will examine particular aspects which have not yet been assessed. The district court has not ruled on this motion.

When Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014-2015, the Bank signed agreements with the sellers (Landsbankinn and two savings banks) concerning losses which Valitor may potentially sustain in relation to these compensatory damages. Thus the Group may lodge a claim against the sellers for their share in the potential loss should Valitor lose the case. The Group has not made any provision in this case.

**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. In May and June 2017 the Supreme Court, in respect of cases which did not involve the Bank, ruled in two cases regarding this issue. In one of those cases the Supreme Court invalidated a mortgage. The district court has recently ruled in four separate court cases involving the Bank regarding the aforementioned dispute. In three of those cases the district court invalidated a mortgage, while in one case the Bank was acquitted. The Bank is assessing the possible impact of a negative outcome on the Bank's loan portfolio.

**Concluded legal matters**

Arion Bank has concluded a settlement with the Icelandic Competition Authority (ICA), the objective of which is to stimulate competition in retail banking services for individuals and small businesses. The Bank has taken action designed to reduce switching costs in financial services and to prevent circumstances that could enforce tacit co-ordination in the market for retail banking services. The settlement with the ICA brings to an end an investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including Arion Bank, which was initiated by separate complaints lodged by BYR hf. and MP Banki hf. in 2010.

With a writ issued in June 2013, Kortaþjónustan ehf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and the Bank's subsidiary Valitor hf. in the amount of ISK 1.2 billion plus interest, as a result of damage Kortaþjónustan hf. contended the five parties caused the company due to violations of the Competition Act. The Bank put forward its arguments in the case and demanded the rejection of Kortaþjónustan's claims. In June the Supreme Court dismissed the case on procedural grounds.

# Notes to the Condensed Consolidated Interim Financial Statements

## Off balance sheet information

### 34. Commitments

| | 30.6.2017 | 31.12.2016 |
|---|---|---|
| *Financial guarantees, unused overdraft and loan commitments the Group has granted its customers* | | |
| Financial guarantees | 14,341 | 15,270 |
| Unused overdrafts | 46,845 | 46,379 |
| Loan commitments | 79,815 | 82,268 |

*Depositors' and Investors' Guarantee Fund*

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without reaching a conclusion on the matter. Even though the law has not been amended Icelandic banks have made quarterly payments to a separate division within the fund since 2010. The calculated liability from 2010 which is according to the old act, was ISK 2,669 million. At the end of June 2017 the Bank received confirmation from the Depositors' and Investors' Guarantee Fund that this liability and issued guarantee for obligation of ISK 3,210 million would not be collected by the fund. Therefore the Bank reversed a previously expensed contribution to the Depositors' and Investors' Guarantee Fund in the second quarter amounting to ISK 2,669 million.

### 36. Assets under management and under custody

| | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Assets under management | 1,026,295 | 1,054,759 |
| Assets under custody | 1,465,115 | 1,356,997 |

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.

### 37. Events after Balance Sheet date

Sameinað Sílikon hf. ("United Silicon"), a borrower and associate of the Bank, was on 14 August 2017 granted an authorisation for a moratorium, with the goal of reaching agreements with creditors regarding outstanding debts. The request was due to operational difficulties of United Silicon's silicon factory in Iceland, which can be traced to recurrent equipment failures since the operation started in November 2016. A recent ruling of an arbitral tribunal in the United Silicon's dispute with the construction company ÍAV hf. has increased its level of indebtedness.

United Silicon intends to use the moratorium period in order to seek agreements with its creditors and other stakeholders for a financial restructuring. Furthermore, it is foreseen that new capital is required in order to make improvements to the equipment and facilities that are necessary for the factory to produce both the quantity and the quality of product as originally intended.

The Bank is the largest creditor of United Silicon, with a total credit exposure of ISK 8 billion (including loan commitments and guarantees). The Bank also holds 16.3% of the share capital, with 23.9% of the voting rights, which has been fully impaired. Further impairment requirements of the Bank's exposure are currently highly uncertain and will be subject to any financial restructuring agreement reached between United Silicon, the Bank and other stakeholders. The Bank is in discussions with United Silicon to minimize any potential further losses..

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## Related party

### 38. Related party

The Group has a related party relationship with Kaupskil ehf., which is the ultimate controlling party with a 57.87% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., which is the parent company of Kaupskil ehf.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13.00% stake in Arion Bank, Attestor Capital LLP through Trinity Investment Designated Activity Company manages 9.99%, Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. manages 9.99%, Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group manages 6.58%, and Goldman Sachs International through ELQ Investors II Ltd. manages 2.57%, and are all defined as related party with influence over the Group.

Through the ownership of ISFI the Group has a related party relationship with Landsbankinn hf. and Íslandsbanki hf. and they provide banking services to the Bank's subsidiary Valitor hf. and have a traditional bank to bank relationship with Arion Bank hf. Balances with those two banks at period end are included in the line item Shareholders with influence over the Group.

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.

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.

*Balances with related parties*

| 30.6.2017 | Assets | Liabilities | Net balance |
|---|---|---|---|
| Shareholders with control over the Group | 389 | (5,527) | (5,138) |
| Shareholders with influence over the Group | 4,684 | (3,753) | 931 |
| Board of Directors and key Management personnel | 214 | (214) | - |
| Associates and other related parties | 5,877 | (136) | 5,741 |
| **Balances with related parties** | 11,164 | (9,630) | 1,534 |

| 31.12.2016 | Assets | Liabilities | Net balance |
|---|---|---|---|
| Shareholders with control over the Group | 192 | (7,255) | (7,063) |
| Shareholders with influence over the Group | 5,832 | (791) | 5,041 |
| Board of Directors and key Management personnel | 255 | (242) | 13 |
| Associates and other related parties | 181 | (369) | (188) |
| **Balances with related parties** | 6,460 | (8,657) | (2,197) |

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## 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 and in the Pillar 3 Risk Disclosures, published on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not audited.

