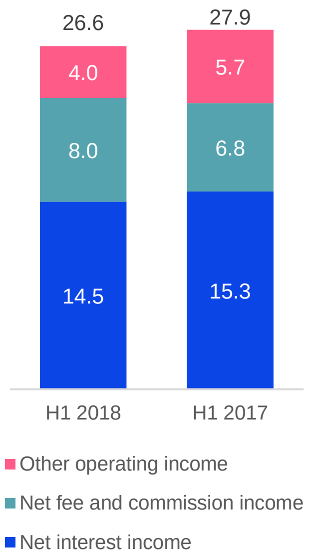
Condensed Consolidated
Interim Financial Statements

1 January - 30 June 2018

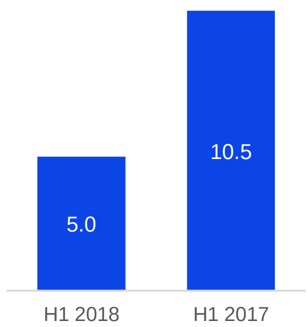
Contents

Key figures

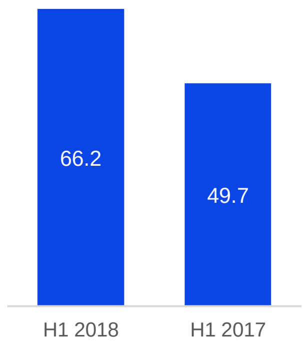
Operating income
(ISK billion)



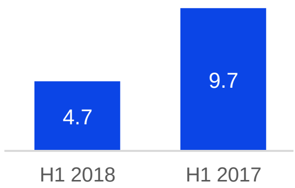
Net earnings
(ISK billion)



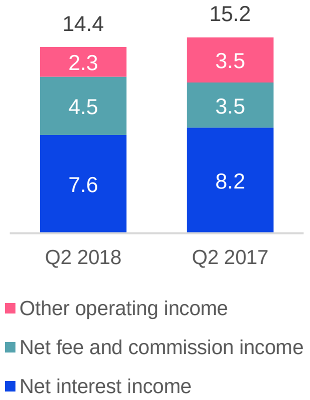
Cost to income
(%)



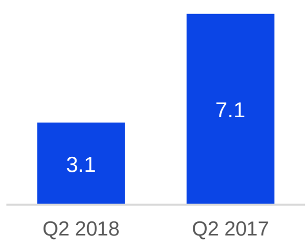
Return on equity
(%)



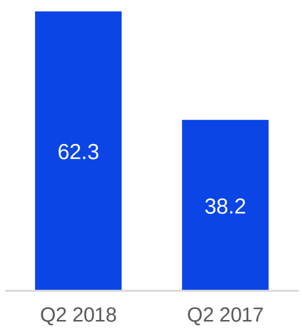
Operating income
(ISK billion)



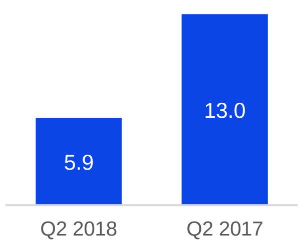
Net earnings
(ISK billion)



Cost to income
(%)

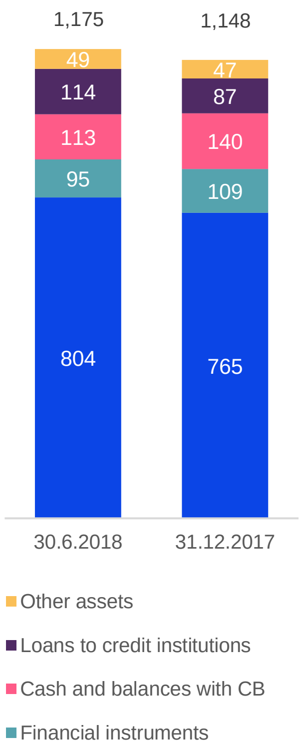


Return on equity
(%)

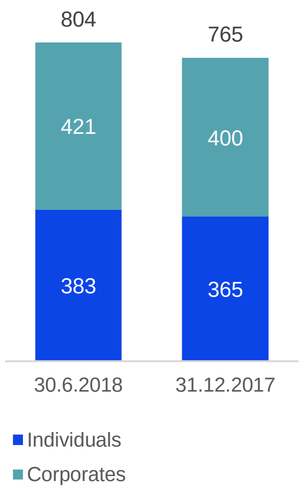


Key figures

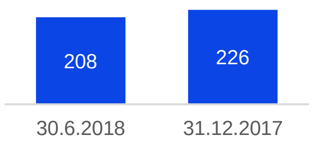
Total assets
(ISK billion)



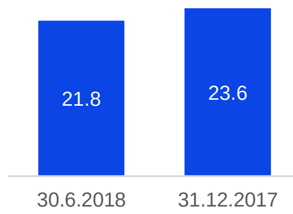
Loans to customers
(ISK billion)



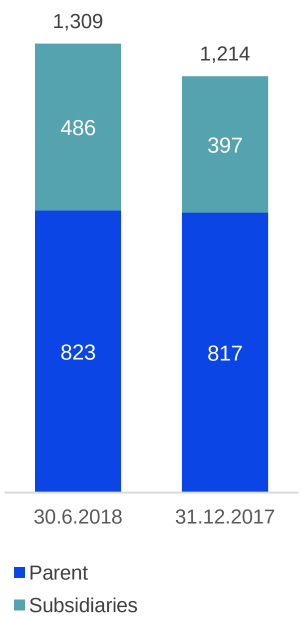
Equity
(ISK billion)



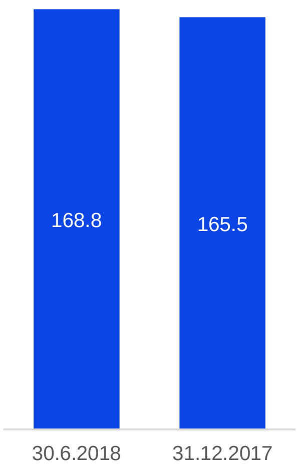
CET 1
(%)



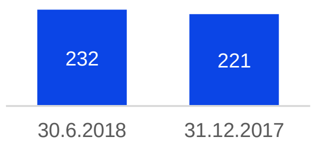
Number of FTE's



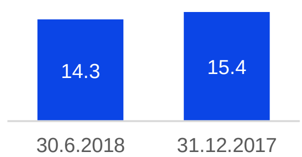
Loans to deposit ratio
(%)



LCR
(%)



Leverage ratio
(%)



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 2018 include the Condensed Consolidated Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Outlook

Following a period of exceptional growth the Icelandic economy is slowing down and approaching equilibrium as the output gap closes. GDP grew by 3.6% in 2017, fueled by strong private consumption and, to a lesser extent, continued investment growth and tourism. In 2017 investment reached a turning point when growth in business investment was dwarfed by housing and public investment. Despite this, investment growth has been slowing down, as has export growth. It appears that tourism has passed its peak growth, at least for the time being, with more moderate growth on the horizon. Inflation remains low in a historical context but exceeded the Central Bank's inflation target in March for the first time in four years. Inflationary pressures seem to be picking up and a tough round of wage bargaining is on the horizon. The Icelandic krona has remained strong and remarkably stable for the past couple of months, even though nearly all capital controls have been removed and domestic investors face no restrictions on investing abroad. Arion Research predicts that the economy will achieve the desired soft landing, with moderate GDP growth, low unemployment but rising inflation in the coming months, albeit still remaining within the Central Bank's tolerance level.

Listing and Initial Public Offering

Arion Bank was listed on Nasdaq Iceland and Nasdaq Stockholm on 15 June following an initial public offering of 28.7% of shares in the Bank. The offering was heavily oversubscribed and the shares were placed with investors in Iceland, Scandinavia, UK, Continental Europe and the US. This is the first listing of an Icelandic bank on the main market in Iceland since 2008. The IPO represents a significant step in the development of Arion Bank and the Bank welcomes the new shareholders.

Operations during the period

Net earnings amounted to ISK 5,011 million for the period ended 30 June 2018 and total equity amounted to ISK 207,631 million at the end of the period. Return on equity was 4.7% for the period. The capital ratio of the Bank, according to the Financial Undertakings Act No. 161/2002, was 21.9% and the corresponding CET 1 ratio was 21.8%. This comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also very strong at period-end and well above the regulatory minimum.

In June 2018 Arion Bank adopted a new share-based remuneration programme, when a limited stock grant was offered to all employees of the parent company in connection with the IPO and listing of the Bank. Remuneration is paid in the form of deferred shares with a vesting period of two years. The aim of the remuneration programme is to build long-term engagement among employees through share ownership. The Bank recognizes expenses related to the programme as salaries and related expenses, a total of ISK 651 million, over the vesting period. The market value of shares at granting date was ISK 295 million, which was deducted from the Bank's own shares.

The main changes in the Balance Sheet from year-end 2017 relate to the purchase of own shares in February and a dividend payment in March, a total of ISK 24.3 billion, an increase in loans to customers of ISK 38.6 billion, or 5.0%, and an increase in borrowings of ISK 25.8 billion or 6.7%, following a new issuance of bonds in the international markets. New lending is mainly in the form of mortgages to individuals and corporate loans in two sectors, wholesale and retail trade and real estate and construction.

The Bank's liquidity position is strong, with a liquidity coverage ratio of 232%, see Note 42, well above the regulatory minimum of 100%. In March 2018 the Bank issued five-year senior unsecured bonds in the amount of EUR 300 million (ISK 36 billion) which were partially used for the repayment of EUR 200 million of bonds, the remainder of the Bank’s first Eurobond issued in 2015. The bonds were sold at rates corresponding to a 0.65 % margin over interbank rates and bear a fixed 1.00% coupon.

In June Arion Bank obtained the services of an international management consultancy company with the aim to assist the Bank in its strategic review as regards the future ownership of the subsidiary Valitor. This review is expected to be finalized before the end of the year.

The Bank continued on its digital journey and finalized four digital projects in the second quarter. These projects are diverse, as two are client facing and the other two are aimed at assisting the Bank deal with new regulations.

In February 2018 an agreement was reached between the administrator of the bankrupt estate of the Bank's subsidiary United Silicon and Arion Bank, whereby the Bank foreclosed against its collateral and acquired all the company's main assets. The assets of the silicon plant are currently managed by Stakksberg ehf., which is held by the Bank through a newly established subsidiary, Eignabjarg ehf. Stakksberg ehf. has, since the transfer of the assets from United Silicon, successfully worked to reduce uncertainties surrounding the recommissioning of the silicon plant, amongst other things by securing all necessary operating permits, power supply and undertaking further engineering design groundwork necessary for the carrying out of remedial work prior to the reopening of the plant. The Bank aims to conduct a sales process of Stakksberg ehf. during the second half of 2018.

In March 2018 Arion Bank acquired the entire shareholding of VISA Ísland ehf., a subsidiary of Valitor Group. The transaction had no effect on these Consolidated Financial Statements.

Endorsement and statement
by the Board of Directors and the CEO

Capital

An important part of Arion Bank's equity story was the Bank's potential to pay extraordinary dividends, in accordance with its dividend and capital policy. The Board of Directors has concluded that the Bank has the ability to lower its capital position and has therefore proposed to an extraordinary shareholders' meeting, scheduled for 18 September 2018, that the Bank will pay an extraordinary dividend amounting to ISK 10 billion. Such dividend payment will reduce Arion Bank's CET 1 ratio from 23.1% to 21.9%, which is above the 21.3% capital requirement set by FME and the Bank.

Employees

The Group had 1,309 full-time equivalent positions at the end of the period, compared with 1,284 at the end of 2017; 823 of these positions were at Arion Bank, compared with 844 at the end of 2017. The increase in FTEs from year-end is mainly due to the growth strategy of Valitor on international markets but is partly off-set by a decrease at the Bank due to the outsourcing of its cash center.

Group ownership

Post IPO the Bank has gained new shareholders and SDR registry. As Kaupskil ehf. and Attestor were the selling shareholders it can be seen from the registry that their share capital has decreased as Kaupskil ehf. sold more than 22% and Attestor 3%. Kaupskil is now the only shareholder holding more than 10% of Arion Bank's share capital. The current shareholder list is comprised of a share registry in Iceland and also SDR registry in Sweden, see Note 34.

New names on the shareholder list include funds owned by Landsdowne and Miton Asset Management which came in as cornerstone investors before the IPO book building process. Funds owned by Eaton Vance and Stefnir are also new on the list.

The total voting rights of Kaupthing ehf., through Kaupskil ehf., and Taconic Capital Advisors LP and related parties, through TCA New Sidecar S.á.r.l., are restricted to 33% of total voting rights in the Bank according to the FME notification from 22 September 2017.

Governance

The Board of Directors has six members, three women and three men. Furthermore, three Alternate Directors (two men and one woman) are elected and they attend meetings of the Board of Directors in the event that a Director resigns or is unable to attend. 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 gender on the board of directors should not be less than 40%. Five Directors are nominated by Kaupskil ehf. and one by Attestor Capital LLP. Five Directors and two Alternates are independent of Arion Bank and its day-to-day managers as well as of Arion Bank's significant shareholders.

At Arion Bank's annual general meeting on 15 March 2018 Herdís Dröfn Fjeldsted was elected as a new Director and replaced Thóra Hallgrímsdóttir. Kirstín Th. Flygenring did not seek re-election as a Director at the annual general meeting and the number of Directors thereby decreased by one. On 30 May 2018 Jakob Ásmundsson, a Director, decided to step down from 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 2018 have been prepared in accordance with International Financial Reporting Standards 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 2018 and its financial position as at 30 June 2018.

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 2018 and confirm them by means of their signatures.

Reykjavík, 2 August 2018

Board of Directors

Eva Cederbalk
Chairman

Brynjólfur Bjarnason

Herdís Dröfn Fjeldsted

John P. Madden

Måns Höglund

Ólafur Örn Svansson

Steinunn K. Thórdardóttir

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 hf. (the "Group") as of 30 June 2018 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 Interim Consolidated 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 Interim Consolidated 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 Interim Consolidated 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 2018, and of its financial performance and its cash flows for the six month period then ended in accordance with International Financial Reporting Standards for 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 Interim Consolidated Financial Statements.

Kópavogur, 2 August 2018

Deloitte ehf.

Páll Grétar Steingrímsson
State Authorized Public Accountant

Gunnar Thorvardarson
State Authorized Public Accountant

Consolidated Interim Income Statement
for the period from 1 January to 30 June 2018

Income Statement

	Notes	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.*
Interest income		28,470	29,840	14,308	16,117
Interest expense		(13,949)	(14,520)	(6,695)	(7,957)
Net interest income	**6**	**14,521**	**15,320**	**7,613**	**8,160**
Fee and commission income		17,906	13,019	9,709	6,928
Fee and commission expense		(9,872)	(6,181)	(5,217)	(3,420)
Net fee and commission income	**7**	**8,034**	**6,838**	**4,492**	**3,508**
Net financial income	8	2,267	3,205	927	1,975
Net insurance income	9	901	1,053	758	606
Share of profit of associates and net impairment	25	(16)	(934)	2	(900)
Other operating income	10	879	2,375	610	1,811
Other net operating income		**4,031**	**5,699**	**2,297**	**3,492**
Operating income		**26,586**	**27,857**	**14,402**	**15,160**
Salaries and related expenses	11	(9,647)	(8,783)	(5,011)	(4,561)
Other operating expenses	12	(7,960)	(5,057)	(3,964)	(1,223)
Operating expenses		**(17,607)**	**(13,840)**	**(8,975)**	**(5,784)**
Bank levy	13	(1,684)	(1,574)	(880)	(777)
Net impairment	14	(291)	1,289	(192)	409
Earnings before tax		**7,004**	**13,732**	**4,355**	**9,008**
Income tax expense	15	(2,105)	(3,266)	(1,287)	(1,895)
Net earnings from continuing operations		**4,899**	**10,466**	**3,068**	**7,113**
Discontinued operations, net of tax	16	112	-	(6)	-
Net earnings		**5,011**	**10,466**	**3,062**	**7,113**

Attributable to

Shareholders of Arion Bank hf.		4,398	10,464	2,449	7,112
Non-controlling interest		613	2	613	1
Net earnings		**5,011**	**10,466**	**3,062**	**7,113**

Earnings per share from continuing operations

Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	17	2.29	5.23	1.36	3.56

Comparative figures have been changed, see Note 1.

*The Consolidated Interim Income Statement for the period 1 April to 30 June 2017 has not been reviewed by the Bank's auditors.

The Notes on pages 17 to 76 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of other Comprehensive Income
for the period from 1 January to 30 June 2018

Other Comprehensive Income	Notes	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.*	2017 1.4.-30.6.*
Net earnings		**5,011**	**10,466**	**3,062**	**7,113**
Net gain on financial assets carried at fair value through OCI, net of tax		3	-	(41)	-
Realized net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement**		(112)	-	(15)	-
Changes to reserve for financial instruments at fair value through OCI	33	**4,902**	**10,466**	**3,005**	**7,113**
Exchange difference on translating foreign subsidiaries	33	12	(83)	71	(127)
Total comprehensive income		**4,914**	**10,383**	**3,077**	**6,986**

Attributable to

Shareholders of Arion Bank	4,301	10,381	2,464	6,985
Non-controlling interest	613	2	613	1
Total comprehensive income	**4,914**	**10,383**	**3,077**	**6,986**

Comparative figures have been changed, see Note 1.

*The Consolidated Interim Statement of Other Comprehensive Income for the period 1 April to 30 June 2017 has not been reviewed by the Bank's auditors.

**Fair value gain of ISK 4 million would have been recognized in the Income Statement during the period if the financial assets had not been reclassified as Financial assets carried at FVOCI, net of tax, in accordance with IFRS 9.

The Notes on pages 17 to 76 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Financial Position
as at 30 June 2018

Assets	Notes	30.6.2018	31.12.2017
Cash and balances with Central Bank	18	112,996	139,819
Loans to credit institutions	19	113,546	86,609
Loans to customers	20	803,694	765,101
Financial instruments	21-23	95,265	109,450
Investment property	23	7,027	6,613
Investments in associates	25	743	760
Intangible assets	26	13,858	13,848
Tax assets	27	603	450
Non-current assets and disposal groups held for sale	28	8,295	8,138
Other assets	29	18,817	16,966
Total Assets		**1,174,844**	**1,147,754**

Liabilities	Notes	30.6.2018	31.12.2017
Due to credit institutions and Central Bank	22	6,336	7,370
Deposits	22	476,182	462,161
Financial liabilities at fair value	22	3,895	3,601
Tax liabilities	27	6,503	6,828
Other liabilities	30	63,524	57,062
Borrowings	22,31	410,773	384,998
Total Liabilities		**967,213**	**922,020**

Equity	Notes	30.6.2018	31.12.2017
Share capital and share premium	33	59,017	75,861
Other reserves	33	14,436	16,774
Retained earnings		133,437	132,971
Total Shareholders' Equity		**206,890**	**225,606**
Non-controlling interest		741	128
Total Equity		**207,631**	**225,734**
Total Liabilities and Equity		**1,174,844**	**1,147,754**

The Notes on pages 17 to 76 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Changes in Equity
for the period from 1 January to 30 June 2018

	Share capital and share premium	Other reserves	Retained earnings	**Total share-holders' equity**	Non-controlling interest	**Total equity**
Equity 31 December 2017	75,861	16,774	132,971	225,606	128	225,734
Impact of adopting IFRS 9	-	3	939	942	-	942
Restated opening balance under IFRS 9	**75,861**	**16,777**	**133,910**	**226,548**	**128**	**226,676**
Net earnings	-	-	4,398	4,398	613	5,011
Realized net gain on financial assets carried at fair value through OCI, net of tax	-	3	-	3	-	3
Realized net gain through the Income Statement on financial assets through OCI, net of tax	-	(112)	-	(112)	-	(112)
Translation difference	-	12	-	12	-	12
Total comprehensive income	**-**	**(97)**	**4,398**	**4,301**	**613**	**4,914**
Dividend paid	-	-	(7,115)	(7,115)	-	(7,115)
Purchase of treasury stock	(17,139)	-	-	(17,139)	-	(17,139)
Own shares allocated to employees	295	-	-	295	-	295
Reserve for investments in subsidiaries	-	(1,942)	1,942	-	-	-
Reserve for investments in associates	-	(17)	17	-	-	-
Reserve for investments in securities	-	(393)	285	(108)	-	(108)
Reserve for financial instruments at FVOCI	-	108	-	108	-	108
Equity 30 June 2018	**59,017**	**14,436**	**133,437**	**206,890**	**741**	**207,631**
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**

The Notes on pages 17 to 76 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Cash flows
for the period from 1 January to 30 June 2018

	2018	2017
Operating activities	1.1.-30.6.	1.1.-30.6.
Net earnings	5,011	10,466
Non-cash items included in net earnings and other adjustments	(9,075)	(16,892)
Changes in operating assets and liabilities	(1,746)	78,271
Interest received	26,908	20,957
Interest paid	(9,740)	(5,285)
Dividend received	3,070	190
Income tax paid	(2,819)	(1,342)
Net cash (to) from operating activities	**11,609**	**86,365**
Investing activities		
Acquisition of associates	-	(961)
Acquisition of subsidiary	-	(237)
Dividend received from associates	-	41
Acquisition of intangible assets	(1,075)	(1,125)
Acquisition of property and equipment	(340)	(395)
Proceeds from sale of property and equipment	25	85
Net cash to investing activities	**(1,390)**	**(2,592)**
Financing activities		
Dividend paid to shareholders of Arion Bank and purchase of treasury stock	(24,254)	-
Net cash used in financing activities	**(24,254)**	**-**
Net increase (decrease) in cash and cash equivalents	(14,035)	83,773
Cash and cash equivalents at beginning of the year	181,898	123,933
Effect of exchange rate changes on cash and cash equivalents	(110)	(2,316)
Cash and cash equivalents	**167,753**	**205,390**
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	365	467
Settlement of loans through foreclosure on collateral from customers with view to resale	(365)	(467)

Comparative figures have been changed with immaterial effects on the Cash flow, see Note 1.

The Notes on pages 17 to 76 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Notes to the Consolidated Interim Statement of Cash flows
for the period from 1 January to 30 June 2018

Non-cash items included in net earnings	2018 1.1.-30.6.	2017 1.1.-30.6.
Net interest income	(14,521)	(15,320)
Net impairment	296	(1,289)
Income tax expense	2,105	3,266
Bank levy	1,684	1,574
Net foreign exchange gain	19	1
Net gain on financial instruments	675	(3,016)
Depreciation and amortization	1,146	1,023
Share of profit of associates and net impairment	16	934
Investment property, fair value change	(383)	(1,362)
Discontinued operations, net of tax	(112)	-
Revised Depositors' and Investors' Guarantee Fund expense	-	(2,669)
Other changes	-	(34)
Non-cash items included in net earnings	**(9,075)**	**(16,892)**

Changes in operating assets and liabilities	2018 1.1.-30.6.	2017 1.1.-30.6.
Mandatory reserve deposit with Central Bank	(533)	(202)
Loans to credit institutions, excluding bank accounts	(13,225)	18,170
Loans to customers	(36,888)	(17,803)
Financial instruments and financial liabilities at fair value	8,475	13,045
Investment property	(31)	(435)
Other assets	625	1,086
Due to credit institutions and Central Bank	(1,036)	(527)
Deposits	9,981	23,270
Borrowings	27,342	41,652
Other liabilities	3,544	15
Changes in operating assets and liabilities	**(1,746)**	**78,271**

Cash and cash equivalents	2018 1.1.-30.6.	2017 1.1.-30.6.
Cash and balances with Central Bank	112,996	151,354
Bank accounts	64,514	63,570
Mandatory reserve deposit with Central Bank	(9,757)	(9,534)
Cash and cash equivalents	**167,753**	**205,390**

The Notes on pages 17 to 76 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Reconciliation of Consolidated Statement of Financial Position

Transition from IAS 39 to IFRS 9 as at 1 January 2018

Reconciliation of the Consolidated Statement of Financial Position carrying amounts under IAS 39 to the Consolidated Statement of Financial Position carrying amounts under IFRS 9 on 1 January 2018

Assets	IAS 39 31.12.2017	Impact of classifi-cation and measure-ment	Impact of impair-ment	**Total impact**	IFRS 9 1.1.2018
Cash and balances with Central Bank	139,819	-	(7)	(7)	139,812
Loans to credit institutions	86,609	-	(3)	(3)	86,606
Loans to customers	765,101	486	930	1,416	766,517
Financial instruments	109,450	-	-	-	109,450
Investment property	6,613	-	-	-	6,613
Investments in associates	760	-	-	-	760
Intangible assets	13,848	-	-	-	13,848
Tax assets	450	-	-	-	450
Non-current assets and disposal groups held for sale	8,138	-	-	-	8,138
Other assets	16,966	-	-	-	16,966
Total Assets	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**
Liabilities					
Due to credit institutions and Central Bank	7,370	-	-	-	7,370
Deposits	462,161	-	-	-	462,161
Financial liabilities at fair value	3,601	-	-	-	3,601
Tax liabilities	6,828	97	138	235	7,063
Other liabilities	57,062	-	229	229	57,291
Borrowings	384,998	-	-	-	384,998
Total Liabilities	**922,020**	**97**	**367**	**464**	**922,484**
Equity					
Share capital and share premium	75,861	-	-	-	75,861
Other reserves	16,774	-	3	3	16,777
Retained earnings	132,971	389	550	939	133,910
Total Shareholders' Equity	**225,606**	**389**	**553**	**942**	**226,548**
Non-controlling interest	128	-	-	-	128
Total Equity	**225,734**	**389**	**553**	**942**	**226,676**
Total Liabilities and Equity	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**

Amounts are in ISK millions

Financial assets and Financial liabilities classification
Transition from IAS 39 to IFRS 9

Original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Group's financial assets and financial liabilities on 1 January 2018

Financial assets	Measurement category under IAS 39	Measurement category under IFRS 9	Carrying amount under IAS 39	Reclassi-fication	Re-measure-ment	Carrying amount under IFRS 9
Cash and balances with Central Bank ..	*Loans*	*Amortized cost*	139,819	-	(7)	139,812
Loans to credit institutions	*Loans*	*Amortized cost*	86,609	-	(3)	86,606
Loans to customers			765,101	486	930	766,517
Overdrafts	*Loans*	*Amortized cost*	*30,942*	-	*(50)*	*30,892*
Credit cards	*Loans*	*Amortized cost*	*12,040*	-	*(11)*	*12,029*
Mortgage loans	*Loans*	*Amortized cost*	*329,735*	-	*276*	*330,011*
Other loans	*Loans*	*Amortized cost*	*386,606*	-	*715*	*387,321*
Other loans	*Loans*	*FVTPL (mandatory)*	*5,778*	*486*	-	*6,264*
Financial instruments			109,450	-	-	109,450
Bonds and debt instruments	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*11,347*	-	-	*11,347*
Bonds and debt instruments	*FVTPL (designated)*	*FVOCI**	*40,408*	-	-	*40,408*
Shares and equity instruments	*FVTPL (designated)*	*FVTPL (mandatory)*	*36,190*	-	-	*36,190*
Derivatives	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*7,624*	-	-	*7,624*
Securities used for hedging	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*13,881*	-	-	*13,881*
Other financial assets	*Amortized cost*	*Amortized cost*	*8,948*	-	-	*8,948*
Total financial assets			**1,109,927**	**486**	**920**	**1,111,333**

Financial liabilities

Due to credit institutions and CB	*Amortized cost*	*Amortized cost*	7,370	-	-	7,370
Deposits	*Amortized cost*	*Amortized cost*	462,161	-	-	462,161
Financial liabilities at fair value	*FVTPL (held for trading)*	*FVTPL (mandatory)*	3,601	-	-	3,601
Other liabilities			34,705	-	229	34,934
Accounts payable	*Amortized cost*	*Amortized cost*	*26,394*	-	-	*26,394*
Unsettled securities trading	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*527*	-	-	*527*
Depositors and investors guarantee fund	*Amortized cost*	*Amortized cost*	*218*	-	-	*218*
Withholding tax	*Amortized cost*	*Amortized cost*	*1,414*	-	-	*1,414*
Sundry financial liabilities	*Amortized cost*	*Amortized cost*	*6,152*	-	*229*	*6,381*
Borrowings	*Amortized cost*	*Amortized cost*	384,998	-	-	384,998
Total financial liabilities			**892,835**	**-**	**229**	**893,064**

Other liabilities

Tax liabilities	*Amortized cost*	*Amortized cost*	*6,828*	*97*	*138*	7,063

*Treasury bonds previously designated at fair value through profit and loss under IAS 39, will be held at fair value through OCI under IFRS 9.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements
Contents

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 for the period ended 30 June 2018 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Condensed Consolidated Interim Financial Statements 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 Condensed Consolidated 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 2017. The Annual Financial Statements are available at Arion Bank's website www.arionbanki.is.

The Condensed Consolidated Interim Financial Statements were approved and authorized for issue by the Board of Directors of Arion Bank on 2 August 2018.

The same accounting policies, presentation and methods of computation are followed in these Condensed Consolidated Interim Financial Statements as were applied in the Group's Consolidated Financial Statements for the year ended 31 December 2017. Amendments to IFRS effective for 2018 did not have a material effect on the results for the 30 June 2018 except for the adoption of IFRS 9 on 1 January 2018.

IFRS 9 replaces IAS 39 for annual periods on or after 1 January 2018. The Group elected, as a policy choice permitted under IFRS 9, to continue to apply hedge accounting in accordance with IAS 39. The Group has not restated comparative information for 2017 for financial instruments in the scope of IFRS 9. Therefore, the comparative information for 2017 is reported under IAS 39 and is not comparable to the information presented for 2018. The net income of ISK 942 million arising from the adoption of IFRS 9 have been recognized directly in retained earnings as of 1 January 2018. For further information, see the overviews for the transition from IAS 39 to IFRS 9.

Basis of measurement

New classification and measurement categories for IFRS 9 have replaced the ones used under IAS 39. For further details on the accounting policy under IAS 39 see the Annual Financial Statements 2017. For further details on the accounting policy under IFRS 9, see Note 45. To view the effects of the changes on individual portfolios see Financial assets and Financial liabilities classification transition from IAS 39 to IFRS 9.

Functional and presentation currency

The Condensed Consolidated 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 105.50 and 123.20 for EUR (31.12.2017: USD 103.70 and EUR 124.52).

Comparative figures

In the Consolidated Interim Income Statement for the period ended 30 June 2018 net income from non-current assets held for sale is presented among other operating income. Prior to the fourth quarter of 2017 net income from non-current assets held for sale was classified as discontinued operations, net of tax. Comparative figures have been changed accordingly by reducing discontinued operations, net of tax, by ISK 420 million for the first six months of 2017 and ISK 273 million for the second quarter 2017, increasing other operating income by ISK 525 million for the first six months of 2017 and ISK 341 million for the second quarter 2017, and increasing income tax by ISK 105 million for the first half of 2017 and ISK 68 million for the second quarter 2017. The effects on the Statement of Cash flow was a shift between Non-cash items included in net earnings and other adjustments and Changes in operating assets and liabilities of ISK 420 million for the first half of 2017 and ISK 273 million for the second quarter of 2017.

2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Consolidated Financial Statements requires management to make judgements, estimates and assumptions that affect the reported amount of revenues, expenses, assets and liabilities, and the accompanying disclosures, as well as the disclosure of contingent liabilities. Uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of assets or liabilities affected in future periods.

Notes to the Condensed Consolidated Interim Financial Statements

3. The Group

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

			Equity interest	
	Operating activity	Currency	30.6.2018	31.12.2017
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%
Bjarnathing ehf., Ögurhvarf 4a, Kópavogur, Iceland ...	Real estate	ISK	100.0%	-
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland ...	Holding company	ISK	30.0%	100.0%
Eignarhaldsfélagid Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland ...	Real estate	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland ...	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjördur, Iceland ...	Payment solutions	ISK	100.0%	100.0%
VISA Ísland ehf., Dalshraun 3, Hafnarfjördur, Iceland ...	Holding company	ISK	100.0%	-
Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland ...	Insurance	ISK	100.0%	100.0%

In addition the Bank holds the subsidiary Eignabjarg ehf. which is classified as Non-current assets and disposal groups held for sale, see Note 28.

The subsidiary EAB 1 ehf. had two classes of share capital. Arion Bank held 100% of the shareholding in class B until June 2018 when the class was settled. The remaining shareholding of Arion Bank is 30% in class A but Arion Bank controls the entity and thus it is classified as a subsidiary of the Bank.

In March 2018 the Bank acquired Valitor's 100% shareholding in VISA Ísland ehf. Combinations of entities under common control, i.e. transactions in which all the combining entities are under the control of the Group both before and after the combination, and that control is not transitory, are outside the scope of the IFRS 3 business combinations. Currently, there is no specific guidance for these transactions under IFRS, therefore, as permitted by IAS 8 accounting policies, changes in accounting and errors, the Group has developed an accounting policy considering pronouncements of other standard-setting bodies. The assets and liabilities recognized as a result of transactions between entities under common control are recognized at the carrying value on the transferor's financial

In March 2018 Arion Bank established the entity SRL slhf. and holds 100% shareholding in the company. SRL is defined as a subsidiary of the Bank. SRL acquired 100% shareholding in Landey ehf., a subsidiary of Eignarhaldsfélagid Landey ehf. The transaction was defined as combination of entities under common control.

In 2017 the Bank's subsidiary Valitor Holding hf. acquired two companies: IPS - International Payment Services Ltd. and Chip and Pin Solutions Ltd. The purpose of the acquisition is to strengthen Valitor's direct channel market position in the UK as the focus has been on partnerships in that market until now. Further information on intangible assets related to those two companies is contained in Note 26. The transactions are as follows:

Purchase price, paid in cash ...	2,123
Asset and liabilities of IPS and Chip and Pin at fair value:	
Loans to credit institutions (Bank accounts) ...	127
Other assets (Accounts receivables) ...	758
Other assets (Property and equipment) ...	21
Intangible assets, other than goodwill ...	404
Other liabilities (Accounts payable) ...	(960)
Fair value of asset and liabilities ...	350
Calculated goodwill ...	1,773

On 1 January 2017 Vördur tryggingar hf. acquired the Bank's 100% shareholding in Okkar líftryggingar hf. Following the acquisition Vördur tryggingar merged its two life insurance subsidiaries under the name of Vördur líftryggingar hf. The transaction was defined as Combination of entities under common control.

Amounts are in ISK millionS

Notes to the Condensed Consolidated Interim Financial Statements

Operating segment reporting

Segment information is presented in respect of the Group's operating segments and is 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 and also distributes 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 from across the Bank's divisions to larger corporate clients in Iceland. Corporate Banking provides a full range of lending products, guarantees, deposit accounts, payment solutions as well as value-added electronic corporate solutions to meet the needs of each customer.

Investment Banking comprises Corporate Finance, Capital Markets and Research. Investment Banking is a leading Icelandic brokerage house and financial advisor, providing a full and diverse range of investment banking services to a broad range of customers. Corporate Finance offers various financial advisory and capital raising services including M&A and financial restructuring advice and IPO management services. Capital Markets is a leading securities and foreign exchange brokerage and provides clients with a diverse range of fixed income services and risk management products. Research is an independent research team producing in-depth analysis of the Icelandic economy and financial markets.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of products and services, including mortgage loans, savings and checking accounts, vehicle and equipment financing, factoring, payment cards, pension services, insurance and funds, to both individuals and SMEs. Retail Banking has a strong focus on digital banking solutions, including internet banking, the Arion Bank app and automated teller machines. As of 30 June 2018, Retail Banking operated out of 21 branches across Iceland over 100,000 customers during the year.

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.

Subsidiaries and other divisions include the subsidiaries Valitor Holding hf., Vördur tryggingar hf., Eignarhaldsfélagid Landey ehf., VISA Ísland ehf., EAB 1 ehf., BG12 slhf. and other smaller entities of the Group and Market Making in domestic securities and currencies. Due to the relative proportion of the subsidiary Valitor Holding hf. in the operation of the Group, financial information for Valitor is reported separately in the disclosure for the operating segments.

In addition to the above operating segments, the Group presents information for units at the corporate headquarters which carry out support functions such as Overhead, Risk Management, Finance (excluding Treasury and Market Making), Legal and IT. The information presented relating to the headquarters does not represent an operating segment. A significant proportion of expenses from support functions is allocated to operating segments in a separate line in the operating segment overview, see Note 4.

4. Operating segments

1.1.-30.6.2018	Asset Manage-ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Subsidi-aries and Other divisions	Head-quarters and Elimination	Total
Net interest income	323	2,778	132	8,643	2,168	538	(61)	14,521
Net fee and commission income	1,731	541	890	2,327	(164)	2,679	30	8,034
Net financial income	48	(146)	1	-	411	1,411	542	2,267
Net insurance income	-	-	-	-	-	930	(29)	901
Share of profit of associates and net impairment	-	-	-	-	-	3	(19)	(16)
Other operating income	13	3	-	155	-	607	101	879
Operating income	2,115	3,176	1,023	11,125	2,415	6,168	564	26,586
Operating expense	(795)	(252)	(443)	(3,546)	(106)	(4,973)	(7,492)	(17,607)
Allocated expense	(436)	(1,514)	(347)	(3,303)	(536)	(6)	6,142	-
Bank levy	(87)	(350)	(24)	(590)	(633)	-	-	(1,684)
Net impairment	-	(789)	-	506	(19)	11	-	(291)
Earnings (loss) before tax	797	271	209	4,192	1,121	1,200	(786)	7,004
Net seg. rev. from ext. customers	892	8,107	959	17,225	(7,975)	6,549	829	26,586
Net seg. rev. from other segments	1,223	(4,931)	64	(6,100)	10,390	(381)	(265)	-
Operating income	2,115	3,176	1,023	11,125	2,415	6,168	564	26,586
Depreciation and amortization	1	2	-	190	-	578	375	1,146
Total assets	65,569	276,985	18,406	562,617	519,764	97,214	(365,711)	1,174,844
Total liabilities	61,046	219,097	17,478	491,717	484,102	63,400	(369,627)	967,213
Allocated equity	4,523	57,888	928	70,900	35,662	33,814	3,916	207,631

1.1.-30.6.2017	Asset Manage-ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Subsidi-aries and Other divisions	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	1,075	-	548	5	501	232	2,375
Operating income (loss)	2,119	4,892	731	10,614	2,852	7,030	(381)	27,857
Operating expense	(434)	(156)	(402)	(1,637)	280	(4,487)	(7,004)	(13,840)
Allocated expense	(513)	(1,161)	(329)	(2,933)	(425)	(8)	5,369	-
Bank levy	(97)	(304)	(22)	(469)	(682)	-	-	(1,574)
Net impairment	-	832	21	402	55	(19)	(2)	1,289
Earnings (loss) before tax	1,075	4,103	(1)	5,977	2,080	2,516	(2,018)	13,732
Net seg. rev. from ext. customers	978	8,614	457	16,040	(5,379)	7,398	(251)	27,857
Net seg. rev. from other segments	1,141	(3,722)	274	(5,426)	8,231	(368)	(130)	-
Operating income (loss)	2,119	4,892	731	10,614	2,852	7,030	(381)	27,857
Depreciation and amortization	-	-	-	176	-	445	402	1,023
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

Income taxes and discontinued operations are excluded from the profit and loss segment information. From prior periods additional line of allocated expense from supporting divisions to business segments has been added. Those supporting divisions are Overhead, Risk Management, Finance (excluding Treasury and Market Making), Legal and IT. Bank levy has also been allocated to business segments. Comparative figures for 2017 have been updated accordingly.