### 39. 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 Condensed Consolidated 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.

| *Maximum exposure to credit risk related to on-balance sheet items* | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Cash and balances with Central Bank | 151,354 | 87,634 |
| Loans to credit institutions | 78,250 | 80,116 |
| Loans to corporates | 390,247 | 375,006 |
| Loans to individuals | 343,402 | 337,416 |
| Financial instruments | 83,066 | 8,617 |
| Other assets with credit risk | 21,890 | 4,581 |
| **Total on-balance sheet maximum exposure to credit risk** | 1,068,209 | 893,370 |
| *Maximum exposure to credit risk related to off-balance sheet items* | | |
| Financial guarantees | 14,341 | 15,270 |
| Unused overdrafts | 46,845 | 46,379 |
| Loan commitments | 79,815 | 82,268 |
| **Total off-balance sheet maximum exposure to credit risk** | 141,001 | 143,917 |
| **Maximum exposure to credit risk** | 1,209,210 | 1,037,287 |

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### 39. Credit risk, continued

| *Loans to customers specified by sectors* | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Individuals | 46.8% | 47.4% |
| Real estate activities and construction | 16.8% | 16.1% |
| Fishing industry | 11.0% | 10.7% |
| Information and communication technology | 3.8% | 4.1% |
| Wholesale and retail trade | 7.5% | 7.4% |
| Financial and insurance activities | 4.5% | 4.9% |
| Industry, energy and manufacturing | 4.0% | 4.0% |
| Transportation | 1.4% | 0.9% |
| Services | 2.4% | 2.4% |
| Public sector | 1.0% | 1.2% |
| Agriculture and forestry | 0.8% | 0.9% |
| | 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 quotas.

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*

| 30.6.2017 | Cash and securities | Real estate | Fishing vessels | Other collateral | Total |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | - | - | - | - | - |
| Loans to credit institutions | - | - | - | - | - |
| Loans to customers | | | | | |
| Individuals | 194 | 303,550 | 16 | 5,985 | 309,745 |
| Real estate activities and construction | 3,342 | 110,059 | 9 | 1,935 | 115,345 |
| Fishing industry | 529 | 7,097 | 50,717 | 7,761 | 66,104 |
| Information and communication technology | 40 | 2,600 | - | 17,084 | 19,724 |
| Wholesale and retail trade | 371 | 28,524 | 3 | 18,572 | 47,470 |
| Financial and insurance activities | 14,246 | 3,500 | 30 | 5,683 | 23,459 |
| Industry, energy and manufacturing | 38 | 17,599 | 6 | 4,450 | 22,093 |
| Transportation | 9 | 930 | 278 | 2,701 | 3,918 |
| Services | 87 | 7,615 | 48 | 2,939 | 10,689 |
| Public sector | 110 | 3,660 | - | 166 | 3,936 |
| Agriculture and forestry | - | 5,190 | - | 358 | 5,548 |
| Financial instruments | 6,085 | - | - | - | 6,085 |
| Financial guarantees | 1,049 | 3,736 | 1,098 | 3,221 | 9,104 |
| **Collateral held against different types of financial assets** | 26,100 | 494,060 | 52,205 | 70,855 | 643,220 |

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### 39. Credit risk, continued

| 31.12.2016 | Cash and securities | Real estates | Fishing vessels | Other collateral | Total |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | - | - | - | - | - |
| Loans to credit institutions | - | - | - | - | - |
| Loans to customers | | | | | |
| Individuals | 481 | 297,974 | 5 | 7,419 | 305,879 |
| Real estate activities and construction | 581 | 106,770 | 34 | 1,444 | 108,829 |
| Fishing industry | 564 | 8,100 | 57,092 | 8,041 | 73,797 |
| Information and communication technology | 27 | 2,598 | - | 18,363 | 20,988 |
| Wholesale and retail trade | 410 | 26,570 | 8 | 19,988 | 46,976 |
| Financial and insurance activities | 14,826 | 7,620 | - | 807 | 23,253 |
| Industry, energy and manufacturing | 3,287 | 15,332 | - | 6,875 | 25,494 |
| Transportation | 73 | 892 | 278 | 3,622 | 4,865 |
| Services | 20 | 7,221 | 71 | 3,650 | 10,962 |
| Public sector | 7 | 3,811 | - | 179 | 3,997 |
| Agriculture and forestry | 5 | 5,128 | - | 327 | 5,460 |
| Financial instruments | 5,953 | - | - | - | 5,953 |
| Financial guarantees | 1,038 | 3,871 | 1,249 | 2,375 | 8,533 |
| **Collateral held against different types of financial assets** | 27,272 | 485,887 | 58,737 | 73,090 | 644,986 |

*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 the end of the period amount to ISK 466 million (31.12.2016: ISK 1,817 million) and other assets ISK 1 million (31.12.2016: ISK 13 million). The assets are held for sale, see Note 28.

**Credit quality**

*Credit quality by class of financial assets*

| 30.6.2017 | Neither past due nor impaired | Past due but not impaired | Individu-ally impaired | Total |
|---|---|---|---|---|
| Cash and balances with Central Bank | 151,354 | - | - | 151,354 |
| Loans to credit institutions | 78,250 | - | - | 78,250 |
| Loans to customers | | | | |
| Loans to corporates | 370,693 | 17,636 | 1,918 | 390,247 |
| Loans to individuals | 323,075 | 18,473 | 1,854 | 343,402 |
| Financial instruments | 73,077 | - | - | 73,077 |
| Other assets with credit risk | 21,890 | - | - | 21,890 |
| **Credit quality by class of financial assets** | 1,018,339 | 36,109 | 3,772 | 1,058,220 |

| 31.12.2016 | | | | |
|---|---|---|---|---|
| Cash and balances with Central Bank | 87,634 | - | - | 87,634 |
| Loans to credit institutions | 80,116 | - | - | 80,116 |
| Loans to customers | | | | |
| Loans to corporates | 358,709 | 14,251 | 2,046 | 375,006 |
| Loans to individuals | 312,259 | 21,854 | 3,303 | 337,416 |
| Financial instruments | 82,042 | - | - | 82,042 |
| Other assets with credit risk | 8,617 | - | - | 8,617 |
| **Credit quality by class of financial assets** | 929,377 | 36,105 | 5,349 | 970,831 |

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## 39. 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 four 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 that has been found to be predictive. Two models rate individuals' exposures – one for prime mortgages and another for other exposures. 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.