Amounts are in ISK millions

4. Operating segments, continued

Subsidiaries and other divisions

	2018 1.1.-30.6.			2017 1.1.-30.6.		
	Valitor	Other	Total	Valitor	Other	Total
Net interest income	401	137	538	565	70	635
Net fee and commission income	2,726	(47)	2,679	1,941	(177)	1,764
Net financial income	(155)	1,566	1,411	1,768	1,289	3,057
Net insurance income	-	930	930	-	1,073	1,073
Share of profit of associates and net impairment	-	3	3	-	-	-
Other operating income	170	437	607	186	315	501
Operating income	3,142	3,026	6,168	4,460	2,570	7,030
Operating expense	(3,923)	(1,050)	(4,973)	(3,320)	(1,167)	(4,487)
Allocated expense	-	(6)	(6)	-	(8)	(8)
Net impairment	11	-	11	(19)	-	(19)
Earnings (loss) before tax	(770)	1,970	1,200	1,121	1,395	2,516
Net seg. rev. from ext. customers	3,513	3,040	6,553	4,801	2,597	7,398
Net seg. rev. from other segments	(371)	(14)	(385)	(341)	(27)	(368)
Operating income	3,142	3,026	6,168	4,460	2,570	7,030
Depreciation and amortization	513	65	578	380	65	445
Total assets	45,536	51,678	97,214	46,031	37,195	83,226
Total liabilities	29,900	33,500	63,400	29,632	22,951	52,583
Allocated equity	15,636	18,178	33,814	16,399	14,244	30,643

Geographic information

1.1.-30.6.2018	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	15,836	265	205	(1,821)	(4)	40	14,521
Net fee and commission income	6,237	408	810	561	16	2	8,034
Net financial income	1,179	(29)	339	660	223	(105)	2,267
Net insurance income	901	-	-	-	-	-	901
Share of profit of associates and net impairment	(16)	-	-	-	-	-	(16)
Other operating income	875	-	-	-	4	-	879
Operating income (loss)	25,012	644	1,354	(600)	239	(63)	26,586

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	2,060	-	315	-	-	-	2,375
Operating income (loss)	26,772	321	701	(875)	930	8	27,857

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Quarterly statements

5. Operations by quarters

2018	Q2	Q1	Total
Net interest income	7,613	6,908	14,521
Net fee and commission income	4,492	3,542	8,034
Net financial income	927	1,340	2,267
Net insurance income	758	143	901
Share of profit of associates and net impairment	2	(18)	(16)
Other operating income	610	269	879
Operating income	14,402	12,184	26,586
Salaries and related expense	(5,011)	(4,636)	(9,647)
Other operating expense	(3,964)	(3,996)	(7,960)
Bank levy	(880)	(804)	(1,684)
Net impairment	(192)	(99)	(291)
Earnings before tax	4,355	2,649	7,004
Income tax expense	(1,287)	(818)	(2,105)
Net earnings from continuing operations	3,068	1,831	4,899
Discontinued operations, net of tax	(6)	118	112
Net earnings	3,062	1,949	5,011

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	1,811	564	2,375
Operating income	15,160	12,697	27,857
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	9,008	4,724	13,732
Income tax expense	(1,895)	(1,371)	(3,266)
Net earnings from continuing operations	7,113	3,353	10,466
Discontinued operations, net of tax	-	-	-
Net earnings	7,113	3,353	10,466

*The half-year results were reviewed by the Bank's auditor. The quarterly statements and the split between quarters were not audited or reviewed by the Bank's auditors.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Notes to the Consolidated Interim Income Statement

6. Net interest income

	2018 1.1.-30.6.				2017 1.1.-30.6.
	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total	
Interest income					
Cash and balances with Central Bank	2,423	-	-	2,423	3,406
Loans	25,137	71	-	25,208	24,808
Securities	-	225	207	432	1,197
Other	407	-	-	407	429
Interest income	27,967	296	207	28,470	29,840
Interest expense					
Deposits	(6,368)	-	-	(6,368)	(6,942)
Borrowings	(7,544)	-	-	(7,544)	(7,533)
Other	(37)	-	-	(37)	(45)
Interest expense	(13,949)	-	-	(13,949)	(14,520)
Net interest income	14,018	296	207	14,521	15,320
Net interest income from financial assets and liabilities at fair value	-	296	207	503	1,197
Interest income from financial assets not at amortized cost	27,967	-	-	27,967	28,643
Interest expense from financial liabilities at amortized cost	(13,949)	-	-	(13,949)	(14,520)
Net interest income	14,018	296	207	14,521	15,320

	2018 1.4.-30.6.				2017 1.4.-30.6.
	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total	
Interest income					
Cash and balances with Central Bank	1,148	-	-	1,148	2,024
Loans	12,638	-	-	12,638	13,373
Securities	-	130	69	199	515
Other	323	-	-	323	205
Interest income	14,109	130	69	14,308	16,117
Interest expense					
Deposits	(3,132)	-	-	(3,132)	(3,819)
Borrowings	(3,557)	-	-	(3,557)	(4,120)
Other	(6)	-	-	(6)	(18)
Interest expense	(6,695)	-	-	(6,695)	(7,957)
Net interest income	7,414	130	69	7,613	8,160
Net interest income from financial assets and liabilities at fair value	-	130	69	199	515
Interest income from financial assets not at amortized cost	14,109	-	-	14,109	15,602
Interest expense from financial liabilities at amortized cost	(6,695)	-	-	(6,695)	(7,957)
Net interest income	7,414	130	69	7,613	8,160

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	2.7%	3.0%	2.8%	3.1%

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

7. Net fee and commission income

	2018 1.1.-30.6.			2017 1.1.-30.6.		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	2,015	(225)	1,790	2,053	(209)	1,844
Cards and payment solution	12,933	(9,253)	3,680	8,219	(5,549)	2,670
Collection and payment services	774	(47)	727	748	(49)	699
Investment banking	556	(18)	538	428	(24)	404
Lending and financial guarantees	950	-	950	947	-	947
Other	678	(329)	349	624	(350)	274
Net fee and commission income	17,906	(9,872)	8,034	13,019	(6,181)	6,838

	2018 1.4.-30.6.			2017 1.4.-30.6.		
Asset management	1,003	(102)	901	1,062	(96)	966
Cards and payment solution	7,063	(4,938)	2,125	4,371	(3,061)	1,310
Collection and payment services	413	(21)	392	409	(22)	387
Investment banking	340	(8)	332	210	(11)	199
Lending and guarantees	488	-	488	538	-	538
Other	402	(148)	254	338	(230)	108
Net fee and commission income	9,709	(5,217)	4,492	6,928	(3,420)	3,508

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.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

8. Net financial income

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	1,773	-	572	-
Net gain on fair value hedge of interest rate swap	373	55	147	(4)
Realized gain on financial assets carried at fair value through OCI*	140	-	19	-
Net gain on financial assets and financial liabilities classified as held for trading (IAS 39)	-	115	-	32
Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)	-	3,036	-	1,916
Net foreign exchange gain (loss)	(19)	(1)	189	31
Net financial income	2,267	3,205	927	1,975

Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Equity instruments mandatorily measured at fair value	1,845	-	667	-
Debt instruments mandatorily measured at fair value	94	-	18	-
Derivatives	(94)	-	(37)	-
Loans	(72)	-	(76)	-
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	1,773	-	572	-

Net gain on fair value hedge of interest rate swap

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Fair value change of interest rate swaps designated as hedging instruments	718	(512)	465	(256)
Fair value change on bonds issued by the Group attributable to interest rate risk	(345)	567	(318)	252
Net gain on fair value hedge of interest rate swap	373	55	147	(4)

Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Equity instruments designated at fair value	-	2,614	-	1,849
Interest rate instruments designated at fair value	-	422	-	67
Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)	-	3,036	-	1,916

*Realized gain on financial assets carried at fair value through OCI comprises gain previously recognized in the Income Statement under IAS 39. With the adoption of IFRS 9 1 January 2018 the total amount of unrealized gain on financial assets carried at fair value through OCI, net of tax was transferred to reserve for financial instruments carried at fair value, net of tax, see Note 33. Upon disposal realized gain on financial assets carried at fair value through OCI was transferred to the Income Statement in accordance with IFRS 9, as the Bank elected not to restate comparative figures.

9. Net insurance income

Earned premiums, net of reinsurers' share	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Premiums written	6,381	6,264	2,794	2,622
Premiums written, reinsurers' shares	(178)	(204)	(89)	(102)
Change in provision for unearned premiums	(1,244)	(1,652)	(188)	(252)
Change in provision for unearned premiums, reinsurers' share	-	1	-	4
Earned premiums, net of reinsurers' share	4,959	4,408	2,517	2,272
Claims incurred, net of reinsurers' share				
Claims paid	(3,504)	(2,908)	(1,653)	(1,438)
Claims paid, reinsurers' share	57	54	27	37
Change in provision for claims	(607)	(503)	(139)	(250)
Changes in provision for claims, reinsurers' share	(4)	2	6	(15)
Claims incurred, net of reinsurers' share	(4,058)	(3,355)	(1,759)	(1,666)
Net insurance income	901	1,053	758	606

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

10. Other operating income

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Fair value changes on investment property	383	1,362	247	1,269
Realized gain on investment property	-	11	-	11
Net gain on non-current assets held for sale	152	525	77	341
Other income	344	477	286	190
Other operating income	879	2,375	610	1,811
Net gain on non-current assets held for sale				
Income from real estates and other assets	246	655	97	389
Expense related to real estates and other assets	(94)	(130)	(20)	(48)
Net gain on non-current assets held for sale	152	525	77	341

Net gain on non-current assets held for sale are classified as other operating income in these Condensed Consolidated Interim Financial Statements. In prior years it was classified as discontinued operations, net of tax. Comparative figures have been changed accordingly, see Note 1.

11. Personnel and salaries

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Number of employees				
Average number of full-time equivalent positions during the period	1,301	1,214	1,313	1,222
Full-time equivalent positions at the end of the period	1,309	1,223	1,309	1,223
Number of employees at Arion Bank				
Average number of full-time equivalent positions during the period	831	826	829	820
Full-time equivalent positions at the end of the period	823	817	823	817
Salaries and related expense				
Salaries	7,816	7,069	4,081	3,678
Defined contribution pension plans	1,115	1,010	579	523
Salary-related expense	1,009	882	513	452
Capitalization of salaries, due to internally developed software	(293)	(178)	(162)	(92)
Salaries and related expense	9,647	8,783	5,011	4,561
Salaries and related expense for Arion Bank				
Salaries	5,145	4,769	2,695	2,452
Defined contribution pension plans	734	682	381	349
Salary-related expense	765	697	402	363
Salaries and related expense	6,644	6,148	3,478	3,164

In June 2018 Arion Bank adopted a new share-based remuneration programme, when a limited stock grant was offered to all employees of the parent company in connection with the IPO and listing of the Bank. Remuneration is paid in the form of deferred shares with a vesting period of two years. The aim of the remuneration programme is to build long-term engagement among employees through share ownership. The Bank recognizes expenses related to the programme as salaries and related expenses, a total of ISK 651 million, over the vesting period. The market value of shares at granting date was ISK 295 million, which was deducted from the Bank's own shares.

During the period the Group made a provision of ISK 247 million (H2 2017: ISK 252 million) for performance plan payments, including salary-related expense, of which the Bank made a provision of ISK 212 million (H2 2017: ISK 232 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 792 million (31.12.2017: ISK 942 million), of which the Bank's accrual amounts to ISK 648 million (31.12.2017: ISK 762 million).

12. Other operating expense

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Administration expense	6,371	6,242	3,169	3,141
Depositors' and Investors' Guarantee Fund	421	(2,258)	207	(2,463)
Depreciation of property and equipment	420	413	215	202
Amortization of intangible assets	726	610	371	313
Other expense	22	50	2	30
Other operating expense	7,960	5,057	3,964	1,223

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.

Amounts are in ISK millions

13. Bank levy

The Bank levy is 0.376% on total debts excluding tax liabilities, in excess of ISK 50 billion. The tax is assessed on Financial Undertakings but non-financial subsidiaries are exempt from this tax.

14. Net impairment

	2018 1.1.-30.6.	2018 1.4.-30.6.
Net change in impairment of cash and balances with Central Bank	5	14
Net change in impairment of loans to credit institutions	(29)	(9)
Net change in impairment of loans to corporates	(1,199)	(456)
Net change in impairment of loans to individuals	359	(12)
Net change in impairment of financial instruments carried at fair value through OCI, net of tax	(16)	5
Net change in impairment of loan commitments, guarantees and unused credit facilities	(59)	(79)
Net impairment on financial instruments	(939)	(537)
Increase in book value of loans to corporates	33	16
Increase in book value of loans to individuals	615	329
Other value changes on loans	648	345
Net impairment	(291)	(192)

Net impairment under IAS 39	2017 1.1.-30.6.	2017 1.4.-30.6.
Net change in impairment of loans to corporates	304	(365)
Net change in impairment of loans to individuals	(181)	(146)
Net change in collective impairment on loans	85	512
Provision for losses	208	1
Increase in book value of loans to corporates	338	49
Increase in book value of loans to individuals	743	359
Net impairment	1,289	409

15. Income tax expense

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Current tax expense	2,245	3,703	1,347	2,179
Deferred tax expense	(140)	(437)	(60)	(284)
Income tax expense	2,105	3,266	1,287	1,895

Reconciliation of effective tax rate	2018 1.1.-30.6.		2017 1.1.-30.6.	
Earnings before tax		7,004		13,732
Income tax using the Icelandic corporate tax rate	20.0%	1,401	20.0%	2,746
Additional 6% tax on Financial Undertakings	6.3%	444	5.6%	770
Non-deductible expenses	0.1%	5	0.0%	5
Tax exempt revenue	(4.2%)	(295)	4.3%	(584)
Non-deductible taxes	4.8%	337	3.4%	315
Tax incentives not recognized in the Income Statement	3.7%	261	0.0%	(5)
Other changes	(0.7%)	(48)	0.1%	19
Effective tax rate	30.1%	2,105	23.8%	3,266

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

Tax exempt revenues consist mainly of profit from equity positions.

Amounts are in ISK millions

16. Discontinued operations, net of tax

	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.4.-30.6.	2017 1.4.-30.6.
Income from discontinued operations	140	-	(8)	-
Income tax expense	(28)	-	2	-
Discontinued operations, net of tax	112	-	(6)	-

Net gain on non-current assets held for sale are classified as other operating income in these Condensed Consolidated Interim Financial Statements. Prior to the fourth quarter of 2017 it was classified as discontinued operations, net of tax. Comparative figures have been changed accordingly, see Note 1.

17. Earnings per share

	Continued operations		Discontinued operations		Continued and discontinued operations	
	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.1.-30.6.	2017 1.1.-30.6.	2018 1.1.-30.6.	2017 1.1.-30.6.
Net earnings attributable to the shareholders of Arion Bank	4,286	10,464	112	-	4,398	10,464
Weighted average number of outstanding shares for the period, million	1,869	2,000	1,869	2,000	1,869	2,000
Basic earnings per share	2.29	5.23	0.06	-	2.35	5.23
	2018 4.1.-30.6.	2017 4.1.-30.6.	2018 4.1.-30.6.	2017 4.1.-30.6.	2018 4.1.-30.6.	2017 4.1.-30.6.
Net earnings attributable to the shareholders of Arion Bank	2,455	7,112	(6)	-	2,449	7,112
Weighted average number of outstanding shares for the period, million	1,810	2,000	1,810	2,000	1,810	2,000
Basic earnings per share	1.36	3.56	(0.00)	-	1.35	3.56

There were no instruments at the end of the period that could potentially dilute basic earnings per share (2017: none).

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Notes to the Condensed Consolidated Interim Statement of Financial Position

18. Cash and balances with Central Bank

	30.6.2018	31.12.2017
Cash on hand	8,286	9,954
Cash with Central Bank	94,953	120,641
Mandatory reserve deposit with Central Bank	9,757	9,224
Cash and balances with Central Bank	112,996	139,819

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

Bank accounts	64,514	51,303
Money market loans	46,781	32,309
Other loans	2,251	2,997
Loans to credit institutions	113,546	86,609

20. Loans to customers

	Individuals		Corporates		Total	
30.6.2018	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	14,231	13,194	21,125	20,007	35,356	33,201
Credit cards	11,190	10,960	1,262	1,236	12,452	12,196
Loans to customers at fair value	-	-	6,301	6,301	6,301	6,301
Mortgage loans	327,612	326,938	21,549	21,496	349,161	348,434
Other loans	33,736	31,458	377,877	372,104	411,613	403,562
Loans to customers	386,769	382,550	428,114	421,144	814,883	803,694
31.12.2017						
Overdrafts	14,469	13,438	18,778	17,504	33,247	30,942
Credit cards	11,133	10,931	1,123	1,109	12,256	12,040
Mortgage loans	311,507	310,318	19,632	19,417	331,139	329,735
Other loans	33,629	30,600	368,312	361,784	401,941	392,384
Loans to customers	370,738	365,287	407,845	399,814	778,583	765,101

The total book value of pledged loans that were pledged against amounts borrowed was ISK 192 billion at the end of the period (31.12.2017: ISK 183 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk Management Disclosures.