| | Risk classification | | | | | | |
|---|---|---|---|---|---|---|---|
| 30.6.2017 | 1 | 2 | 3 | 4 | 5 | Not rated | Total |
| Individuals | 172,797 | 101,762 | 31,245 | 11,363 | 2,616 | 3,292 | 323,075 |
| Real estate activities and construction | 44,763 | 37,433 | 29,622 | 3,835 | 276 | 1,830 | 117,759 |
| Fishing industry | 28,845 | 41,643 | 5,339 | 912 | 918 | - | 77,657 |
| Information and communication technology | 17,724 | 2,617 | 6,189 | 140 | - | 12 | 26,682 |
| Wholesale and retail trade | 12,854 | 21,357 | 13,317 | 1,812 | 509 | - | 49,849 |
| Financial and insurance activities | 13,048 | 1,633 | 12,208 | 154 | - | 5,209 | 32,252 |
| Industry, energy and manufacturing | 8,350 | 9,312 | 9,699 | 689 | 158 | 337 | 28,545 |
| Transportation | 4,540 | 4,357 | 1,069 | 338 | - | - | 10,304 |
| Services | 1,733 | 5,643 | 5,333 | 386 | 2,372 | 331 | 15,798 |
| Public sector | 669 | 4,413 | 689 | 1,019 | 47 | 507 | 7,344 |
| Agriculture and forestry | 691 | 1,585 | 1,740 | 413 | 74 | - | 4,503 |
| **Neither past due nor impaired loans** | 306,014 | 231,755 | 116,450 | 21,061 | 6,970 | 11,518 | 693,768 |
| | | | | | | | |
| 31.12.2016 | | | | | | | |
| Individuals | 68,538 | 162,930 | 55,500 | 17,036 | 4,331 | 3,924 | 312,259 |
| Real estate activities and construction | 43,172 | 33,819 | 24,557 | 5,679 | 348 | 3,184 | 110,759 |
| Fishing industry | 24,480 | 36,143 | 9,700 | 2,579 | 604 | 79 | 73,585 |
| Information and communication technology | 18,372 | 3,207 | 966 | 5,476 | - | 12 | 28,033 |
| Wholesale and retail trade | 11,342 | 19,302 | 16,890 | 2,244 | 208 | - | 49,986 |
| Financial and insurance activities | 9,669 | 2,210 | 15,623 | 207 | - | 5,730 | 33,439 |
| Industry, energy and manufacturing | 7,908 | 7,854 | 10,101 | 719 | 635 | 351 | 27,568 |
| Transportation | 958 | 3,753 | 989 | 433 | 20 | - | 6,153 |
| Services | 2,303 | 5,312 | 7,263 | 847 | 28 | 3 | 15,756 |
| Public sector | 377 | 4,425 | 1,874 | 1,146 | 53 | 656 | 8,531 |
| Agriculture and forestry | 478 | 1,147 | 2,029 | 1,227 | 18 | - | 4,899 |
| **Neither past due nor impaired loans** | 187,597 | 280,102 | 145,492 | 37,593 | 6,245 | 13,939 | 670,968 |

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

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### 39. Credit risk, continued

| *Past due but not impaired loans by class of loans*<br>30.6.2017 | Up to 3 days | 4 to 30 days | 31 to 60 days | 61 to 90 days | More than 90 days | Total |
|---|---|---|---|---|---|---|
| Loans to corporates | 6,596 | 5,182 | 1,912 | 956 | 2,990 | 17,636 |
| Loans to individuals | 2,602 | 7,839 | 3,926 | 1,128 | 2,978 | 18,473 |
| **Past due but not impaired loans** | 9,198 | 13,021 | 5,838 | 2,084 | 5,968 | 36,109 |
| | | | | | | |
| 31.12.2016 | | | | | | |
| Loans to corporates | 5,388 | 4,282 | 1,589 | 1,211 | 1,781 | 14,251 |
| Loans to individuals | 3,196 | 8,708 | 4,989 | 391 | 4,570 | 21,854 |
| **Past due but not impaired loans** | 8,584 | 12,990 | 6,578 | 1,602 | 6,351 | 36,105 |

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.

| | 30.6.2017 | | 31.12.2016 | |
|---|---|---|---|---|
| *Impaired loans to customers specified by sector* | Impair-ment amount | Gross carrying amount | Impair-ment amount | Gross carrying amount |
| Individuals | 5,367 | 7,221 | 7,069 | 10,372 |
| Real estate activities and construction | 662 | 1,044 | 770 | 1,056 |
| Fishing industry | 872 | 1,701 | 966 | 1,648 |
| Information and communication technology | 61 | 61 | 179 | 182 |
| Wholesale and retail trade | 477 | 716 | 540 | 868 |
| Financial and insurance activities | 247 | 263 | 261 | 298 |
| Industry, energy and manufacturing | 781 | 800 | 786 | 878 |
| Transportation | - | - | 4,301 | 4,307 |
| Services | 3,226 | 3,560 | 3,145 | 3,624 |
| Public sector | 60 | 60 | 89 | 113 |
| Agriculture and forestry | 173 | 272 | 175 | 284 |
| **Impaired loans to customers specified by sector** | 11,926 | 15,698 | 18,281 | 23,630 |

**Large exposure**

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's eligible capital according to Financial Undertakings Act No. 161/2002 and FME Rules No. 625/2013. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible credit risk mitigation.

The Group has one large exposure of ISK 27 billion at the end of the period, before taking account of eligible credit risk mitigation (31.12.2016: no large exposure).

| | 30.6.2017 | | 31.12.2016 | |
|---|---|---|---|---|
| No. | Gross | Net | Gross | Net |
| 1 | 12% | <10% | <10% | <10% |
| **Sum of large exposure gross and net > 10%** | 12% | 0% | 0% | 0% |

The sum of exposures exceeding 10% of the capital base is 12% of the Group's capital base, before eligible credit risk mitigation. There are no exposures exceeding 10% of the capital base, after eligible credit risk mitigation.

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## 40. 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 characterized 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 23, 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.

| 30.6.2017<br>*Assets* | Up to 3 months | 3-12 months | 1-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|
| Balances with Central Bank | 142,157 | - | - | - | - | 142,157 |
| Loans to credit institutions | 78,250 | - | - | - | - | 78,250 |
| Loans to customers | 409,782 | 63,077 | 143,735 | 5,883 | 116,993 | 739,470 |
| Financial instruments | 33,346 | 1,749 | 3,870 | 5,850 | 1,890 | 46,705 |
| **Assets** | 663,535 | 64,826 | 147,605 | 11,733 | 118,883 | 1,006,582 |
| *Liabilities* | | | | | | |
| Due to credit institutions and Central Bank | 7,619 | 25 | - | - | - | 7,644 |
| Deposits | 386,127 | 36,404 | 12,802 | 1,320 | 841 | 437,494 |
| Borrowings | 35,658 | 46,244 | 145,449 | 34,093 | 143,654 | 405,098 |
| **Liabilities** | 429,404 | 82,673 | 158,251 | 35,413 | 144,495 | 850,236 |
| Derivatives and other off-balance sheet items (net position) | (129,145) | 35,241 | 95,508 | 1,341 | - | 2,945 |
| **Net interest gap** | 104,986 | 17,394 | 84,862 | (22,339) | (25,612) | 159,291 |

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## 40. Market risk, continued

| 31.12.2016<br>*Assets* | Up to 3 months | 3-12 months | 1-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|
| Balances with Central Bank | 80,186 | - | - | - | - | 80,186 |
| Loans to credit institutions | 80,116 | - | - | - | - | 80,116 |
| Loans to customers | 382,928 | 63,694 | 138,540 | 4,457 | 127,601 | 717,220 |
| Financial instruments | 41,495 | 1,695 | 5,182 | 6,349 | 1,897 | 56,618 |
| **Assets** | 584,725 | 65,389 | 143,722 | 10,806 | 129,498 | 934,140 |
| *Liabilities* | | | | | | |
| Due to credit institutions and Central Bank | 7,962 | 25 | - | - | - | 7,987 |
| Deposits | 376,424 | 21,111 | 12,450 | 1,263 | 816 | 412,064 |
| Borrowings | 62,830 | 8,653 | 126,836 | 20,670 | 129,423 | 348,412 |
| **Liabilities** | 447,216 | 29,789 | 139,286 | 21,933 | 130,239 | 768,463 |
| Derivatives and other off-balance sheet items (net position) | (107,799) | (916) | 111,083 | (146) | - | 2,222 |
| **Net interest gap** | 29,710 | 34,684 | 115,519 | (11,273) | (741) | 167,899 |

*Interest rate risk in the trading book*

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

| | 30.6.2017 | | | 31.12.2016 | | |
|---|---|---|---|---|---|---|
| *Trading financial instruments, long positions* | MV | Duration | BPV | MV | Duration | BPV |
| ISK, CPI index-linked | 8,763 | 2.5 | (2.2) | 8,084 | 2.2 | (1.8) |
| ISK, Non index-linked | 15,054 | 0.9 | (1.4) | 10,992 | 1.0 | (1.1) |
| FX | 58,038 | (0.3) | 1.7 | 37,399 | (0.5) | 2.0 |
| **Total** | 81,855 | 0.2 | (1.9) | 56,475 | 0.2 | (0.9) |
| *Trading financial instruments, short positions* | | | | | | |
| ISK, CPI index-linked | 1,096 | 3.7 | (0.4) | 518 | 4.7 | (0.2) |
| ISK, Non index-linked | 34,457 | 0.2 | (0.5) | 15,680 | 0.3 | (0.4) |
| FX | 37,336 | (0.6) | 2.4 | 29,847 | (0.8) | 2.4 |
| **Total** | 72,889 | (0.2) | 1.5 | 46,045 | (0.4) | 1.8 |

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## 40. 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

| 30.6.2017<br>*Assets, CPI index-linked* | Up to 1 year | 1 to 5 years | Over 5 years | Total |
|---|---|---|---|---|
| Loans to customers | 16,935 | 98,062 | 226,417 | 341,414 |
| Financial instruments | 7,201 | - | - | 7,201 |
| Off-balance sheet position | 4,013 | 3,119 | - | 7,132 |
| **Assets, CPI index-linked** | 28,149 | 101,181 | 226,417 | 355,747 |
| *Liabilities, CPI index-linked* | | | | |
| Deposits | 65,252 | 12,298 | 2,127 | 79,677 |
| Borrowings | 2,650 | 24,534 | 121,829 | 149,013 |
| Other | 1,061 | 189 | 1,355 | 2,605 |
| Off-balance sheet position | - | 524 | - | 524 |
| **Liabilities, CPI index-linked** | 68,963 | 37,545 | 125,311 | 231,819 |
| Net on-balance sheet position | (44,827) | 61,041 | 101,106 | 117,320 |
| Net off-balance sheet position | 4,013 | 2,595 | - | 6,608 |
| **CPI Balance** | (40,814) | 63,636 | 101,106 | 123,928 |

| 31.12.2016<br>*Assets, CPI index-linked* | | | | |
|---|---|---|---|---|
| Loans to customers | 12,911 | 97,225 | 218,981 | 329,117 |
| Financial instruments | 7,100 | - | - | 7,100 |
| Off-balance sheet position | 851 | 6,619 | - | 7,470 |
| **Assets, CPI index-linked** | 20,862 | 103,844 | 218,981 | 343,687 |
| *Liabilities, CPI index-linked* | | | | |
| Deposits | 69,621 | 12,121 | 2,050 | 83,792 |
| Borrowings | 2,253 | 24,437 | 114,747 | 141,437 |
| Off-balance sheet position | - | 518 | - | 518 |
| Other | 395 | 692 | 893 | 1,980 |
| **Liabilities, CPI indexed linked** | 72,269 | 37,768 | 117,690 | 227,727 |
| Net on-balance sheet position | (52,258) | 59,975 | 101,291 | 109,008 |
| Net off-balance sheet position | 851 | 6,101 | - | 6,952 |
| **CPI Balance** | (51,407) | 66,076 | 101,291 | 115,960 |

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# Notes to the Condensed Consolidated Interim Financial Statements