21. Financial instruments

	30.6.2018	31.12.2017
Bonds and debt instruments	49,659	51,755
Shares and equity instruments with variable income	20,801	36,190
Derivatives	5,130	7,624
Securities used for economic hedging	19,675	13,881
Financial instruments	95,265	109,450

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

22. Financial assets and financial liabilities

30.6.2018 **Financial assets** *Loans*	Amortized cost	Fair value through OCI	Manda-torily at fair value through P/L	Total
Cash and balances with Central Bank	112,996	-	-	112,996
Loans to credit institutions	113,546	-	-	113,546
Loans to customers	797,393	-	6,301	803,694
Loans	1,023,935	-	6,301	1,030,236
Bonds and debt instruments				
Listed	-	33,308	13,723	47,031
Unlisted	-	2,373	255	2,628
Bonds and debt instruments	-	35,681	13,978	49,659
Shares and equity instruments with variable income				
Listed	-	-	8,080	8,080
Unlisted	-	-	10,163	10,163
Bond funds with variable income, unlisted	-	-	2,558	2,558
Shares and equity instruments with variable income	-	-	20,801	20,801
Derivatives				
OTC derivatives	-	-	4,216	4,216
Derivatives used for hedge accounting	-	-	914	914
Derivatives	-	-	5,130	5,130
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	9,459	9,459
Shares and equity instruments with variable income, listed	-	-	10,204	10,204
Shares and equity instruments with variable income, unlisted	-	-	12	12
Securities used for economic hedging	-	-	19,675	19,675
Accounts receivable	6,402	-	-	6,402
Other financial assets	3,462	-	-	3,462
Financial assets	1,027,397	35,681	65,885	1,128,963

Financial liabilities				
Due to credit institutions and Central Bank	6,336	-	-	6,336
Deposits	476,182	-	-	476,182
Borrowings	410,773	-	-	410,773
Short position in bonds	-	-	529	529
Short position in equity	-	30	-	30
Derivatives	-	-	3,336	3,336
Other financial liabilities	37,573	-	-	37,573
Financial liabilities	930,864	30	3,865	934,759

For further information on the transition, reclassification and measurements at 1 January 2018, see Financial assets and Financial liabilities classification transition from IAS 39 to IFRS 9.

Amounts are in ISK millions

22. Financial assets and financial liabilities, continued

31.12.2017* **Financial assets**	Amortized cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	139,819	-	-	139,819
Loans to credit institutions	86,609	-	-	86,609
Loans to customers	765,101	-	-	765,101
Loans	991,529	-	-	991,529
Bonds and debt instruments				
Listed	-	2,452	46,638	49,090
Unlisted	-	23	2,642	2,665
Bonds and debt instruments	-	2,475	49,280	51,755
Shares and equity instruments with variable income				
Listed	-	1,677	5,380	7,057
Unlisted	-	1,303	10,397	11,700
Bond funds with variable income, unlisted	-	1,782	15,651	17,433
Shares and equity instruments with variable income	-	4,762	31,428	36,190
Derivatives				
OTC derivatives	-	7,544	-	7,544
Derivatives used for hedge accounting	-	80	-	80
Derivatives	-	7,624	-	7,624
Securities used for economic hedging				
Bonds and debt instruments, listed	-	6,024	-	6,024
Shares and equity instruments with variable income, listed	-	7,846	-	7,846
Shares and equity instruments with variable income, unlisted	-	11	-	11
Securities used for economic hedging	-	13,881	-	13,881
Other financial assets	8,948	-	-	8,948
Financial assets	1,000,477	28,742	80,708	1,109,927
Financial liabilities				
Due to credit institutions and Central Bank	7,370	-	-	7,370
Deposits	462,161	-	-	462,161
Borrowings	384,998	-	-	384,998
Short position in bonds	-	1,467	-	1,467
Short position in equity	-	67	-	67
Derivatives	-	1,722	-	1,722
Derivatives used for hedge accounting	-	345	-	345
Other financial liabilities	34,705	-	-	34,705
Financial liabilities	889,234	3,601	-	892,835

*Comparative figures have not been restated in accordance with IFRS 9.

Amounts are in ISK millions

22. Financial assets and financial liabilities, continued

Bonds and debt instruments measured at fair value, specified by issuer

30.6.2018	FVOCI	Mandatorily FVPL	Total
Financial and insurance activities	2,816	4,448	7,264
Public sector	26,709	8,747	35,456
Corporates	6,156	783	6,939
Bonds and debt instruments at fair value	35,681	13,978	49,659

31.12.2017*	Trading	Designated at fair value	Total
Financial and insurance activities	1,575	4,415	5,990
Public sector	823	38,389	39,212
Corporates	77	6,476	6,553
Bonds and debt instruments designated at fair value	2,475	49,280	51,755

*Comparative figures have not been restated in accordance with IFRS 9.

The total amount of pledged bonds was ISK 5.4 billion at the end of the period (31.12.2017: ISK 13.4 billion). Pledged bonds comprised 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. On 1 January 2018 the Group implemented IFRS 9 and as a result of the implementation assets previously measured at amortized cost were reclassified to mandatorily measured at fair value through profit and loss. The reclassified assets are measured as Level 2 assets.

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

30.6.2018

Assets at fair value	Level 1	Level 2	Level 3	Total
Loans to customers	-	6,301	-	6,301
Bonds and debt instruments	41,000	8,619	40	49,659
Shares and equity instruments with variable income	4,713	14,941	1,147	20,801
Derivatives	-	4,216	-	4,216
Derivatives used for hedge accounting	-	914	-	914
Securities used for economic hedging	19,507	168	-	19,675
Investment property	-	-	7,027	7,027
Assets at fair value	65,220	28,858	8,214	102,292
Liabilities at fair value				
Short position in bonds	529	-	-	529
Derivatives	30	-	-	30
Derivatives used for hedge accounting	-	3,336	-	3,336
Liabilities at fair value	559	3,336	-	3,895

Amounts are in ISK millions

23. Fair value hierarchy, continued

31.12.2017

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	32,452	19,264	39	51,755
Shares and equity instruments with variable income	4,140	30,920	1,130	36,190
Derivatives	-	7,544	-	7,544
Derivatives used for hedge accounting	-	80	-	80
Securities used for economic hedging	13,713	168	-	13,881
Investment property	-	-	6,613	6,613
Assets at fair value	50,305	57,976	7,782	116,063

Liabilities at fair value	Level 1	Level 2	Level 3	Total
Short position in bonds	1,467	-	-	1,467
Short position in equity	67	-	-	67
Derivatives	-	1,722	-	1,722
Derivatives used for hedge accounting	-	345	-	345
Liabilities at fair value	1,534	2,067	-	3,601

Transfers from Level 2 to Level 1 amounted to ISK 201 million during the period due to listing of companies on Nasdaq Iceland (2017: 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.

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.

Level 1: Fair value established from quoted market prices

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 valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent market transactions between knowledgeable and willing parties, if available, reference to 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.

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.

Amounts are in ISK millions

23. Fair value hierarchy, continued

Level 2 instruments include unlisted shares, unlisted funds with underlying bonds and equity holdings (share certificates), unlisted and less liquid listed bonds and all OTC derivatives.

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	Financial assets		
30.6.2018	property	Bonds	Shares	Total
Balance at the beginning of the year	6,613	39	1,130	7,782
Net fair value changes	383	6	(31)	358
Additions	31	-	115	146
Disposals	-	(5)	(1)	(6)
Transfers out of Level 3	-	-	(66)	(66)
Balance at the end of the period	7,027	40	1,147	8,214

31.12.2017				
Balance at the beginning of the year	5,358	89	18	5,465
Net fair value changes	1,036	(617)	23	442
Net gain from disposal	15	-	-	15
Additions	767	-	234	1,001
Disposal	(563)	(147)	(15)	(725)
Transfers into Level 3*	-	714	870	1,584
Balance at the end of the period	6,613	39	1,130	7,782

*In a routine review of the portfolio the Bank reclassified a number of unlisted shares and bonds from Level 2 to Level 3. Presumptions for classification to Level 2 were no longer considered available.

Line items where effects of Level 3 assets are recognized in the Consolidated Interim Income Statement

	Investment	Financial assets		
1.1.-30.6.2018	property	Bonds	Shares	Total
Net financial income	-	6	(31)	(25)
Other operating income	383	-	-	383
Effects recognized in the Income Statement	383	6	(31)	358

1.1.-30.6.2017				
Net interest income	-	16	-	16
Net financial income	-	(60)	35	(25)
Other operating income	1,373	-	-	1,373
Effects recognized in the Income Statement	1,373	(44)	35	1,364

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

23. Fair value hierarchy, continued

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

30.6.2018

Financial assets not carried at fair value	Carrying value	Fair value	Unrealized gain (loss)
Cash and balances with Central Bank	112,996	112,996	-
Loans to credit institutions	113,546	113,546	-
Loans to customers	803,694	808,203	4,509
Other financial assets	9,864	9,864	-
Financial assets not carried at fair value	1,040,100	1,044,609	4,509

Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	6,336	6,336	-
Deposits	476,182	476,182	-
Borrowings	410,773	421,597	(10,824)
Other financial liabilities	37,573	37,573	-
Financial liabilities not carried at fair value	930,864	941,688	(10,824)

31.12.2017

Financial assets not carried at fair value			
Cash and balances with Central Bank	139,819	139,819	-
Loans to credit institutions	86,609	86,609	-
Loans to customers	765,101	772,185	7,084
Other financial assets	8,948	8,948	-
Financial assets not carried at fair value	1,000,477	1,007,561	7,084

Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,370	7,370	-
Deposits	462,161	462,161	-
Borrowings	384,998	402,355	(17,357)
Other financial liabilities	34,705	34,705	-
Financial liabilities not carried at fair value	889,234	906,591	(17,357)

Loans to customers are largely with variable interest rate. Those loans, including corporate loans, are presented at book value as they have generally short duration and very limited interest rate risk. Loans with fixed interest rate, mainly long term retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account loan to value. 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.

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.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

23. Fair value hierarchy, continued

Derivatives	Notional	Fair value	
30.6.2018	value	Assets	Liabilities
Forward exchange rate agreements	57,891	317	619
Fair value hedge of interest rate swap	135,520	914	-
Interest rate and exchange rate agreements	143,353	2,822	2,501
Bond swap agreements	6,589	10	16
Share swap agreements	11,332	1,063	178
Options - purchased agreements	624	4	22
Derivatives	355,309	5,130	3,336
31.12.2017			
Forward exchange rate agreements	52,914	563	251
Fair value hedge of interest rate swap	99,613	80	345
Interest rate and exchange rate agreements	199,723	6,265	1,392
Bond swap agreements	1,818	1	15
Share swap agreements	8,270	701	64
Options - purchased agreements	1,219	14	-
Derivatives	363,557	7,624	2,067

The Group applies fair value hedge accounting only with respect to 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 bonds, see Note 31, arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. On 1 January 2018 the Group implemented IFRS 9, but has elected to continue to apply the hedge accounting principles under IAS 39. For further information about the Group's hedge, accounting policy, see Note 54 in the Annual Financial Statement 2017.

Amounts are in ISK millions

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				
30.6.2018	Gross assets before nettings	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, net
Reverse repurchase agreements	11,816	-	11,816	(624)	-	11,192	-	11,816
Derivatives	3,756	-	3,756	(2,153)	-	1,603	1,374	5,130
Total assets	15,572	-	15,572	(2,777)	-	12,795	1,374	16,946
31.12.2017								
Reverse repurchase agreements	15,197	-	15,197	(82)	-	15,115	-	15,197
Derivatives	6,350	-	6,350	(1,210)	-	5,140	1,274	7,624
Total assets	21,547	-	21,547	(1,292)	-	20,255	1,274	22,821

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the Balance Sheet				
30.6.2018	Gross liabilities before nettings	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	624	-	624	(624)	-	-	-	624
Derivatives	2,263	-	2,263	(2,153)	-	110	1,073	3,336
Total liabilities	2,887	-	2,887	(2,777)	-	110	1,073	3,960
31.12.2017								
Repurchase agreements	82	-	82	(82)	-	-	-	82
Derivatives	1,299	-	1,299	(1,210)	-	89	768	2,067
Total liabilities	1,381	-	1,381	(1,292)	-	89	768	2,149

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

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

25. Investments in associates

The Group's interest in its principal associates	30.6.2018	31.12.2017
Audkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	25.4%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	35.8%	35.8%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	23.0%	23.0%
220 Fjördur ehf., Fjardargötu 13-15, Hafnarfjördur, Iceland	37.4%	35.3%

Investments in associates		
Carrying amount at the beginning of the year	760	839
Acquisitions	-	961
Dividend received	-	(41)
Disposals	-	(74)
Share of profit (loss) of associates and net impairment	(16)	(925)
Investment in associates	743	760

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.

26. Intangible assets

Intangible assets comprise following categories; Goodwill, which arises on business combinations; Infrastructure, Customer relationships and related agreements which are identified during the acquisition of subsidiaries and related to the activities of the businesses being acquired; and Software, which is either acquired (i.e. software licenses) or internally developed.

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 which the Bank acquired in subsidiaries and agreements bought. 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 relationship related to individual customers through Retail Banking. The customer relationships is tested for impairment and related agreements are amortized over a period of five years with one year remaining. When deciding on the lifetime of those agreements it was based on experience of the Bank and the industry. As a result, those agreements are assessed as having an identified useful lifetime.

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.

Policies applied to the Group's intangible assets	Goodwill and infrastructure	Customer relationship and related agreements	Software
Useful lives	Undefined	Finite 5-15 years and undefined	Finite 3-10 years
Amortization method	Impairment test	Straight-line basis over 5-15 years and impairment test	Straight-line basis over 3-10 years
Internally generated or acquired	Acquired	Acquired	Internally generated and acquired

Amounts are in ISK millions

26. Intangible assets, continued

30.6.2018	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	4,315	3,705	1,492	4,336	13,848
Additions and transfers	-	-	-	782	782
Additions, internally developed	-	-	-	293	293
Exchange difference	(32)	-	(5)	(8)	(45)
Transfers and recalculation	(414)	-	106	14	(294)
Amortization	-	-	(172)	(554)	(726)
Intangible assets	3,869	3,705	1,421	4,863	13,858

31.12.2017	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	1,773	-	297	107	2,177
Additions and transfers	174	-	(125)	1,310	1,359
Additions, internally developed	-	-	-	347	347
Exchange difference	166	-	20	41	227
Impairment	-	-	(3)	-	(3)
Amortization	-	-	(305)	(1,011)	(1,316)
Intangible assets	4,315	3,705	1,492	4,336	13,848

Goodwill is recognized in the segment Subsidiaries and other divisions, see Note 4.

27. Tax assets and tax liabilities

	30.6.2018		31.12.2017	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	5,991	-	6,329
Deferred tax	603	512	450	499
Tax assets and tax liabilities	603	6,503	450	6,828

28. Non-current assets and disposal groups held for sale

	30.6.2018	31.12.2017
Disposal groups held for sale	5,930	5,219
Real estate	2,302	2,879
Other assets	63	40
Non-current assets and disposal groups held for sale	8,295	8,138

Real estates and other assets classified as non-current assets held for sale are generally the result of foreclosures on companies and individuals.

Stakksberg ehf. a subsidiary of Eignabjarg ehf.

On 22 January 2018 United Silicon was declared bankrupt following serious operational problems which resulted it its operating license being temporarily suspended, as well as a failed attempt at reaching a composition with its creditors. In February 2018 an agreement was reached between the administrator of the bankrupt estate of United Silicon and Arion Bank, whereby the Bank foreclosed against its collateral and acquired all the company's main assets. Disputes with other creditors regarding the validity of the collateral and assurances provided by the Bank in relation thereto are disclosed in Note 35. The assets of the silicon plant are currently managed by Stakksberg ehf., which is held by the Bank through a newly established subsidiary, Eignabjarg ehf. Stakksberg ehf. has, since the transfer of the assets from United Silicon, successfully worked to reduce uncertainties surrounding the recommissioning of the silicon plant, amongst other things by securing all necessary operating permits, power supply and undertaking further engineering design groundwork necessary for the carrying out of remedial work prior to the reopening of the plant. The Bank's objective is to divest Stakksberg ehf. during the second half of 2018 on the basis of the preparatory work already undertaken. Consequently the Stakksberg ehf. shares are currently classified as an asset held for sale and as discontinued operations as of 30 June 2018 in accordance with IFRS 5.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

29. Other assets

	30.6.2018	31.12.2017
Property and equipment	6,456	6,561
Accounts receivable	6,402	6,531
Unsettled securities trading	1,723	481
Investment for life assurance policyholders where risk is held by policyholder	861	869
Sundry assets	3,375	2,524
Other assets	18,817	16,966

30. Other liabilities

	30.6.2018	31.12.2017
Accounts payable	26,078	26,394
Unsettled securities trading	1,620	527
Depositors' and Investors' Guarantee Fund	214	218
Technical provision	13,980	12,129
Technical provision for life assurance policyholders were investment risk is held by policyholder	861	869
Withholding tax	504	1,414
Bank levy	4,855	3,172
Sundry liabilities	15,412	12,339
Other liabilities	63,524	57,062

Technical provision	Technical provision	Reinsurers' share	Total 30.6.2018	Technical provision	Reinsurers' share	Total 31.12.2017
Claims reported and loss adjustment expenses	6,775	(103)	6,672	5,587	(121)	5,466
Claims incurred but not reported	1,083	(113)	970	1,664	(99)	1,565
Claims outstanding	7,858	(216)	7,642	7,251	(220)	7,031
Provision for unearned premiums	6,122	(19)	6,103	4,878	(19)	4,859
Own technical provision	13,980	(235)	13,745	12,129	(239)	11,890

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.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

31. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	30.6.2018	31.12.2017
ARION CBI 19, ISK 4,500 million	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,650	4,586
ARION CB 19, ISK 2,740 million	2016	2019	At maturity	Fixed, 5.50%	1,788	1,789
ARION CBI 21, ISK 10,220 million ...	2014	2021	At maturity	Fixed, CPI linked, 3.50%	9,777	9,729
ARION CB 22, ISK 26,960 million	2015	2022	At maturity	Fixed, 6.50%	26,750	23,339
ARION CBI 25, ISK 30,520 million ...	2017	2025	At maturity	Fixed, CPI linked, 3.00%	30,806	22,875
ARION CBI 29, ISK 25,220 million ...	2014	2029	At maturity	Fixed, CPI linked, 3.50%	26,552	26,243
ARION CBI 34, ISK 2,500 million	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	-	2,152
ARION CBI 48 ISK 5,160 million	2018	2048	Amortizing	Fixed, CPI linked, 2.50%	4,110	-
Statutory covered bonds					104,433	90,713
ARION CB 2, ISK 51,125 million	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	78,604	78,267
Structured Covered bonds					78,604	78,267
Total Covered bonds					183,037	168,980
EUR 21 million	2009	2018	Amortizing	Floating, EURIBOR +1.00%	173	348
ISK 3,835 million	2010	2018	Amortizing	Floating, REIBOR +1.00%	267	531
EUR 300 million	2015	2018	At maturity	Fixed, 3.125%	-	25,461
SEK 500 million	2016	2018	At maturity	Floating, 3 month STIBOR +1.09%	5,898	6,348
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	37,104	37,957
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	939	966
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	3,240	3,485
SEK 100 million	2017	2019	At maturity	Fixed, 0.29%	1,180	1,268
NOK 800 million	2015	2020	At maturity	Floating, NIBOR +2.95%	10,461	10,236
NOK 320 million	2016	2020	At maturity	Floating, NIBOR +1.95%	4,174	4,087
EUR 300 million*	2017	2020	At maturity	Fixed, 0.75%	36,861	37,356
SEK 300 million	2017	2020	At maturity	Floating, 3 month STIBOR +1.35%	3,544	3,811
SEK 250 million	2017	2020	At maturity	Floating, 3 month STIBOR +0.75%	2,949	3,173
EUR 500 million*	2016	2021	At maturity	Fixed, 1.625%	61,302	61,341
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,252	3,231
EUR 300 million*	2018	2023	At maturity	Fixed, 1.00%	37,014	-
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,254	3,240
Senior unsecured bonds					211,612	202,839
Bills issued					15,916	10,794
Other					208	2,385
Other loans/bills					16,124	13,179
Borrowings					410,773	384,998

*The Group applies fair value hedge accounting to these bond issuances 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 these fixed-rate foreign currency denominated bonds arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. The total carrying amount of the bond issuances is ISK 135,177 million and included in the amount are negative fair value changes amounting to ISK 345 million, see Note 8.