## 40. 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

30.6.2017

| *Assets* | ISK | EUR | USD | GBP | DKK | NOK | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 148,719 | 874 | 625 | 340 | 185 | 104 | 507 | 151,354 |
| Loans to credit institutions | 19,726 | 30,307 | 9,555 | 4,519 | 2,536 | 6,385 | 5,222 | 78,250 |
| Loans to customers | 602,040 | 83,469 | 34,277 | 2,737 | 6,645 | 66 | 4,415 | 733,649 |
| Financial instruments | 80,283 | 16,815 | 10,302 | 76 | - | 1,554 | 323 | 109,353 |
| Investment property | 7,166 | - | - | - | - | - | - | 7,166 |
| Investments in associates | 817 | 8 | - | - | - | - | - | 825 |
| Intangible assets | 8,451 | - | - | 455 | 2,733 | - | - | 11,639 |
| Tax assets | 411 | - | - | 2 | - | - | - | 413 |
| Other assets | 29,434 | 501 | 944 | 1,894 | 920 | 20 | 49 | 33,762 |
| **Assets** | 897,047 | 131,974 | 55,703 | 10,023 | 13,019 | 8,129 | 10,516 | 1,126,411 |
| *Liabilities and equity* | | | | | | | | |
| Due to credit inst. and Central Bank | 6,891 | 642 | 60 | 3 | - | 1 | 47 | 7,644 |
| Deposits | 396,416 | 18,254 | 12,384 | 5,707 | 1,367 | 2,099 | 1,267 | 437,494 |
| Financial liabilities at fair value | 3,856 | 770 | 16 | 41 | 17 | 99 | 230 | 5,029 |
| Tax liabilities | 9,246 | - | - | - | 96 | - | - | 9,342 |
| Other liabilities | 54,844 | 3,703 | 1,199 | 1,968 | 1,961 | 387 | 1,012 | 65,074 |
| Borrowings | 190,463 | 151,395 | 3,442 | 1,876 | - | 19,876 | 13,009 | 380,061 |
| Shareholders' equity | 221,593 | - | - | - | - | - | - | 221,593 |
| Non-controlling interest | 174 | - | - | - | - | - | - | 174 |
| **Liabilities and equity** | 883,483 | 174,764 | 17,101 | 9,595 | 3,441 | 22,462 | 15,565 | 1,126,411 |
| Net on-balance sheet position | 13,564 | (42,790) | 38,602 | 428 | 9,578 | (14,333) | (5,049) | |
| Net off-balance sheet position | (13,944) | 43,777 | (37,359) | (993) | (10,169) | 13,970 | 4,718 | |
| **Net position** | (380) | 987 | 1,243 | (565) | (591) | (363) | (331) | |

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### 40. Market risk, continued

31.12.2016

| *Assets* | ISK | EUR | USD | GBP | DKK | NOK | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 85,052 | 775 | 627 | 364 | 197 | 108 | 511 | 87,634 |
| Loans to credit institutions ............... | 18,946 | 16,963 | 17,444 | 8,522 | 1,826 | 10,064 | 6,351 | 80,116 |
| Loans to customers .......................... | 593,185 | 66,242 | 34,012 | 2,857 | 7,378 | 7 | 8,741 | 712,422 |
| Financial instruments ....................... | 91,566 | 13,403 | 9,572 | 311 | 244 | 2,245 | 115 | 117,456 |
| Investment property ........................ | 5,358 | - | - | - | - | - | - | 5,358 |
| Investments in associates ................. | 831 | 8 | - | - | - | - | - | 839 |
| Intangible assets ............................... | 6,978 | - | - | - | 4,079 | - | - | 11,057 |
| Tax assets ......................................... | 272 | - | - | - | 16 | - | - | 288 |
| Other assets ..................................... | 19,356 | 650 | 556 | 142 | 135 | 13 | 2 | 20,854 |
| **Assets ............................................** | 821,544 | 98,041 | 62,211 | 12,196 | 13,875 | 12,437 | 15,720 | 1,036,024 |
| | | | | | | | | |
| *Liabilities and equity* | | | | | | | | |
| Due to credit inst. and Central Bank .. | 6,857 | 978 | 84 | 3 | - | 1 | 64 | 7,987 |
| Deposits ........................................... | 377,195 | 15,762 | 12,038 | 4,186 | 844 | 1,301 | 738 | 412,064 |
| Financial liabilities at fair value ......... | 3,020 | 408 | 272 | - | - | 16 | 10 | 3,726 |
| Tax liabilities .................................... | 7,075 | - | - | - | 218 | - | - | 7,293 |
| Other liabilities ................................ | 44,625 | 2,660 | 1,160 | 4,255 | 756 | 229 | 409 | 54,094 |
| Borrowings ....................................... | 176,530 | 109,217 | 32,723 | - | - | 13,520 | 7,486 | 339,476 |
| Shareholders' equity ........................ | 211,212 | - | - | - | - | - | - | 211,212 |
| Non-controlling interest ................... | 172 | - | - | - | - | - | - | 172 |
| **Liabilities and equity ......................** | 826,686 | 129,025 | 46,277 | 8,444 | 1,818 | 15,067 | 8,707 | 1,036,024 |
| | | | | | | | | |
| Net on-balance sheet position .......... | (5,142) | (30,984) | 15,934 | 3,752 | 12,057 | (2,630) | 7,013 | |
| Net off-balance sheet position .......... | 279 | 31,775 | (15,315) | (3,232) | (8,579) | 2,335 | (7,263) | |
| | | | | | | | | |
| **Net position ...................................** | (4,863) | 791 | 619 | 520 | 3,478 | (295) | (250) | |

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### 41. 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

| 30.6.2017<br>*Assets* | Carrying amount | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | With no maturity |
|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 151,354 | 141,820 | - | 9,534 | - | - | - |
| Loans to credit institutions | 78,250 | 73,339 | 4,911 | - | - | - | - |
| Loans to customers | 733,649 | 13,968 | 47,607 | 101,472 | 244,069 | 326,533 | - |
| Financial instruments | 109,353 | 12,315 | 3,152 | 3,508 | 42,331 | 11,771 | 36,276 |
| *Derivatives - assets leg* | *113,599* | - | *28,381* | *10,657* | *73,417* | *1,144* | - |
| *Derivatives - liabilities leg* | *(107,382)* | - | *(27,373)* | *(8,918)* | *(70,064)* | *(1,027)* | - |
| Investment property | 7,166 | - | - | - | - | - | 7,166 |
| Investments in associates | 825 | - | - | - | - | - | 825 |
| Intangible assets | 11,639 | - | - | - | - | - | 11,639 |
| Tax assets | 413 | - | - | - | 413 | - | - |
| Other assets | 33,762 | 2,541 | 15,915 | 2,838 | 596 | - | 11,872 |
| **Assets** | 1,126,411 | 243,983 | 71,585 | 117,352 | 287,409 | 338,304 | 67,778 |
| *Liabilities* | | | | | | | |
| Due to credit institutions and Central Bank | 7,644 | 7,619 | - | - | 25 | - | - |
| Deposits | 437,494 | 348,479 | 51,112 | 27,192 | 9,179 | 1,532 | - |
| Financial liabilities at fair value | 5,029 | 23 | 2,691 | 979 | 1,075 | 261 | - |
| *Derivatives - assets leg* | *(58,044)* | *(2,796)* | *(20,554)* | *(18,089)* | *(12,314)* | *(4,291)* | - |
| *Derivatives - liabilities leg* | *61,337* | *2,819* | *21,509* | *19,068* | *13,389* | *4,552* | - |
| *Short position bonds and derivatives* | *572* | - | *572* | - | - | - | - |
| *Short position securities used for hedging* | *1,164* | - | *1,164* | - | - | - | - |
| Tax liabilities | 9,342 | - | 750 | 6,630 | 1,962 | - | - |
| Other liabilities | 65,074 | 19,535 | 19,972 | 3,008 | 2,931 | 6 | 19,622 |
| Borrowings | 380,061 | - | 8,253 | 41,547 | 180,979 | 149,282 | - |
| **Liabilities** | 904,644 | 375,656 | 82,778 | 79,356 | 196,151 | 151,081 | 19,622 |
| **On-balance sheet items** | 221,767 | (131,673) | (11,193) | 37,996 | 91,258 | 187,223 | 48,156 |
| *Off-balance sheet items* | | | | | | | |
| Financial guarantees | 14,341 | 2,889 | 2,273 | 4,828 | 2,672 | 1,679 | - |
| Unused overdraft | 46,845 | 1,069 | 10,097 | 18,700 | 16,979 | - | - |
| Loan commitments | 79,815 | 3,555 | 24,609 | 21,888 | 25,763 | 4,000 | - |
| **Off-balance sheet items** | 141,001 | 7,513 | 36,979 | 45,416 | 45,414 | 5,679 | - |
| **Net assets (liabilities)** | 80,766 | (139,186) | (48,172) | (7,420) | 45,844 | 181,544 | 48,156 |

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**41. Liquidity and Funding risk, continued**

| 31.12.2016 *Assets* | Carrying amount | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | With no maturity |
|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 87,634 | 78,302 | - | 9,332 | - | - | - |
| Loans to credit institutions | 80,116 | 54,104 | 26,012 | - | - | - | - |
| Loans to customers | 712,422 | 9,051 | 54,203 | 79,205 | 253,938 | 316,025 | - |
| Financial instruments | 117,456 | 12,715 | 2,100 | 3,670 | 51,729 | 11,828 | 35,414 |
| *Derivatives - assets leg* | *75,527* | - | *28,038* | *19,179* | *27,825* | *485* | - |
| *Derivatives - liabilities leg* | *(70,368)* | - | *(27,300)* | *(17,927)* | *(24,886)* | *(255)* | - |
| Investment property | 5,358 | - | - | - | - | - | 5,358 |
| Investments in associates | 839 | - | - | - | - | - | 839 |
| Intangible assets | 11,057 | - | - | - | - | - | 11,057 |
| Tax assets | 288 | - | - | - | 288 | - | - |
| Other assets | 20,854 | 2,687 | 3,883 | 1,303 | 745 | - | 12,236 |
| **Assets** | 1,036,024 | 156,859 | 86,198 | 93,510 | 306,700 | 327,853 | 64,904 |
| *Liabilities* | | | | | | | |
| Due to credit institutions and Central Bank | 7,987 | 7,636 | - | 326 | 25 | - | - |
| Deposits | 412,064 | 288,390 | 74,202 | 37,769 | 10,088 | 1,615 | - |
| Financial liabilities at fair value | 3,726 | - | 2,400 | 127 | 895 | 304 | - |
| *Derivatives - assets leg* | *(57,923)* | - | *(13,857)* | *(3,960)* | *(39,388)* | *(718)* | - |
| *Derivatives - liabilities leg* | *59,765* | - | *14,373* | *4,087* | *40,283* | *1,022* | - |
| *Short position bonds used for hedging* | *1,884* | - | *1,884* | - | - | - | - |
| Tax liabilities | 7,293 | - | - | 6,626 | 667 | - | - |
| Other liabilities | 54,094 | 21,837 | 7,414 | 3,446 | 3,660 | 6 | 17,731 |
| Borrowings | 339,476 | - | 10,293 | 13,371 | 153,607 | 162,205 | - |
| **Liabilities** | 824,640 | 317,863 | 94,309 | 61,665 | 168,942 | 164,130 | 17,731 |
| **On-balance sheet items** | 211,384 | (161,004) | (8,111) | 31,845 | 137,758 | 163,723 | 47,173 |
| *Off-balance sheet items* | | | | | | | |
| Financial guarantees | 15,270 | 2,893 | 4,032 | 4,136 | 2,538 | 1,671 | - |
| Unused overdraft | 46,379 | 1,460 | 9,098 | 18,305 | 17,516 | - | - |
| Loan commitments | 82,268 | 1,348 | 38,757 | 17,075 | 21,088 | 4,000 | - |
| **Off-balance sheet items** | 143,917 | 5,701 | 51,887 | 39,516 | 41,142 | 5,671 | - |
| **Net assets (liabilities)** | 67,467 | (166,705) | (59,998) | (7,671) | 96,616 | 158,052 | 47,173 |

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## 41. 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. The NSFR for foreign currency 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.

| 30.6.2017 | ISK | FX | Total |
|---|---|---|---|
| Available stable funding | 667,366 | 173,910 | 841,276 |
| Required stable funding | 560,842 | 104,015 | 664,857 |
| FX imbalance | | (3,226) | |
| **Net stable funding ratio** | 119% | 164% | 127% |

| 31.12.2016 | | | |
|---|---|---|---|
| Available stable funding | 612,964 | 169,821 | 782,785 |
| Required stable funding | 544,854 | 87,010 | 631,864 |
| FX imbalance | | (4,019) | |
| **Net stable funding ratio** | 113% | 191% | 124% |

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## 41. 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.