The book value of listed bonds was ISK 394 billion at the end of the period (31.12.2017: ISK 371 billion). The market value of those bonds was ISK 405 billion (31.12.2017: ISK 388 billion). The Group repurchased own debts during the period for the amount of ISK 1 billion (2017: ISK 20 billion) with minor effects on the Consolidated Interim Income Statement.

Amounts are in ISK millions

32. Pledged assets

Pledged assets against liabilities	30.6.2018	31.12.2017
Assets, pledged as collateral against borrowings	219,056	202,381
Assets, pledged as collateral against loans from credit institutions and short positions	5,360	13,364
Pledged assets against liabilities	224,416	215,745

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 219 billion at the end of the period (31.12.2017: ISK 202 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 183 billion at the end of the period (31.12.2017: ISK 169 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.

33. 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)	30.6.2018	Number (million)	31.12.2017
Issued share capital	2,000	75,861	2,000	75,861
Purchase of treasury stock	(186)	(16,844)	-	-
Shares outstanding	1,814	59,017	2,000	75,861
Own shares	186	16,658	-	-

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

Other reserves	30.6.2018	31.12.2017
Statutory reserve	1,637	1,637
Reserve for investments in subsidiaries	12,069	14,011
Reserve for investments in associates	22	39
Reserve for investments in securities	507	901
Reserve for financial instruments carried at fair value through OCI, net of tax	3	-
Foreign currency translation reserve	198	186
Other reserves	14,436	16,774

Notes to the Condensed Consolidated Interim Financial Statements

Other information

34. Shareholders of Arion Bank

Shareholders of Arion Bank hf. with shareholding exceeding 1% of the Bank's issued share capital

	30.6.2018	31.12.2017
Kaupskil ehf.	32.67%	55.57%
Taconic Capital	10.00%	9.99%
Arion banki hf.	9.30%	9.50%
Attestor Capital	9.09%	12.44%
Och Ziff Capital management	6.58%	6.58%
Goldman Sachs funds	3.37%	3.37%
Lansdowne funds	2.95%	-
Miton Asset Management funds	1.63%	-
Goldman Sachs & Co. LLC (Custodian)	1.44%	-
Morgan Stanley - MSIL IPB Client account (Custodian)	1.37%	-
Stefnir funds	1.28%	-
Eaton Vance funds	1.23%	-
JP Morgan Bank Luxembourg S.A. (Custodian)	1.00%	-
Other	18.09%	2.55%
Issued share capital	100.00%	100.00%

35. Legal matters

The Group has in place formal controls and policies for managing legal claims. Once professional advice has been obtained and the likelihood and amount of loss reasonably estimated, the Group makes adjustments, if appropriate, to account for any adverse effects the claims may have on its financial standing. Should the Group conclude that it is to the detriment of the Group's case to disclose such potential amounts, relating to the legal claims raised, 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., has filed two cases against the Bank with a claim for damages in the amount of more than ISK 4 billion, plus interest. The plaintiffs maintain that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagid Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. In April 2018 the District Court of Reykjavík dismissed the case ex officio. The plaintiffs appealed the judgment to the Court of Appeal. In June 2018 the Court of Appeal annulled the judgment of the District Court and ordered the District Court to hear the case again. The case is scheduled to be heard again on 23 August 2018. 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. requested a new assessment, which would examine particular aspects which have not yet been assessed. The District Court and the Court of Appeal have rejected the request. Recently Datacell and Sunshine Press Production applied for the freezing of Valitor's assets on the basis of the aforementioned claim of compensatory damages but the district magistrate declined the application. The plaintiffs subsequently filed a complaint with the District Court to re-evaluate the decision by the Magistrate to decline the freezing of assets. The District Court of Reykjavík confirmed the magistrate's decision with a judgment on 7 June 2018. Datacell and Sunshine Press Production again applied for the freezing of Valitor's assets which the district magistrate again rejected on 6 July 2018. Datacell and Sunshine Press Productions have appealed the decision to the District Court, with a first hearing expected in August. 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 the compensatory damages described above. 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.

Amounts are in ISK millions

35. Legal matters, continued

Other legal matters

Mortgage documents

Cases have been lodged against the Bank, where claims are made for the invalidation of mortgaging of parts of a property. The claims are made on the basis that the signatures of the mortgagor on the respective mortgage documents were incorrect. In 2017, the Supreme Court ruled on the issue in several cases which did not involve the Bank. In the majority of those cases, the Supreme Court invalidated the disputed mortgage. At the district court level, several court cases involving the Bank regarding the aforementioned issue have been ruled upon. In the majority of those, the district court invalidated the disputed mortgage. The overall legal situation has become clearer and the Bank is assessing how to treat those loan documents to which the above precedent may apply.

United Silicon

The company United Silicon was granted a moratorium on payments on 14 August 2017 and filed for bankruptcy on 22 January 2018. The Bank had collateral in the company's assets and the estate has transferred the assets to the Bank. The trustee in the estate has approved the Bank's claims but two unsecured creditors have lodged a protest against the Bank's lien on the assets of United Silicon. The trustee in the bankruptcy has referred the disagreement to the District Court of Reykjanes. The Bank has examined these protests and rejects them all. It should be noted that in the agreement between the Bank and the estate, it is stated that should the Bank's collateral be judicially deemed to be invalid, the Bank will refund the estate the amount of the invalidated bond.

Penalty interest during extension of payments

The Supreme Court ruled on 8 March 2018, in case no. 159/2017, that the Bank was not permitted to calculate penalty interest on a customer’s debt during the period in which the said customer had been granted an extension of payments under the law on debt mitigation. Since the judgment was handed out the Bank has been examining how many customers have paid penalty interest on their debts to the Bank during this extension period. A more detailed examination of these cases will reveal whether any customers may be able to claim repayment from the Bank, particularly where the debt has been paid in full or if they are entitled to have their debts reduced. An evaluation of the financial impact on the Bank is currently being conducted.

Legal matters concluded

In a lawsuit brought in June 2013, Kortathjónustan hf. 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 Kortathjónustan hf. contended the five parties caused the company due to violations of the Competition Act. In June 2017 the Supreme Court dismissed the case on procedural grounds. Kortathjónustan hf. brought a new lawsuit in September 2017 regarding the same matter of dispute, this time with a claim for damages in the amount of ISK 922 million plus interest from the same defendants. The District Court of Reykjavík dismissed the case in March 2018 and the Court of Appeal confirmed the dismissal in May 2018. Kortathjónustan tried to appeal the dismissal to the Supreme Court but the court dismissed the case as there was no right of complaint.

38. Events after the reporting period

The Board of Directors has concluded that the Bank has the ability to lower its capital position and has therefore proposed to an extraordinary shareholders' meeting scheduled for 18 September 2018, that the Bank will pay an extraordinary dividend amounting to ISK 10 billion. Such dividend payment will reduce Arion Bank's CET 1 ratio from 23.1% to 21.8%, which is above the 21.3% capital requirement set by FME and the Bank. For further information regarding capital management see Note 43.

Notes to the Condensed Consolidated Interim Financial Statements

Off balance sheet information

36. Commitments

Financial guarantees, unused credit facilities and undrawn loan commitments the Group has granted its customers

	30.6.2018	31.12.2017
Financial guarantees	14,309	13,224
Unused overdrafts	46,152	45,897
Undrawn loan commitments	93,730	87,942
Financial guarantees, unused credit facilities and undrawn loan commitments the Group has granted its customers	154,191	147,063

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.

37. Assets under management and under custody

	30.6.2018	31.12.2017
Assets under management	971,304	984,653
Assets under custody	1,418,172	1,620,355

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.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Related party

39. Related party

The Group has a related party relationship with entities with influence over the Group as the largest shareholders of Arion Bank, which are on 30 June 2018 Kaupskil ehf. (32.67%) and Taconic Capital (10.00%), the Board of Directors of Kaupskil ehf. and Kaupthing hf., being the parent company of Kaupskil ehf. and entities controlled by them. At year end 2017 Kaupskil ehf. (55.57%) was defined as shareholders with control over the Group as well as Taconic Capital Advisors UK LLP (9.99%) and Och Ziff Capital management (6.58%) as their shareholdings were managed by Kaupskil ehf.

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

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

30.6.2018	Assets	Liabilities	Net balance
Shareholders with influence over the Group	61	(2,577)	(2,516)
Board of Directors and key Management personnel	187	(830)	(643)
Associates and other related parties	-	(7)	(7)
Balances with related parties	248	(3,414)	(3,166)

31.12.2017	Assets	Liabilities	Net balance
Shareholders with control over the Group	57	(4,785)	(4,728)
Shareholders with influence over the Group	423	(151)	272
Board of Directors and key Management personnel	183	(101)	82
Associates and other related parties	-	(83)	(83)
Balances with related parties	663	(5,121)	(4,457)

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Risk management disclosures

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

Further information regarding risk management is available in the Annual Financial Statements and in the Pillar 3 Risk Disclosures, published on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not audited.

40. 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 guarantees.

Managing and analyzing the Group's loan portfolio is of utmost importance. Great emphasis is placed on the quality of the credit portfolio, by maintaining a strict credit process, critically inspecting loan applications, actively monitoring the credit portfolio and identifying and reacting to possible problem loans at an early stage as well as restructuring of impaired credits.

The Group grants credit based on well informed lending decisions and seeks business with strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in the pricing.

Credit risk is managed and controlled by setting limits on the amount of risk the Group is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits. The Group seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to group of connected clients.

Exposure to credit risk

The table below shows the maximum exposure to credit risk for the components of the Interim Statement of Financial Position before the effect of mitigation due to collateral agreements or other credit enhancements. The table also shows related collateral and 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. Collateral value are capped by the exposure amount. Comparative figures have not been updated.

Notes to the Condensed Consolidated Interim Financial Statements

40. Credit risk, continued

Maximum exposure to credit risk and collateral held against different types of financial instruments subject to the impairment requirements of IFRS 9

30.6.2018	Maximum exposure	Collateral: Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	112,996	-	-	-	-	-
Loans to credit institutions	113,546	-	-	-	-	-
Loans to customers at amortized cost	797,393	16,246	559,077	54,505	70,805	700,633
Individuals	*382,550*	*99*	*345,983*	*6*	*9,933*	*356,021*
Corporates	*414,843*	*16,147*	*213,094*	*54,499*	*60,872*	*344,612*
Real estate activities and construction	*135,510*	*622*	*125,918*	*18*	*1,903*	*128,461*
Fishing industry	*77,247*	*10*	*9,372*	*53,357*	*7,736*	*70,475*
Information and communication technology	*23,633*	*536*	*3,315*	-	*8,721*	*12,572*
Wholesale and retail trade	*64,492*	*374*	*32,655*	*15*	*24,527*	*57,571*
Financial and insurance activities	*30,173*	*14,333*	*5,492*	*711*	*6,847*	*27,383*
Industry, energy and manufacturing	*31,304*	*215*	*19,795*	-	*5,993*	*26,003*
Transportation	*19,365*	*2*	*1,132*	*286*	*1,774*	*3,194*
Services	*19,058*	*44*	*7,088*	*112*	*2,963*	*10,207*
Public sector	*6,980*	*11*	*1,847*	-	*175*	*2,033*
Agriculture and forestry	*7,081*	-	*6,480*	-	*233*	*6,713*
Other assets with credit risk	9,864	7,313	-	-	-	7,313
Financial guarantees	14,309	1,584	3,940	1,700	3,848	11,072
Undrawn loan commitments and unused overdrafts	139,882	-	-	-	-	-
Fair value through OCI	35,681	-	-	-	-	-
Government bonds	*26,709*	-	-	-	-	-
Corporate bonds	*8,972*	-	-	-	-	-
Balance at the end of the period	1,223,671	25,143	563,017	56,205	74,653	719,018

Maximum exposure to credit risk and collateral held against different types of financial instruments under IAS 39

31.12.2017	Maximum exposure	Collateral: Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	139,819	-	-	-	-	-
Loans to credit institutions	86,609	-	-	-	-	-
Loans to customers	765,101	15,571	525,401	53,986	55,790	650,748
Individuals	*365,287*	*195*	*326,456*	*16*	*8,413*	*335,080*
Corporates	*399,814*	*15,376*	*198,945*	*53,970*	*47,377*	*315,668*
Real estate activities and construction	*128,153*	*371*	*115,467*	*208*	*1,928*	*117,974*
Fishing industry	*78,937*	*24*	*8,569*	*52,693*	*10,580*	*71,866*
Information and communication technology	*22,020*	*541*	*1,103*	-	*2,035*	*3,679*
Wholesale and retail trade	*57,432*	*208*	*32,294*	*12*	*16,131*	*48,645*
Financial and insurance activities	*34,138*	*13,440*	*4,184*	*681*	*6,174*	*24,479*
Industry, energy and manufacturing	*29,452*	*660*	*19,367*	-	*5,747*	*25,774*
Transportation	*17,111*	*3*	*973*	*278*	*1,395*	*2,649*
Services	*18,157*	*15*	*7,365*	*98*	*3,047*	*10,525*
Public sector	*7,824*	*114*	*3,657*	-	*92*	*3,863*
Agriculture and forestry	*6,590*	-	*5,966*	-	*248*	*6,214*
Financial instruments	78,784	5,948	-	-	-	5,948
Other assets with credit risk	8,948	-	-	-	-	-
Financial guarantees	13,224	871	3,343	1,598	3,343	9,155
Undrawn loan commitments and unused overdrafts	133,839					-
Balance at the end of the period	1,226,324	22,390	528,744	55,584	59,133	665,851

Amounts are in ISK millions

40. Credit risk, continued

LTV ratio for residential mortgage lending

The following table describes the loan to value (LTV) and impairment status of the Group's mortgage loan book. LTV is calculated as the ratio of the gross amount of the loan to the value of the collateral without adjusting for possible costs of obtaining and selling the collateral. The collateral value is based on the value at origination, the most recent appraisals or official property valuation from the Icelandic Property Registry. For credit impaired loans the value of collateral is based on the most recent appraisals.

30.6.2018	Gross carrying amount	Thereof credit impaired
Less than 50%	119,843	1,058
50-70%	122,240	2,110
70-90%	66,697	1,650
90-100%	17,122	438
100%-110%	9,235	544
More than 110%	14,019	894
Not classified	5	-
Balance at the end of the period	349,161	6,694

At the end of the period the gross carrying amount of assets in stage 3 are ISK 18,644 million with ISK 11,890 million in collateral, there of ISK 10,916 million in real estate.

Collateral repossessed

During the period the Group took possession of assets due to foreclosures. The total amounts of real estates the Group took possession of during the period and still holds at the end of the period amount to ISK 336 million (31.12.2017: ISK 833 million) and other assets ISK 29 million (31.12.2017: ISK 2 million). The assets are held for sale, see Note 29.

Credit quality

The Bank uses internal credit rating models and external credit ratings if available to monitor credit risk. The internal credit rating models rate customers with one of four statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgement for large corporate exposures. Two models rate individuals' exposures – one for prime mortgages and another for other exposures. The models are updated at least 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. External ratings are used for marketable securities, cash and balances, and loans to credit institutions. For further information on the rating scales used see Note 44.

The tables below show financial instruments subject to the impairment requirements of IFRS 9 broken down by rating scale, where risk class 5, DD denotes, the highest risk. Assets carried at fair value through profit and loss are not subject to the impairment requirements of IFRS 9. The tables below sum up the gross carrying amount of assets by rating class and current impairment stage. The gross carrying amount net of loss allowance shows the book value of the underlying assets.

Exposures that are 'Unrated' are typically due to newly formed entities, entities for which the Bank's rating models are not applicable or no external rating is available. Comparative figures have not been restated.

Amounts are in ISK millions

40. Credit risk, continued

Credit quality profile by rating class

30.6.2018	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI
Assets carrying stage 1 ECL			
Investment grade	112,998	110,803	35,701
Non-investment grade	-	372	-
Unrated	-	2,403	-
Gross carrying amount	112,998	113,578	35,701
Loss allowance	(2)	(32)	(20)
Book value	112,996	113,546	35,681

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 1 - (Grades A+ to BBB-)	361,947	199	-	-	362,146
Risk class 2 - (Grades BB+ to BB-)	238,455	15,763	-	49	254,267
Risk class 3 - (Grades B+ to B-)	115,031	16,960	-	-	131,991
Risk class 4 - (Grades CCC+ to CCC-)	18,360	12,642	-	8	31,010
Risk class 5 - (DD)	-	-	18,436	5,418	23,854
Unrated	4,195	911	208	-	5,314
Gross carrying amount	737,988	46,475	18,644	5,475	808,582
Loss allowance	(1,343)	(803)	(6,491)	(2,552)	(11,189)
Book value	736,645	45,672	12,153	2,923	797,393
Loans to customers - mortgage loans					
Risk class 1 - (Grades A+ to BBB-)	188,841	-	-	-	188,841
Risk class 2 - (Grades BB+ to BB-)	99,076	3,530	-	40	102,646
Risk class 3 - (Grades B+ to B-)	31,720	3,634	-	-	35,354
Risk class 4 - (Grades CCC+ to CCC-)	8,848	6,610	-	8	15,466
Risk class 5 - (DD)	-	-	5,955	738	6,693
Unrated	81	80	-	-	161
Gross carrying amount	328,566	13,854	5,955	786	349,161
Loss allowance	(160)	(81)	(416)	(70)	(727)
Book value	328,406	13,773	5,539	716	348,434

Loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Risk class 1 - (Grades A+ to BBB-)	89,516	-	-	89,516
Risk class 2 to 4 - (Grades BB+ to CCC-)	58,877	5,009	530	64,416
Unrated	224	35	-	259
Gross carrying amount	148,617	5,044	530	154,191
Loss Allowance	(197)	(107)	(42)	(346)
Book value	148,420	4,937	488	153,845

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

40. Credit risk, continued

31.12.2017 *Credit quality by class of financial assets*	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	139,819	-	-	139,819
Loans to credit institutions	86,609	-	-	86,609
Loans to customers				
Loans to corporates	385,197	13,655	962	399,814
Loans to individuals	344,829	18,929	1,529	365,287
Financial instruments	78,784	-	-	78,784
Other assets with credit risk	8,948	-	-	8,948
Credit quality by class of financial assets	1,044,186	32,584	2,491	1,079,261

The following table shows loans to customers that are neither past due nor impaired, broken down by the Bank's classification scale as under IAS 39, where 5 denotes the highest risk. The disclosure has not been restated after the implementation of IFRS 9.