On 31 March 2017, new liquidity rules no. 266/2017 took effect. The rules are issued by the Central Bank of Iceland and effectively adopt the liquidity rules of the EU Capital Requirements Regulation (CRR), replacing the previous LCR rules no. 1031/2014. The Bank is required to maintain a 100% minimum LCR ratio for both foreign currencies and all currencies.

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. The figures at 30 June 2017 are based on rules no. 266/2017 while the figures at 31 December 2016 are based on rules no. 1031/2014.

| 30.6.2017 | ISK | FX | Total |
|---|---|---|---|
| Liquid assets level 1 * | 157,527 | 16,363 | 173,890 |
| Liquid assets level 2 | - | - | - |
| **Liquid Assets** | 157,527 | 16,363 | 173,890 |
| Deposits | 91,513 | 20,561 | 112,074 |
| Market Borrowing | 4,488 | 95 | 4,583 |
| Other Cash outflows | 9,029 | 7,148 | 16,177 |
| **Cash outflows** | 105,030 | 27,804 | 132,834 |
| Short-term deposits with other banks *** | 2,444 | 51,691 | 54,135 |
| Other Cash inflows | 9,098 | 4,290 | 13,388 |
| **Cash inflows** | 11,542 | 55,981 | 67,523 |
| **Liquidity coverage ratio (LCR) ****** | 168% | 235% | 266% |

| 31.12.2016 | ISK | FX | Total |
|---|---|---|---|
| Liquid assets level 1 * | 112,770 | 13,026 | 125,796 |
| Liquid assets level 2 ** | - | 2,932 | 2,932 |
| **Liquid Assets** | 112,770 | 15,958 | 128,728 |
| Deposits | 93,584 | 16,885 | 110,469 |
| Market Borrowing | 3,192 | 371 | 3,563 |
| Other Cash outflows | 12,426 | 7,013 | 19,439 |
| **Cash outflows** | 109,202 | 24,269 | 133,471 |
| Short-term deposits with other banks *** | 1,688 | 51,779 | 53,467 |
| Other Cash inflows | 3,843 | 1,011 | 4,854 |
| **Cash inflows** | 5,531 | 52,790 | 58,321 |
| **Liquidity coverage ratio (LCR) ****** | 109% | 263% | 171% |

* Level 1 assets include the Group's cash and balances with the Central Bank, domestic bonds eligible as collateral at the Central Bank and foreign government bonds which receive 100% weight. Under Rules no. 266/2017 the Group's covered bonds also classify as Level 1 assets and receive 93% weight.

** 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 = Weighted liquid assets / (weighted cash outflows - weighted cash inflows) where weighted cash inflows are capped at 75% of weighted cash outflows.

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### 41. Liquidity and Funding risk, continued

*Composition of liquid assets*

The following table shows the composition of the Bank's liquidity buffer.

| 30.6.2017 | ISK | USD | EUR | Other | Total |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | 148,719 | 625 | 874 | 1,136 | 151,354 |
| Short-term deposits in other banks | 2,444 | 8,243 | 28,231 | 15,217 | 54,135 |
| Domestic bonds eligible as collateral at the Central Bank | 18,342 | - | - | - | 18,342 |
| Foreign government bonds | - | 5,914 | 5,345 | - | 11,259 |
| Covered bonds with a minimum rating of AA- | - | - | 1,177 | 1,478 | 2,655 |
| **Liquidity reserve** | 169,505 | 14,782 | 35,627 | 17,831 | 237,745 |

| 31.12.2016 | ISK | USD | EUR | Other | Total |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | 85,053 | 627 | 775 | 1,179 | 87,634 |
| Short-term deposits in other banks | 1,688 | 16,018 | 14,090 | 21,671 | 53,467 |
| Domestic bonds eligible as collateral at the Central Bank | 27,718 | - | - | - | 27,718 |
| Foreign government bonds | - | 5,536 | 4,908 | - | 10,444 |
| Covered bonds with a minimum rating of AA- | - | - | 1,202 | 2,247 | 3,449 |
| **Liquidity reserve** | 114,459 | 22,181 | 20,975 | 25,097 | 182,712 |

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## 41. 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 | | | | | |
|---|---|---|---|---|---|---|
| 30.6.2017 | Less Stable | Weight (%) | Stable | Weight (%) | Term deposits* | Total deposits |
| Retail | 151,586 | 10% | 48,322 | 5% | 66,458 | 266,366 |
| Corporations | 52,071 | 40% | 912 | 20% | 9,183 | 62,166 |
| Sovereigns, central banks and PSE | 13,214 | 40% | - | - | 1,985 | 15,199 |
| Pension funds | 38,448 | 100% | - | - | 16,983 | 55,431 |
| Domestic financial entities | 21,479 | 100% | - | - | 21,867 | 43,346 |
| Foreign financial entities | 2,630 | 100% | - | - | - | 2,630 |
| **Total** | 279,428 | | 49,234 | | 116,476 | 445,138 |
| | | | | | | |
| 31.12.2016 | | | | | | |
| Retail | 137,055 | 10% | 44,331 | 5% | 63,106 | 244,492 |
| Corporations | 55,094 | 40% | 921 | 20% | 5,850 | 61,865 |
| Sovereigns, central banks and PSE | 11,653 | 40% | - | - | 1,379 | 13,032 |
| Pension funds | 31,157 | 100% | - | - | 15,959 | 47,116 |
| Domestic financial entities | 24,310 | 100% | - | - | 16,730 | 41,040 |
| Foreign financial entities | 2,150 | 100% | - | - | - | 2,150 |
| Other foreign parties | 4,466 | 100% | 3,276 | 25% | 2,288 | 10,030 |
| **Total** | 265,885 | | 48,528 | | 105,312 | 419,725 |

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

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## 43. Capital management

### Capital ratio

The focus of capital management at the Group is to normalize the capital structure in the medium term and consequently maintain the Group's capitalization comfortably above the regulatory minimum, including capital buffers and Pillar 2 requirements.

The Group's capital ratios are calculated in accordance with Act No. 161/2002 on Financial Undertakings and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR), but has temporarily excluded Article 501 on capital requirements relief for small and medium enterprises. The Group uses the standardized approach to calculate the capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

| *Capital Base* | 30.6.2017 | 31.12.2016 |
|---|---|---|
| Total equity | 221,767 | 211,384 |
| Non-controlling interest not eligible for inclusion in CET1 capital | (174) | (172) |
| Intangible assets | (11,639) | (11,057) |
| Tax assets | (413) | (288) |
| Cash flow hedges | 16 | (22) |
| Additional value adjustments | (122) | (127) |
| **Common equity Tier 1 capital** | 209,435 | 199,718 |
| Non-controlling interest not eligible for inclusion in CET1 capital | 174 | 172 |
| **Tier 1 capital** | 209,609 | 199,890 |
| General credit risk adjustments | 4,471 | 4,557 |
| **Tier 2 capital** | 4,471 | 4,557 |
| **Total capital base** | 214,080 | 204,447 |

| *Risk-weighted assets* | | |
|---|---|---|
| Credit risk, loans | 585,148 | 577,661 |
| Credit risk, securities and other | 61,101 | 62,524 |
| Counterparty credit risk | 6,721 | 5,550 |
| Market risk due to currency imbalance | 2,272 | 5,449 |
| Market risk other | 10,390 | 12,966 |
| Credit valuation adjustment | 2,770 | 2,678 |
| Operational risk | 86,490 | 86,490 |
| **Total risk-weighted assets** | 754,892 | 753,318 |

| *Capital ratios* | | |
|---|---|---|
| CET1 ratio | 27.7% | 26.5% |
| Tier 1 ratio | 27.8% | 26.5% |
| Capital adequacy ratio | 28.4% | 27.1% |

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## 43. Capital management, continued

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

| *Capital buffer requirement, % of RWA* | 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% |
| **Combined capital buffer requirement** | 6.75% | 7.50% | 8.50% | 8.75% |

The Bank carries out an ongoing process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Group 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 with its risk profile. The 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 2R capital add-on, which is the result of the ICAAP/SREP, may comprise 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. With the current capital structure, the Pillar 2R requirement is solely met with CET1 capital.

| *Total capital requirement, % of RWA* | Current | Fully implemented 1.11.2017 |
|---|---|---|
| Pillar 1 capital requirement | 8.0% | 8.0% |
| Pillar 2R capital requirement ** | 4.3% | 4.3% |
| Combined buffer requirement | 8.2% | 8.4% |
| **Total regulatory capital requirement** | 20.5% | 20.7% |
| Available capital | 28.4% | 28.4% |
| *CET1 requirement, % of RWA* | | |
| Pillar 1 CET1 requirement | 4.5% | 4.5% |
| Pillar 2R CET1 requirement ** | 2.4% | 2.4% |
| Combined buffer requirement | 8.2% | 8.4% |
| **CET1 regulatory capital requirement** | 15.1% | 15.3% |
| Available CET1 capital | 27.7% | 27.7% |

*The effective capital buffers for systemic risk and countercyclical effects are determined by calculating the weighted average of the corresponding buffer levels of each country, the weights being the total risk weighted exposures for credit risk against counterparties residing in those countries.

** The SREP result based on the Group's financial statement of 31.12.2015.

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## 43. Capital management, continued

### Leverage ratio

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The minimum leverage ratio requirement is 3% as stated in Act No. 161/2002 on Financial Undertakings.

| | 30.6.2017 | 31.12.2016 |
|---|---|---|
| On-balance sheet exposures | 1,100,729 | 1,011,735 |
| Derivative exposures | 9,934 | 8,226 |
| Securities financing transaction exposures | 9,014 | 9,330 |
| Off-balance sheet exposures | 86,171 | 83,156 |
| **Total exposure** | 1,205,848 | 1,112,447 |
| **Tier 1 capital** | 209,609 | 199,890 |
| Leverage ratio | 17.4% | 18.0% |

### Solvency II

At the end of the year 2016 the Bank held the insurance companies Vörður tryggingar and Okkar líftryggingar. On 1 January 2017 Vörður tryggingar acquired the entire shareholding in Okkar líftryggingar and following the acquisition Vörður tryggingar merged its two life insurance subsidiaries. The solvency capital requirements as well as calculated solvency for Vörður Group is not available for 31 December 2016.

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vörður Group was 2,923 million at 30 June 2017 (31.12.2016: Vörður tryggingar ISK 2,489 million and Okkar líftryggingar ISK 574 million) and calculated solvency of Vörður Group was ISK 5,592 million at 30 June 2017 (31.12.2016: Vörður tryggingar ISK 3,609 million and Okkar líftryggingar ISK 1,236 million). The solvency ratio, which is the ratio of calculated solvency to the solvency requirements, of Vörður Group was 191.3% at 30 June 2017 (31.12.2016: Vörður tryggingar 145.0% and Okkar líftryggingar 215,0%).

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# Notes to the Condensed Consolidated Interim Financial Statements

## 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 ended 31 December 2016.

*Hedge accounting*

During the first quarter of 2017, the Group started applying fair value hedge accounting with respect to designated hedging relationship of certain fixed-rate foreign currency denominated notes issued by the Bank as the hedged items and certain foreign currency denominated interest rate swaps as the hedging instruments. The Group recognizes the changes in fair value of the interest rate swaps together with changes in the fair value of bonds attributable to interest rate risk immediately in profit or loss in the line item of Note 8, Net gain on fair value hedge of interest rate swap. Calculated accrued interest on both swaps and bonds are included in the line item of Note 7, Interest expense.

Other derivatives, not designated in a qualifying hedge relationship, are used to manage its exposure to foreign currency, interest rate, equity market and credit risk. The financial instruments used include, but are not limited to, interest rate swaps, cross-currency swaps, forward contracts, futures, options, credit swaps and equity swaps.

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80–125%.

If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. Any adjustments, up to the point of discontinuation, to a hedged item for which the effective interest method is used, is amortized to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

### 45. 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.