	Risk classification						
Neither past due nor impaired loans	1	2	3	4	5	Unrated	Total
Individuals	176,980	116,296	36,507	9,953	2,238	2,855	344,829
Real estate activities and construction	28,508	51,363	40,327	3,013	83	479	123,773
Fishing industry	37,742	28,908	9,129	1,498	653	-	77,930
Information and communication technology	17,691	1,162	2,958	21	-	3	21,835
Wholesale and retail trade	19,996	20,822	9,368	2,117	563	141	53,007
Financial and insurance activities	14,638	3,708	15,103	105	-	10	33,564
Industry, energy and manufacturing	17,236	6,394	4,233	794	187	-	28,844
Transportation	10,644	3,713	2,201	48	-	65	16,671
Services	2,392	6,227	5,224	432	2,443	3	16,721
Public sector	1,730	4,938	862	108	47	-	7,685
Agriculture and forestry	863	1,740	1,816	585	163	-	5,167
Neither past due nor impaired loans	328,420	245,271	127,728	18,674	6,377	3,556	730,026

Past due but not impaired loans by class of loans	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	4,361	4,221	1,774	1,339	1,960	13,655
Loans to individuals	3,065	8,149	4,387	350	2,978	18,929
Past due but not impaired loans	7,426	12,370	6,161	1,689	4,938	32,584

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.

	31.12.2017	
Impaired loans to customers specified by sector	Impairment amount	Gross carrying amount
Individuals	4,010	5,539
Real estate activities and construction	467	762
Fishing industry	658	861
Information and communication technology	111	112
Wholesale and retail trade	490	702
Financial and insurance activities	297	314
Industry, energy and manufacturing	473	581
Transportation	1	1
Services	3,570	3,617
Public sector	45	45
Agriculture and forestry	165	244
Impaired loans to customers specified by sector	10,287	12,778

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

40. Credit risk, continued

The following tables reconciles the opening and closing allowance balance for debt securities at amortized cost and FVOCI by their impairment requirements. The reconciliation includes:

• Transfers of financial assets between impairment requirements: include transfers to 12 month expected credit losses, to lifetime expected credit losses and credit impaired financial assets. All transfers are presumed to occur before any corresponding remeasurement of the loss allowance.

• Net remeasurement of loss allowance: comprise the impact of changes in model inputs or assumptions, including changes in forward-looking macroeconomic conditions, partial repayments and additional draws on existing facilities, inflation, changes in the measurement following a transfer between stages, and unwinding of the time value discount due to the passage of time.

• New financial assets: include purchases and originations and reflect the allowance related to assets newly recognized during the period.

• Derecognitions and maturities, reflect the allowance related to assets derecognized during the period without a credit loss being incurred, including those assets that were derecognized following a modification of terms.

• Write-offs: the amount after net remeasurements of loss allowance written off during the period.

• Foreign exchange: the effects of foreign exchange on the loss allowance between periods.

During the first quarter there were no significant changes to the models used to estimate expected credit loss.

Impairment loss allowance total

1.1.-30.6.2018	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	3,195	-	10,346	-	13,541
Net remeasurement	(1,309)	621	(363)	363	(688)
Opening balance at 1.1.2018	1,886	621	9,983	363	12,853
Transfers of financial assets:					
Transfers to Stage 1 - (12-month ECL)	716	(304)	(412)	-	-
Transfers to Stage 2 - (lifetime ECL)	(173)	353	(180)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(96)	(157)	253	-	-
Net remeasurement of loss allowance	(914)	463	1,796	64	1,409
New financial assets, originated or purchased	391	48	183	2,247	2,869
Derecognitions and maturities	(199)	(77)	(2,778)	(27)	(3,081)
Write-offs	(16)	(39)	(2,306)	(114)	(2,475)
Foreign exchange difference	(2)	2	(6)	19	13
Impairment loss allowance	1,593	910	6,533	2,552	11,588

1.4.-30.6.2018	Stage 1	Stage 2	Stage 3	POCI	Total
Opening balance at 1.4.2018	1,723	769	10,357	289	13,138
Transfers of financial assets:					
Transfers to Stage 1 - (12-month ECL)	390	(137)	(253)	-	-
Transfers to Stage 2 - (lifetime ECL)	(110)	273	(163)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(67)	(89)	156	-	-
Net remeasurement of loss allowance	(393)	138	354	53	152
New financial assets, originated or purchased	151	37	147	2,247	2,582
Derecognitions and maturities	(96)	(53)	(2,542)	(10)	(2,701)
Write-offs	(10)	(32)	(1,621)	(46)	(1,709)
Foreign exchange difference	5	4	98	19	126
Impairment loss allowance	1,593	910	6,533	2,552	11,588

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

40. Credit risk, continued

Impairment loss allowance for assets only carrying 12-month ECL

1.1.-30.6.2018	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI	Total
ECL balance at 31.12.2017	-	-	-	-
Net remeasurement	7	3	3	13
Opening balance at 1.1.2018	7	3	3	13
Net remeasurement of loss allowance	(5)	29	9	33
Net effects of trading	-	-	7	7
Impairment loss allowance for assets only carrying 12-month ECL	2	32	19	53

1.4.-30.6.2018	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI	Total
Opening balance at 1.4.2018	16	23	24	63
Net remeasurement of loss allowance	(14)	9	1	(4)
Net effects of trading	-	-	(6)	(6)
Impairment loss allowance for assets only carrying 12-month ECL	2	32	19	53

Impairment loss allowance for loans to customers

1.1.-30.6.2018	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	3,195	-	10,288	-	13,483
Net remeasurement	(1,502)	572	(363)	363	(930)
Opening balance at 1.1.2018	1,693	572	9,925	363	12,553
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	661	(279)	(382)	-	-
Transfers to Stage 2 - (lifetime ECL)	(158)	338	(180)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(95)	(155)	250	-	-
Net remeasurement of loss allowance	(904)	383	1,457	64	1,000
New financial assets, originated or purchased	281	41	180	2,247	2,749
Derecognitions and maturities	(117)	(59)	(2,430)	(27)	(2,633)
Write-offs	(16)	(39)	(2,306)	(114)	(2,475)
Foreign exchange	(2)	1	(23)	19	(5)
Impairment loss allowance for loans to customers	1,343	803	6,491	2,552	11,189

1.4.-30.6.2018	Stage 1	Stage 2	Stage 3	POCI	Total
Opening balance at 1.4.2018	1,489	706	9,991	289	12,475
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	376	(125)	(251)	-	-
Transfers to Stage 2 - (lifetime ECL)	(97)	260	(163)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(66)	(88)	154	-	-
Net remeasurement of loss allowance	(412)	84	350	53	75
New financial assets, originated or purchased	109	32	144	2,247	2,532
Derecognitions and maturities	(51)	(37)	(2,194)	(10)	(2,292)
Write-offs	(10)	(33)	(1,638)	(46)	(1,727)
Foreign exchange	5	4	98	19	126
Impairment loss allowance for loans to customers	1,343	803	6,491	2,552	11,189

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

40. Credit risk, continued

Impairment loss allowance for loans to customers - mortgage loans

1.1.-30.6.2018	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	538	-	797	-	1,335
Net remeasurement	(345)	70	(128)	127	(276)
Opening balance at 1.1.2018	193	70	669	127	1,059
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	132	(26)	(106)	-	-
Transfers to Stage 2 - (lifetime ECL)	(14)	24	(10)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(1)	(16)	17	-	-
Net remeasurement of loss allowance	(183)	32	(27)	(42)	(220)
New financial assets, originated or purchased	42	4	-	-	46
Derecognitions and maturities	(5)	(1)	(45)	(10)	(61)
Write-offs	(4)	(6)	(82)	(5)	(97)
Impairment loss allowance for loans to customers - mortgage loans	160	81	416	70	727

1.4.-30.6.2018	Stage 1	Stage 2	Stage 3	POCI	Total
Opening balance at 1.4.2018	170	68	585	104	927
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	43	(13)	(30)	-	-
Transfers to Stage 2 - (lifetime ECL)	(7)	8	(1)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(1)	(5)	6	-	-
Net remeasurement of loss allowance	(57)	28	(20)	(22)	(71)
New financial assets, originated or purchased	18	2	-	-	20
Derecognitions and maturities	(5)	(1)	(45)	(10)	(61)
Write-offs	(1)	(6)	(79)	(2)	(88)
Impairment loss allowance for loans to customers - mortgage loans	160	81	416	70	727

Impairment loss allowance for loan commitments, guarantees and unused credit facilities

1.1.-30.6.2018	Stage 1	Stage 2	Stage 3	Total
ECL balance at 31.12.2017	-	-	58	58
Net remeasurement	180	49	-	229
Opening balance at 1.1.2018	180	49	58	287
Transfers of financial assets				
Transfers to 12-month ECL	55	(25)	(30)	-
Transfers to lifetime ECL	(15)	15	-	-
Transfers to credit impaired financial assets	(1)	(2)	3	-
Net remeasurement of loss allowance	(43)	80	339	376
New financial assets, originated or purchased	103	7	3	113
Derecognitions and maturities	(82)	(18)	(348)	(448)
Foreign exchange	-	1	17	18
Impairment loss allowance for loan commitments, guarantees and unused credit facilities	197	107	42	346

1.4.-30.6.2018	Stage 1	Stage 2	Stage 3	Total
Opening balance at 1.4.2018	171	63	366	600
Transfers of financial assets				
Transfers to 12-month ECL	14	(12)	(2)	-
Transfers to lifetime ECL	(13)	13	-	-
Transfers to credit impaired financial assets	(1)	(1)	2	-
Net remeasurement of loss allowance	23	54	4	81
New financial assets, originated or purchased	48	5	3	56
Derecognitions and maturities	(45)	(16)	(348)	(409)
Foreign exchange	-	1	17	18
Impairment loss allowance for loan commitments, guarantees and unused credit facilities	197	107	42	346

Amounts are in ISK millions

40. Credit risk, continued

The following table reconciles the opening and closing loss allowance balance as measured under IAS 39. The comparative amounts have not been restated after the implementation of IFRS 9.

31.12.2017	Specific	Collective	Total
Balance at the beginning of the year	18,281	4,557	22,838
Provision for losses	3,029	(1,362)	1,667
Effects due to acquisition of subsidiary*	(8,723)	-	(8,723)
Write-offs	(2,421)	-	(2,421)
Foreign exchange difference	3	-	3
Payment of loans previously written-off	118	-	118
Balance at the end of the period	10,287	3,195	13,482

*At the end of September 2017 Arion Bank became majority owner of United Silicon, see Note 28. Arion Bank had made provision for losses on loans to United Silicon which was eliminated on Group level when United Silicon became a subsidiary of Arion Bank.

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which is equal to or exceeds 10% of the Group's eligible capital according to Financial Undertakings Act No. 161/2002 and Regulation No. 233/2017 on prudential requirements. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible credit risk mitigation.

The Group had no large exposure at the end of the period before taking account of eligible credit mitigation (31.12.2017: no large exposure).

Amounts are in ISK millions

41. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates adversely affect the Group's earnings and equity position due to changes to the value and cash flows of its assets and liabilities.

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.

The Group keeps close track of market risk and separates its exposures for the trading book and the banking book. Market risk in the trading book arises from proprietary trading activities and non-strategic derivatives positions arising from the Bank's operations of meeting customers' investment and risk management needs. Market risk in the banking book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. Market risk in the trading book and in the banking book is managed separately.

Market risk allowance is set by the Board in the Bank's risk appetite and limit frameworks are in place for each trading desk. The Asset and Liability Committee (ALCO) is responsible for managing the Bank's overall market risk. Risk Management is responsible for measuring and monitoring market risk exposure, and reporting the exposure, usage and limit breaches.

The Group's strategy towards market risk is to limit the risk exposure due to imbalances in the Group's balance sheet but accept limited risk in its trading book.

Interest rate risk

Interest rate risk arises from the possibility that changes in market rates adversely affect net interest income and fair value of interest-bearing instruments on the Group's balance sheet. The Group's operations are subject to interest rate risk due to mismatches in the fixing of interest rates between assets and liabilities, 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.

The Group's interest rate risk for foreign currencies is limited as foreign denominated assets predominantly have short fixing periods and the Group has applied cash flow hedging for its foreign denominated fixed rate borrowings. For domestic rates, longer fixing periods are more common, and this especially applies to indexed mortgages issued between 2004 and 2006. The fixing profile of indexed mortgages is however matched by that of the Group's structured covered bonds issue, which serves as a hedge against repricing risk. The Group has been able to manage relatively small interest fixing gaps.

In the past few years domestic interest rates, nominal and real, have fallen. Due to favorable refinancing spreads, prepayments and/or refinancing of loans have been considerable. Prepayment risk is mitigated by prepayment fees and the Group's own prepayment options. The Group's prepayment of structured covered bonds is a reaction to mortgage prepayments and mortgage refinancing.

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 Condensed Consolidated Interim Financial Statements. The fair value reflects the likelihood of prepayment. 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.

30.06.2018	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	104,710	-	-	-	-	104,710
Loans to credit institutions	113,546	-	-	-	-	113,546
Loans to customers	481,952	80,028	140,148	7,858	98,217	808,203
Financial instruments	9,681	14,889	-	1,899	1,938	28,407
Assets	709,889	94,917	140,148	9,757	100,155	1,054,866
Liabilities						
Due to credit institutions and Central Bank	6,317	19	-	-	-	6,336
Deposits	423,447	37,562	12,900	1,357	916	476,182
Borrowings	42,480	43,785	187,870	34,924	112,538	421,597
Liabilities	472,244	81,366	200,770	36,281	113,454	904,115
Derivatives and other off-balance sheet items (net position)	(177,036)	38,067	139,341	1,159	-	1,531
Net interest gap	60,609	51,618	78,719	(25,365)	(13,299)	152,282

Amounts are in ISK millions

41. Market risk, continued

31.12.2017

Assets						
Balances with Central Bank	129,864	-	-	-	-	129,864
Loans to credit institutions	86,609	-	-	-	-	86,609
Loans to customers	440,161	77,099	141,944	5,867	107,114	772,185
Financial instruments	27,342	3,033	8,186	-	1,866	40,427
Assets	683,976	80,132	150,130	5,867	108,980	1,029,085
Liabilities						
Due to credit institutions and Central Bank	7,370	-	-	-	-	7,370
Deposits	427,393	19,453	13,083	1,343	889	462,161
Borrowings	64,533	6,637	187,998	31,293	111,946	402,407
Liabilities	499,296	26,090	201,081	32,636	112,835	871,938
Derivatives and other off-balance sheet items (net position)	(99,372)	114	102,038	1,548	-	4,328
Net interest gap	85,308	54,156	51,087	(25,221)	(3,855)	161,475

Sensitivity analysis of interest rate risk in the banking book

The following table shows the sensitivity of the Group's net present value (NPV) of interest-bearing assets and liabilities and variation of annual net interest income (NII), due to changes in interest rates by currencies. The variation is calculated on the basis of simultaneous parallel shifts upwards or downwards of yield curves. The choice of shifts is not an estimate of risk likelihood. Behavioral maturities are taken into account in the NPV calculations, including prepayment likelihood and expected behavior of non-maturing deposits. The change to NII is however purely based on contractual interest rate adjustments where it is simplistically assumed that all rates are equally sensitive to the presumed change in market rates.

Interest rates for foreign currencies are predominantly short term for the Group and hedging is applied for fixed rate borrowings. As a result the Group's effective interest income is marginally sensitive to changes to foreign currency interest rates. This is however not fully reflected in the NII variation analysis for 31 December 2017 as a substantial part of the Group's liquid assets in foreign currency was invested in liquidity funds, the income of which is not recognized as interest income.

	30.6.2018		31.12.2017	
NPV change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(3,102)	2,816	(1,465)	2,411
ISK, Non index-linked	150	1,205	(76)	742
Foreign currencies	226	(254)	88	(113)

	30.6.2018		31.12.2017	
NII change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(912)	912	(693)	693
ISK, Non index-linked	(37)	37	(429)	429
Foreign currencies	13	(13)	353	(353)

Sensitivity analysis of interest rate risk in the trading book

The following table shows the interest sensitivity of the Group's net positions in the trading book by currencies. Sensitivity is quantified as the net change in value when assuming a simultaneous parallel shift upwards and downwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income and is not an estimate of risk. The calculations are based on duration and convexity in this table.

	30.6.2018		31.12.2017	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	114	(101)	99	(95)
ISK, Non index-linked	61	(53)	19	(14)
Foreign currencies	2	(2)	27	(27)

Amounts are in ISK millions

41. Market risk, continued

Indexation risk

A significant part of the Group's balance sheet is linked to the Icelandic Consumer Price Index (CPI). Index-linked loans and borrowings are typically annuities, where the principal and monthly payments change in the same proportion as the CPI. The Group is exposed to indexation risk as indexed assets exceed indexed liabilities. Financial instruments held for liquidity or market making purposes are assumed to be on demand.

Book value and maturity profile of indexed assets and liabilities

30.6.2018	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	36,714	79,433	237,984	354,131
Financial instruments	7,611	-	-	7,611
Off-balance sheet position	(316)	(865)	(384)	(1,565)
Assets, CPI index-linked	44,009	78,568	237,600	360,177
Liabilities, CPI index-linked				
Deposits	66,741	12,427	2,257	81,425
Borrowings	1,531	21,147	132,018	154,696
Other	921	207	1,360	2,488
Off-balance sheet position	-	536	-	536
Liabilities, CPI index-linked	69,193	34,317	135,635	239,145
Net on-balance sheet position	(24,868)	45,652	102,349	123,133
Net off-balance sheet position	(316)	(1,401)	(384)	(2,101)
CPI Balance	(25,184)	44,251	101,965	121,032

31.12.2017				
Assets, CPI index-linked				
Loans to customers	16,928	100,149	233,292	350,369
Financial instruments	6,659	-	-	6,659
Off-balance sheet position	4,667	2,096	-	6,763
Assets, CPI index-linked	28,254	102,245	233,292	363,791
Liabilities, CPI index-linked				
Deposits	68,667	12,499	2,201	83,367
Borrowings	1,832	20,867	121,692	144,391
Other	982	203	1,369	2,554
Off-balance sheet position	-	539	-	539
Liabilities, CPI indexed linked	71,481	34,108	125,262	230,851
Net on-balance sheet position	(47,894)	66,580	108,030	126,716
Net off-balance sheet position	4,667	1,557	-	6,224
CPI Balance	(43,227)	68,137	108,030	132,940

Amounts are in ISK millions

41. 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

30.6.2018

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	110,245	1,246	477	260	219	95	454	112,996
Loans to credit institutions	15,442	32,404	31,568	7,884	5,342	11,589	9,317	113,546
Loans to customers	660,124	95,711	32,512	3,579	5,668	1,046	5,054	803,694
Financial instruments	53,205	20,875	19,399	112	52	1,584	38	95,265
Other financial assets	6,616	566	1,581	917	150	9	(6,377)	3,462
Assets	845,632	150,802	85,537	12,752	11,431	14,323	8,486	1,128,963
Liabilities								
Due to credit inst. and Central Bank .	5,775	472	39	3	-	1	46	6,336
Deposits	413,605	31,763	22,498	4,177	1,803	1,117	1,219	476,182
Financial liabilities at fair value	1,387	561	1,646	36	-	234	31	3,895
Other financial liabilities	22,974	4,240	3,676	3,692	1,303	723	965	37,573
Borrowings	200,345	172,465	-	11	-	21,141	16,811	410,773
Liabilities	644,086	209,501	27,859	7,919	3,106	23,216	19,072	934,759
Net on-balance sheet position	201,546	(58,699)	57,678	4,833	8,325	(8,893)	(10,586)	
Net off-balance sheet position	(1,951)	53,475	(56,506)	(962)	(8,131)	8,969	5,106	
Net position	199,595	(5,224)	1,172	3,871	194	76	(5,480)	

Addition, for management reporting

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Investment property	7,027	-	-	-	-	-	-	7,027
Investments in associates	735	8	-	-	-	-	-	743
Intangible assets	8,916	-	-	1,961	2,981	-	-	13,858
Tax assets	603	-	-	-	-	-	-	603
Non-current assets and disposal groups held for sale	8,295	-	-	-	-	-	-	8,295
Other non financial assets	8,512	82	31	261	31	14	6,424	15,355
Assets	34,088	90	31	2,222	3,012	14	6,424	45,881
Liabilities and equity								
Tax liabilities	6,503	-	-	-	-	-	-	6,503
Other non-financial liabilities	26,927	90	(1,132)	64	1	-	1	25,951
Shareholders' equity	206,890	-	-	-	-	-	-	206,890
Non-controlling interest	741	-	-	-	-	-	-	741
Liabilities and equity	241,061	90	(1,132)	64	1	-	1	240,085
Management reporting of currency risk*	(7,378)	(5,224)	2,335	6,029	3,205	90	943	

Amounts are in ISK millions

41. Market risk, continued

31.12.2017

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	137,399	943	293	266	265	117	536	139,819
Loans to credit institutions	17,678	15,033	27,117	8,518	1,910	10,621	5,732	86,609
Loans to customers	624,192	97,687	27,879	3,283	7,245	646	4,169	765,101
Financial instruments	56,240	39,891	11,309	102	9	1,691	208	109,450
Other financial assets	6,023	965	613	1,102	171	24	50	8,948
Assets	841,532	154,519	67,211	13,271	9,600	13,099	10,695	1,109,927
Liabilities								
Due to credit inst. and Central Bank	6,989	292	38	3	-	1	47	7,370
Deposits	412,981	23,792	15,382	3,309	1,349	3,692	1,656	462,161
Financial liabilities at fair value	2,253	1,183	34	27	32	35	37	3,601
Other financial liabilities	20,150	3,870	2,183	5,505	1,393	565	1,039	34,705
Borrowings	181,787	162,486	1,832	14	-	20,794	18,085	384,998
Liabilities	624,160	191,623	19,469	8,858	2,774	25,087	20,864	892,835
Net on-balance sheet position	217,372	(37,104)	47,742	4,413	6,826	(11,988)	(10,169)	
Net off-balance sheet position	(536)	34,743	(46,994)	(1,557)	(9,142)	12,331	11,155	
Net position	216,836	(2,361)	748	2,856	(2,316)	343	986	

Addition, for management reporting

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Investment property	6,613	-	-	-	-	-	-	6,613
Investments in associates	752	8	-	-	-	-	-	760
Intangible assets	13,848	-	-	-	-	-	-	13,848
Tax assets	450	-	-	-	-	-	-	450
Non-current assets and disposal groups held for sale	8,138	-	-	-	-	-	-	8,138
Other non-financial assets	7,843	61	34	36	2	19	23	8,018
Assets	37,644	69	34	36	2	19	23	37,827
Liabilities and equity								
Tax liabilities	6,828	-	-	-	-	-	-	6,828
Other non-financial liabilities	22,106	99	30	122	1	-	(1)	22,357
Shareholders' equity	225,606	-	-	-	-	-	-	225,606
Non-controlling interest	128	-	-	-	-	-	-	128
Liabilities and equity	254,668	99	30	122	1	-	(1)	254,919
Management reporting of currency risk*	(188)	(2,391)	752	2,770	(2,315)	362	1,010	

*The net position of the currency risk is presented in accordance with IFRS. The management monitors currency risk with more assets and liabilities underlying, such as tax assets and liabilities and intangible assets, as it is considered to be a more accurate measurement of the Group's currency exposure. The net position, as seen by the management, is the position used for managing the currency imbalance.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

41. Market risk, continued

Sensitivity analysis on currency risk

The table below indicates the currencies to which the Group had significant exposure at the end of the period. The analysis calculates the effect of a reasonably possible movement of the currency rate against the ISK, with all other variables held constant, on the Consolidated Interim Income Statement (due to the fair value of currency sensitive non-trading monetary assets and liabilities). A negative amount in the table reflects a potential net reduction in the Consolidated Interim Income Statement or equity, while a positive amount reflects a net potential increase. An equivalent decrease in each of the below currencies against the ISK would have resulted in an equivalent but opposite impact (+10% denotes a depreciation of the ISK).

	30.6.2018		31.12.2017	
Currency	-10%	+10%	-10%	+10%
EUR	522	(522)	239	(239)
USD	(234)	234	(75)	75
GBP	(603)	603	(277)	277
DKK	(321)	321	232	(232)
NOK	(9)	9	(36)	36
Other	(94)	94	(101)	101

Equity risk

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. For information on assets seized and held for sale and equity exposures, see Notes 29 and 22 respectively.

Sensitivity analysis of equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices on the Consolidated Interim Income Statement. A negative amount in the table reflects a potential net reduction in the Consolidated Interim Income Statement or equity, while a positive amount reflects a potential net increase. Investments in associates are excluded. The result of value-at-risk calculations for the trading book are shown in the Group's Pillar 3 Disclosures.

	30.6.2018		31.12.2017	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(307)	307	(166)	166
Banking book - listed	(502)	502	(540)	540
Banking book - unlisted	(1,016)	1,016	(1,170)	1,170

Derivatives

Derivatives are a part of the Group's customer product offering. The types of derivatives currently offered are forward contracts, swaps and options. Eligible underlying market factors are interest rates, foreign exchange rates, equities and commodities. Exposure limits, hedging requirements and collateral requirements are determined in accordance with the Group's risk appetite and monitored by Risk Management on a daily basis. The Group also uses derivatives to reduce market risk on its balance sheet. Note 23 shows a breakdown of the Group's derivative positions by type.

Amounts are in ISK millions

42. 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.

The Group's primary source of funding is deposits from individuals, businesses and financial undertakings. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 67% is on-demand.

Liquidity risk is one of the Group's most significant risk factors and a great deal of emphasis is placed on managing it. The Asset and Liability Committee (ALCO) is responsible for managing liquidity and funding risk within the risk appetite set by the Board of Directors. The Bank's Treasury manages liquidity positions on a day-to-day basis. Risk Management measures, monitors and reports the Bank's liquidity and funding risk on a daily basis.

The Group's strategy in relation to liquidity risk is to actively manage its liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. The Group seeks to maintain a stable funding profile which supports its business strategy and liquidity profile, ensuring that the Group can withstand periods of market turbulence, without reliance on volatile funding or external support.

Maturity analysis of assets and liabilities

The maturity analysis is based on contractual cash flows. The amounts are not discounted and include future interest payments, but CPI-linked amounts do not include accrued indexation due to future inflation. The total amount for each item is higher than the corresponding amount on the Bank's balance sheet, since the amounts on the balance sheet are either at amortized cost and do not contain future interest payments, or at fair value where future cash flows have been discounted.

Contractual cash flows differ in many ways from expected cash flows. The difference is most significant for deposits on the liability side and bonds on the asset side. Deposits are always assumed to be withdrawn at the earliest possible date, despite the fact that a large part of the deposit base is considered to be stable funding where behavioral maturity considerably exceeds contractual maturity. Furthermore, although contractual cash flows are presented for bonds held by the Bank, a large portion of the bonds are a part of the Bank's liquidity buffer and are considered to be highly liquid and can be sold and/or pledged to the Central Bank of Iceland and thus converted into cash at very short notice.

Contractual cash flow of assets and liabilities

30.6.2018	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Assets								
Cash and balances with CB	12,422	95,729	4,952	-	-	-	113,103	112,996
Loans to credit institutions	74,690	37,963	538	377	-	-	113,568	113,546
Loans to customers	5,483	112,057	118,401	325,629	604,203	-	1,165,773	797,393
Financial instruments	13,832	6,784	11,095	28,189	6,667	31,017	97,584	95,265
Derivatives - assets leg	-	*39,619*	*19,579*	*44,379*	*2,622*	-	*106,199*	*106,199*
Derivatives - liabilities leg	-	*(38,674)*	*(19,006)*	*(38,670)*	*(2,402)*	-	*(98,752)*	*(98,752)*
Other financial assets	627	4,953	3,376	908	-	-	9,864	9,864
Assets	107,054	257,486	138,362	355,103	610,870	31,017	1,499,892	1,129,064
Liabilities								
Due to credit inst. and Central Bank ..	6,590	-	-	-	-	-	6,590	6,336
Deposits	318,582	104,379	39,179	12,887	3,512	-	478,539	476,182
Financial liabilities at fair value	-	1,287	1,599	4,405	125	-	7,416	3,895
Derivatives - assets leg	-	*(31,767)*	*(15,108)*	*(31,193)*	*(972)*	-	*(79,040)*	*(79,040)*
Derivatives - liabilities leg	-	*32,495*	*16,707*	*35,599*	*1,097*	-	*85,898*	*85,898*
Short position bonds and derivatives ..	-	*500*	-	-	-	-	*500*	*500*
Short position securities used for economic hedging	-	*59*	-	-	-	-	*59*	*59*
Other financial liabilities	21,348	16,342	845	2,729	924	-	42,188	42,188
Borrowings	-	15,162	62,904	240,900	182,657	-	501,623	410,773
Liabilities	346,520	137,170	104,527	260,921	187,218	-	1,036,356	939,374
Net position for assets and liab.	(239,466)	120,316	33,835	94,182	423,652	31,017	463,536	189,690
Off-balance sheet items								
Financial guarantees	3,410	1,343	4,030	2,937	2,589	-	14,309	14,309
Unused overdraft	-	46,152	-	-	-	-	46,152	46,152
Undrawn loan commitments	-	65,283	21,470	6,977	-	-	93,730	93,730
Off-balance sheet items	3,410	112,778	25,500	9,914	2,589	-	154,191	154,191
Net contractual cash flow	(242,876)	7,538	8,335	84,268	421,063	31,017	309,345	35,499

Amounts are in ISK millions

42. Liquidity and Funding risk, continued

31.12.2017 *Assets*	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Cash and balances with CB	31,281	99,340	9,362	-	-	-	139,983	139,819
Loans to credit institutions	52,320	34,294	-	-	-	-	86,614	86,609
Loans to customers	2,908	107,790	90,076	336,545	568,833	-	1,106,152	765,101
Financial instruments	8,512	15,082	14,641	20,028	5,926	44,047	108,236	109,450
Derivatives - assets leg	*1,436*	*38,718*	*18,153*	*71,627*	*678*	-	*130,612*	*126,111*
Derivatives - liabilities leg	*(1,423)*	*(37,084)*	*(18,084)*	*(68,879)*	*(585)*	-	*(126,055)*	*(118,487)*
Other financial assets	1,535	5,103	2,224	86	-	-	8,948	8,948
Assets	96,556	261,609	116,303	356,659	574,759	44,047	1,449,933	1,109,927
Liabilities								
Due to credit inst. and Central Bank	7,658	-	26	-	-	-	7,684	7,370
Deposits	331,796	86,524	30,244	13,071	2,246	-	463,881	462,161
Financial liabilities at fair value	-	2,182	(102)	593	(273)	-	2,400	3,601
Derivatives - assets leg	-	*(20,039)*	*(11,449)*	*(14,407)*	*(1,557)*	-	*(47,452)*	*(40,931)*
Derivatives - liabilities leg	-	*20,688*	*11,347*	*15,000*	*1,284*	-	*48,319*	*42,998*
Short position bonds and derivatives	-	*410*	-	-	-	-	*410*	*410*
Short position securities used for economic hedging	-	*1,124*	-	-	-	-	*1,124*	*1,124*
Other financial liabilities	25,538	7,296	28	1,843	-	-	34,705	34,705
Borrowings	-	37,110	23,066	239,210	175,845	-	475,231	384,998
Liabilities	364,992	133,112	53,262	254,717	177,818	-	983,901	892,835
Net position for assets and liab.	(268,436)	128,497	63,041	101,942	396,941	44,047	466,032	217,092
Off-balance sheet items								
Financial guarantees	2,918	2,852	3,164	2,827	1,463	-	13,224	13,224
Unused overdraft	-	45,897	-	-	-	-	45,897	45,897
Undrawn loan commitments	2,966	45,788	17,751	9,559	11,878	-	87,942	87,942
Off-balance sheet items	5,884	94,537	20,915	12,386	13,341	-	147,063	147,063
Net contractual cash flow	(274,320)	33,960	42,126	89,556	383,600	44,047	318,969	70,029

Amounts are in ISK millions

42. 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. 1032/2014. 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 ratio for foreign currencies, a negative foreign currency balance is subtracted from the numerator and a positive balance is subtracted from the denominator. The foreign currency balance used is different from that of this Consolidated Financial Statement due to the sub-consolidation applied.

30.6.2018	ISK	Foreign currency	Total
Available stable funding	665,962	210,421	876,383
Required stable funding	579,301	113,450	692,751
Foreign currency balance		(2,244)	
Net stable funding ratio	115%	183%	127%

31.12.2017			
Available stable funding	663,850	199,770	863,620
Required stable funding	577,761	110,473	688,234
Foreign currency balance		7	
Net stable funding ratio	115%	181%	125%

Amounts are in ISK millions

42. 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, repo-able at the Central Bank and not issued by the Group or related entities.

The Bank complies with The Central Bank of Iceland's liquidity rules No. 266/2017, which effectively adopt the liquidity rules of the EU Capital Requirements Regulation (CRR). The Bank is required to maintain a 100% minimum LCR ratio for both the aggregate position in all foreign currencies and all currencies.

The following table shows the breakdown for the Group's LCR calculations broken down by currencies. All amounts are weighted by their respective LCR weights. The calculations are based on consolidated figures for the Bank, the Arion Bank Mortgages Institutional Investor Fund and Valitor hf.

30.6.2018	ISK	Foreign currency	Total
Liquid assets level 1 *	97,536	32,302	129,838
Liquid assets level 2**	-	-	-
Liquid Assets	97,536	32,302	129,838
Deposits	94,837	37,113	131,950
Borrowing	4,741	108	4,849
Other cash outflows	5,320	10,592	15,912
Cash outflows	104,898	47,813	152,711
Short-term deposits with other banks ***	2,497	77,583	80,080
Other cash inflows	12,169	4,415	16,584
Cash inflows	14,666	81,998	96,664
Liquidity coverage ratio (LCR) ****	108%	270%	232%

31.12.2017	ISK	Foreign currency	Total
Liquid assets level 1 *	131,197	27,716	158,913
Liquid assets level 2 **	-	-	-
Liquid Assets	131,197	27,716	158,913
Deposits	108,442	24,738	133,180
Borrowing	2,426	96	2,522
Other cash outflows	6,067	9,500	15,567
Cash outflows	116,935	34,334	151,269
Short-term deposits with other banks ***	1,048	59,528	60,576
Other cash inflows	12,232	6,540	18,772
Cash inflows	13,280	66,068	79,348
Liquidity coverage ratio (LCR) ****	127%	323%	221%

* 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.

Amounts are in ISK millions

42. Liquidity and Funding risk, continued

Composition of liquid assets

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

30.6.2018	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	110,245	477	1,246	1,028	112,996
Short-term deposits in other banks	2,497	25,235	28,504	23,844	80,080
Domestic bonds eligible as collateral at the Central Bank	2,058	-	-	-	2,058
Foreign government bonds	-	13,831	13,081	-	26,912
Covered bonds with a minimum rating of AA-	-	-	1,245	1,571	2,816
Liquidity reserve	114,800	39,543	44,076	26,443	224,862
31.12.2017					
Cash and balances with Central Bank	137,399	293	943	1,184	139,819
Short-term deposits in other banks	1,048	24,796	15,334	19,398	60,576
Domestic bonds eligible as collateral at the Central Bank	3,022	-	-	-	3,022
Foreign government bonds	-	6,401	16,291	-	22,692
Covered bonds with a minimum rating of AA-	-	-	1,262	1,538	2,800
Liquidity reserve	141,469	31,490	33,830	22,120	228,909

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. 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					
30.6.2018	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Retail	165,280	10%	52,606	5%	71,304	289,190
Corporations	43,022	40%	796	20%	8,025	51,843
Sovereigns, central banks and PSE	15,403	40%	-	-	6,068	21,471
Pension funds	53,194	100%	-	-	18,796	71,990
Domestic financial entities	22,050	100%	-	-	21,216	43,266
Foreign financial entities	4,758	100%	-	-	-	4,758
Total	303,707		53,402		125,409	482,518
31.12.2017						
Retail	163,542	11%	52,401	5%	68,741	284,684
Corporations	51,968	40%	811	20%	5,757	58,536
Sovereigns, central banks and PSE	14,583	40%	-	-	1,383	15,966
Pension funds	53,116	100%	-	-	15,391	68,507
Domestic financial entities	23,175	100%	-	-	15,949	39,124
Foreign financial entities	2,714	100%	-	-	-	2,714
Total	309,098		53,212		107,221	469,531

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

Amounts are in ISK millions

43. Capital management

Capital adequacy

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 requirement, 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 capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

The Group's consolidated situation as stipulated in CRR is the Group's accounting consolidation excluding insurance subsidiaries. The capital position and solvency requirements of Vörður tryggingar hf. should be viewed independently from capital adequacy for the Group's consolidated situation.

Own funds	30.6.2018	31.12.2017
Total equity	207,631	225,734
Deductions related to the consolidated situation	(8,067)	(8,635)
Non-controlling interest not eligible for inclusion in CET 1 capital	(741)	(128)
Common Equity Tier 1 capital before regulatory adjustments	198,823	216,971
Intangible assets	(11,230)	(11,125)
Tax assets	(509)	(357)
Indirect holdings of own CET1 instruments	(190)	-
Cash flow hedges	(914)	265
Additional value adjustments	(112)	(119)
Foreseeable dividend*	(12,199)	(25,000)
Common equity Tier 1 capital	173,669	180,635
Non-controlling interest not eligible for inclusion in CET 1 capital	741	128
Tier 1 capital	174,410	180,763
General credit risk adjustments**	-	3,195
Tier 2 capital	-	3,195
Total own funds	174,410	183,958

Risk-weighted assets		
Credit risk, loans	630,789	605,058
Credit risk, securities and other	50,131	56,979
Counterparty credit risk	4,172	5,844
Market risk due to currency imbalance	12,608	4,895
Market risk other	9,666	5,473
Credit valuation adjustment	2,699	2,506
Operational risk	86,013	86,013
Total risk-weighted assets	796,078	766,768

Capital ratios		
CET 1 ratio	21.8%	23.6%
Tier 1 ratio	21.9%	23.6%
Capital adequacy ratio	21.9%	24.0%

* On 30 June 2018, the foreseeable dividend consists of 50% of the accumulated net earnings attributable to shareholders of Arion Bank hf. in 2018 which reflects the Bank's dividend policy and a proposed extraordinary dividend payment in Q3 amounting to ISK 10 billion, which the Board of Directors has approved 2 August 2018 to propose to a shareholders meeting in September 2018. At 31 December 2017 the amount is the equity reduction executed in the first quarter of 2018 through purchase of own shares and dividend distribution.

** Under IAS 39, the Bank's general provisions accounted as Tier 2 capital as stipulated in CRR. As per EBA's opinion, all provisions under IFRS 9 are considered specific credit risk adjustments (SCRA). FME has adopted this opinion - as a result the Group's own funds no longer include general credit risk adjustments and these are now treated as SCRA, effectively reducing risk-weighted assets.

Amounts are in ISK millions

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	Current	1.5.2019
Capital conservation buffer	2.50%	2.50%
Capital buffer for systematically important institutions	2.00%	2.00%
Systemic risk buffer *	3.00%	3.00%
Countercyclical capital buffer *	1.25%	1.75%
Combined capital buffer requirement	8.75%	9.25%

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 own funds 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.

Capital requirement, % of RWA, current

30.6.2018	CET 1	Tier 1	Total
Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.9%	2.6%	3.4%
Combined buffer requirement *	8.4%	8.4%	8.4%
Regulatory capital requirement	14.8%	17.0%	19.8%
Available capital	21.8%	21.9%	21.9%

*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 (if recognized by the FME), 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 at 31.12.2016. The Pillar 2 requirement is 3.7% of risk-weighted assets based on accounting consolidation. Based on the Group's consolidated situation under CRR, which excludes Vörður tryggingar hf., the requirement is 3.4%.

Leverage ratio

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The ratio is calculated on the basis of the Group's consolidated situation as per the CRR, which excludes the Group's insurance subsidiaries. The minimum leverage ratio requirement is 3% as stated in Act No. 161/2002 on Financial Undertakings.

	30.6.2018	31.12.2017
On-balance sheet exposures	1,116,222	1,074,207
Derivative exposures	8,544	10,957
Securities financing transaction exposures	7,974	8,925
Off-balance sheet exposures	86,975	83,058
Total exposure	1,219,715	1,177,147
Tier 1 capital	174,410	180,763
Leverage ratio	14.3%	15.4%

Solvency II

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vördur Group was ISK 3,679 million at 30 June 2018 (31.12.2017: ISK 3,503 million) and calculated solvency of Vördur Group was ISK 5,941 million (31.12.2017: ISK 4,949 million). The solvency ratio, which is the ratio of calculated solvency to the solvency requirements was 161% at 30 June 2018 31.12.2017: 141%).

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Significant accounting policies

The accounting policies adopted in the preparation of these Condensed Consolidated Interim Financial Statements are consistent with those followed in the preparation of the Annual Financial Statements for the year ended 31 December 2017 except for changes due to implementation of new accounting standards.

The Group adopted IFRS 9 Financial Instruments on 1 January 2018. As a result of the implementation, the Group changed the accounting policies in the areas outlined below regarding classification of financial assets and impairment calculations. The Group has elected to continue to apply the hedge accounting principles under IAS 39 instead of those under IFRS 9. The new policies were applicable from January 1, 2017. As permitted by the transition provisions of IFRS 9, the Group elected not to restate comparative figures; Accordingly, all comparative periods are presented in accordance with IAS 39. For further detail on the accounting policy under IAS 39 see the Groups Annual Financial statements 2017. Adjustments to carrying amounts of financial assets and liabilities at the date of initial application were recognized in Retained earnings and Other reserves within Equity. New or amended interim disclosures have been provided for the period, where applicable, and comparative period disclosures are consistent with those made in prior year. For further information, see Financial assets and Financial liabilities classification transition from IAS 39 to IFRS 9.

On 1 January 2018 the Group adopted IFRS 15 Revenue from contracts with customers. The standard introduces a five-step approach to determine how and when to recognize revenue, but it does not impact the recognition of income from financial instruments, insurance contracts or leasing contracts. The standard also establishes principles for reporting useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The Group adopted the requirements using the modified retrospective method, with the effect of initial application recognized on the date of initial application and without restatement of the comparative periods. The adoption of IFRS 15 had minor impacts on the Statement of Comprehensive Income.

44. 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 Condensed Consolidated Interim Financial Statements are prepared on a going concern basis.

45. Financial assets and financial liabilities - Classification and Measurement

Recognition and initial measurement

The Group initially recognizes financial assets and financial liabilities on the date that they are originated at the fair value of consideration paid. Regular-way purchases and sales of financial assets are recognized on the trade date at which the Group commits to purchase or sell assets. All other financial assets and liabilities are recognized on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction cost that are directly attributable to its acquisition or issue. Financial assets include both debt and equity instruments.

Debt instruments

Debt instruments, including loans and debt securities, are classified into one of the following measurement categories:

- amortized cost;
- fair value through profit and loss (FVTPL)
- fair value through other comprehensive income (FVOCI)

A debt instrument is measured at amortized cost only if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to collect contractual cash flows; and
- its contractual cash flows are solely payments of principal and interest (SPPI).

A debt instrument is measured at FVOCI only if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to collect contractual cash flows and selling financial assets; and
- its contractual cash flows are SPPI.

All other debt instruments are carried at FVTPL.

Business model assessment

Business model assessment involves determining whether financial assets are managed in order to generate cash flows from collection of contractual cash flows, selling financial assets or both. The Group assesses the business model at a portfolio level reflective of how groups of assets are managed together to achieve a particular business objective. For the assessment of business models the Group takes into consideration the following factors:

- how the performance of assets in a portfolio is evaluated and reported to group heads and other key decision makers within the Group's business lines

45. Financial assets and financial liabilities - Classification and Measurement, continued

- the risks that affect the performance of assets held within a business model and how those risks are managed;
- whether the assets are held for trading purposes, i.e. assets that the Group acquires or incurs principally for the purpose of selling or repurchasing in the near term, or holds as part of a portfolio that is manage together for short-term profit or position taking;
- how compensation is determined for the Group's business lines' management that oversee the assets; and
- the frequency and volume of sales in prior periods and expectations about future sales activity.

Cash flow characteristics assessment

The contractual cash flow characteristics assessment involves assessing the contractual features of an instrument to determine if they give rise to cash flows that are consistent with a basic lending arrangement. Contractual cash flows that are consistent with a basic lending arrangement are considered SPPI.

Interest is defined as consideration for the time value of money and the credit risk associated with the principal amount outstanding and for other basic lending risks and costs (expected losses, liquidity risk and administrative costs), as well as a profit margin. Indexation of loans to the Consumer Price Index (CPI) are considered part of interest as CPI guarantees the time value of money of the original outstanding balance. Principal may change over the life of the instruments due to repayments. Indexation on principal accumulates over time.

In performing this assessment, the Group takes into consideration contractual features that could change the amount or timing of contractual cash flows, such that the cash flows are no longer consistent with a basic lending arrangement. If the Group identifies any contractual features that could modify the cash flows of the instruments such that they are no longer consistent with a basic lending arrangement, the related financial assets is classified at FVTPL.

Debt instruments measured at amortized cost

Debt instrument are measured at amortized cost if they are held within a business model whose objective is to hold for collection of contractual cash flows where those cash flows represent solely payments of principal and interest. After initial measurement, debt instruments in this category are carried at amortized cost using the effective interest rate method. The effective interest rate is the rate that discounts estimated cash payments or receipt through the expected life of the financial asset to the gross carrying amount of a financial asset. Amortized cost is calculated taking into account any discount or premium on acquisition, transaction cost and fees that are an integral part of the effective interest rate. Amortization is included in interest income in the Consolidated Statement of Comprehensive Income.

Impairment on debt instruments measured at amortized cost is calculated using the expected credit loss approach. Loans and debt securities measured at amortized cost are presented net of allowance for credit losses (ACL) in the Consolidated Statement of Financial Position

Debt instruments measured at FVOCI

Debt instrument are measured at FVOCI if they are held within a business model whose objective is to hold for collection of contractual cash flows and selling financial assets, where the assets' cash flows represent payments that are solely payments of principal and interest. Subsequent to initial recognition, unrealized gains and losses on debt instruments measured at FVOCI are recorded in Other Comprehensive Income (OCI), unless the instrument is designated in a fair value hedge relationship. When designated in a fair value hedge relationship any changes in fair value due to changes in the hedged risk is recognized in Non-interest income in the Consolidated Statement of Comprehensive Income on an average cost basis. Foreign exchange gains and losses that relate to the amortized cost of the debt instrument are recognized in the Consolidated Statement of Comprehensive Income. Premiums, discount and related transaction costs are amortized over the expected life of the instrument to interest income in the Consolidated Statement of Comprehensive Income using the effective interest rate method.

Impairment on debt instruments measured at FVOCI is calculated using the expected credit loss approach. The ECL on debt instruments measured at FVOCI does not reduce the carrying amount of the asset in the Statement of Financial Position, which remains at its fair value. Instead, an amount equal to the allowance that would arise if the assets were measured at amortized cost is recognized in OCI whit a corresponding charge to net impairment in the Consolidated Statement of Comprehensive Income. The accumulated allowance recognized in OCI is recycled to the Consolidated Statement of Comprehensive Income upon derecognition of the debt instrument.

Debt instruments measured at FVTPL

Debt instrument are measured at FVTPL if they are held for trading purposes, assets and liabilities held as part of a portfolio managed on a fair value basis and assets whose cash flow do not represent payments that are solely payments of principal and interest. These instruments are measured at fair value in the Consolidated Statement of Financial Position. Realized and unrealized gains and losses are recognized as part of Net financial income in the Consolidated Statement of Comprehensive Income.

45. Financial assets and financial liabilities - Classification and Measurement, continued

Equity instruments

Equity instruments are measured at FVTPL unless an election is made to designate them at FVOCI at initial recognition.

For equity instruments measured at FVTPL, changes in fair value are recognized as part of non-interest income in the Consolidated Statement of Comprehensive Income.

The Group can elect to classify non-trading equity instruments at FVOCI. This election will be used for certain equity instruments for strategic or longer term investment purposes. The FVOCI election is made upon initial recognition, on an instrument-by-instrument basis and once made is irrevocable. Gains and losses on these instruments including when derecognized/sold are recorded in OCI and are not subsequently reclassified to the Consolidated Statement of Comprehensive Income. Dividends received are recorded in Interest income in the Consolidated Statement of Comprehensive Income. Any transaction costs incurred upon purchase of the security are added to the cost basis of the security and are not reclassified to the Consolidated Statement of Comprehensive Income of the security.

Financial assets and liabilities designated at FVTPL

Financial assets and financial liabilities classified in this category are those that have been designated by the Group on initial recognition.

Financial assets are designated at FVTPL if doing so eliminates or significantly reduces an accounting mismatch which would otherwise arise.

Financial liabilities are designated at FVTPL when one of the following criteria is met:

- The designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- The financial liability contains one or more embedded derivatives which significantly modify the cash flows otherwise required.

Financial assets and financial liabilities designated at FVTPL are recorded in the Consolidated Statement of Financial Position at fair value. For assets designated at FVTPL, changes in fair value are recognized in Non-interest income in the Consolidated Statement of Comprehensive Income. For liabilities designated at fair value through profit or loss, all changes in fair value are recognized in Non-interest income in the consolidated statement of Comprehensive Income, except for changes in fair value arising from changes in the Bank's own credit risk which are recognized in OCI. Changes in fair value of liabilities due to changes in the Bank's own credit risk, which are recognized in OCI, are not subsequently reclassified to the Consolidated Statement of Comprehensive Income upon derecognition/extinguishment of the liabilities.

Purchased loans

All purchased loans are initially measured at fair value on the date of acquisition. As a result no allowance for credit losses would be recorded in the Consolidated Statement of Financial Positions on the date of acquisition. Purchased loans may fit into either of the two categories: Performing loans or Purchased or Originated Credit Impaired (POCI) loans.

Purchased performing loans are reflected in Stage 1 and will follow the same accounting as other performing loans. They will be subject to a 12-month allowance for credit losses at the end of the first reporting period after acquisition date which is recorded as provision for credit losses in the Consolidated Statement of Comprehensive Income. The fair value adjustments set up for these loans on the date of acquisition is amortized into interest income over the life of these loans.

POCI loans do not have allowance at initial recognition but subsequently the allowance will reflect the changes in the lifetime expected losses. At recognition the discount of each POCI loan is split up into two categories, impairment discount and interest discount or premium. Interest is calculated with a credit adjusted effective interest rate and is posted to interest income. Periodically the Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original credit adjusted effective interest rate, any changes in the expected cash flows since the date of acquisition are recorded as a charge/recovery in net impairment in the Consolidated Statement of Comprehensive Income at the end of all reporting periods

Expected credit losses

Expected credit loss (ECL) is established for all financial assets, except for financial assets classified or designated as FVTPL and equity instruments designated as FVOCI, which are not subject to impairment assessment. Assets subject to impairment assessment include debt instruments (including loans to customers) measured at amortized cost or FVOCI, lease receivables, loan commitments and financial guarantee contracts. ECL on financial assets is presented in Net impairment. Other financial assets carried at amortized cost are presented net of ECL in the Group's Consolidated Statement of Financial Position. Off-balance sheet items subject to impairment assessment include financial guarantees and undrawn loan commitments. ECL for Off-balance sheet items is separately calculated and included in Other Liabilities.

Notes to the Condensed Consolidated Interim Financial Statements

45. Financial assets and financial liabilities - Classification and Measurement, continued

The Group measures the ECL on each balance sheet date according to a three-stage expected credit loss impairment model:

Stage	Criteria	Assessment of expected credit loss, and effective interest
1	Exposures not impaired and with no significant increase in credit risk	12 month expected credit loss is recorded. The expected credit loss is computed using a probability of default occurring over the next 12 months. For those instruments with a remaining maturity of less than 12 months, a probability of default corresponding to remaining term to maturity is used. The effective interest rate is calculated on the gross carrying amount.
2	Exposures not impaired with significant increase in credit risk subsequent to origination.	Lifetime expected credit loss is recorded, based on the probability of default over the remaining estimated life of the financial instrument. Effective interest rate is calculated on the gross carrying amount.
3	Exposures in default / Credit impaired	Lifetime expected credit loss is recorded. Effective interest rate is calculated on the book value.

The ECL is a discounted probability-weighted estimate of the cash shortfalls expected to results from defaults over the relevant time horizon.

The ECL is a discounted probability-weighted estimates of the cash shortfalls expected to results from defaults over the relevant time horizon. For guarantees and loan commitments, credit loss estimates consider the portion of the commitment that is expected to be paid out or expected to be drawn over the relevant time period.

Increases or decreases in the required ECL attributable to purchases and new originations, derecognitions or maturities, and remeasurements due to changes in loss expectations or state migrations are recorded in net impairment. Write-offs and recoveries of amounts previously written off are recorded against ECL.

The ECL represents an unbiased estimate of expected credit losses on our financial assets as at the balance sheet date. Judgement is required in making assumptions and estimations when calculating the ECL, including movements between the three stages and the application of forward looking scenarios. The underlying assumptions and estimates may results in changes to the provisions from period to period that significantly affect our results of operations.

Definition of default

The Group considers a financial assets to be in default when:

- the borrower is more than 90 days past due, or
- the borrower is considered to be unlikely to pay.

In assessing whether a borrower is unlikely to pay, the Group considers both qualitative and quantitative indicators, e.g. overdue status, debt and equity ratios, market circumstances and other data developed internally or obtained from external sources.

For corporate counterparties it is assumed that if one exposure is in default, all other exposures to that counterparty are also in default (cross-default). For individuals however, mortgages and other exposures are assessed separately, meaning that if an individual is in default on a mortgage, his other exposures are not assumed to be in default, and vice versa. A default event for a mortgage can however be an indicator on the likelihood of default for the borrower's other exposures, and vice versa.

Frequent default events within a year are treated as a single default event. A defaulted exposure is considered to be cured if it has returned to non-default state, with no amount in arrears, within 12 months from default and without any incurred loss for the Group.

Probability of default and credit risk rating

The Group allocates to each exposure a credit risk rating (e.g. A+, A, A-, BBB+, etc.) based on the calculated 12 month probability of default ('the PD'). The PD is assessed through the Group's credit rating models or based on external ratings if available. The Group's credit rating models are statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgement for large corporate exposures. Factors vary depending on the nature of the exposure and the profile of the borrower. The PD estimates used for the purpose of calculating IFRS 9 impairments are point-in-time, i.e. dependent on the economic cycle. The Group's credit rating models are subject to annual performance tests and are recalibrated on a regular basis if needed.

45. Financial assets and financial liabilities - Classification and Measurement, continued

The Group's rating scale is shown below.

Risk class	Rating	Lower PD	Upper PD
1	A+	0.00%	0.07%
	A	0.07%	0.11%
	A-	0.11%	0.17%
	BBB+	0.17%	0.26%
	BBB+	0.26%	0.41%
	BBB-	0.41%	0.64%
2	BB+	0.64%	0.99%
	BB	0.99%	1.54%
	BB-	1.54%	2.40%
3	B+	2.40%	3.73%
	B+	3.73%	5.80%
	B-	5.80%	9.01%
4	CCC+	9.01%	31.00%
	CCC-	31.00%	99.99%
5	DD	99.99%	100.00%

The Group uses external ratings for counterparties that receive such ratings from recognized rating agencies such as Moody's and Standard & Poor's. The external rating is reviewed with a level of professional judgement to allocate a probability of default. External ratings are primarily used to assess expected losses for counterparties of marketable securities, money market and deposit accounts positions which fall under the Impairment requirements of IFRS 9. The Bank's ECL is broken down by investment grade and non-investment grade classes for such exposures, as per the definition of the corresponding rating agency.

Each exposure is allocated a credit risk rating at initial recognition. The calculations are based on rules and available information at the time of origination. Exposures are continuously monitored and revaluated, which may result in transitions between risk ratings. The monitoring typically involves the use of credit history, audited financial statements, management accounts, budgets, KPI's, projections, quality of management, data from credit reference agencies, overdue status and other qualitative and quantitative information available.

PD term structures

In addition to calculating PD and allocating a credit risk rating to each exposure, the Group calculates the lifetime probability of default (LPD), which is an assessment of the probability that a default event occurs over the lifetime of the exposure. The LPD incorporates management's view of possible future macroeconomic developments and the likelihood of rating transitions over the lifetime of the exposure. For the determination of LPD, the Bank calculates PD term structures – which effectively provides the probability of default for any given time period, one for each rating grade, PD model and economic scenario. The annualized lifetime probability of default (ALPD) of an exposure is the fixed 12 month PD (without transitions) that corresponds to the exposure's LPD. The credit risk rating that corresponds to the ALPD is defined as the lifetime credit risk rating.

The assessed 12 months PDs are the basis for the determination of the term structure of PDs for exposures. The Group applies transition models, developed on the basis of historical data, to predict the development of risk grades for periods that exceed one year. The Group has separated transition behavior due to specific and general risk and applies its macro-economic forecasts to the latter. The analysis of credit rating transitions due to general risk includes the identification and calibration of relationships between changes in default rates and changes in key macro-economic factors. Unemployment rate is the predominant predictive variable. Among other indicators examined are GDP growth and benchmark interest rates.

Assumptions on key macro-economic indicators are on an ongoing basis estimated based on internal and external information available at each time. The Group formulates a 'base case' view of the future direction of relevant economic variables as well as a representative range of other possible forecast scenarios. The Group uses these forecasts to adjust its estimates of lifetime probability of default and other factors that affect the lifetime expected credit loss.

45. Financial assets and financial liabilities - Classification and Measurement, continued

Significant increase in credit risk

The assessment of significant increase in credit risk requires significant judgment. In determining whether the risk of default for an exposure has increased significantly since initial recognition, the Group considers relevant, reasonable and supportable information on an ongoing basis. Assumptions are drawn based on the Group's historical experience and expert judgement including forward-looking expectations. If a debt investment security has low credit risk and is considered investment grade at 31 March 2018, the Group will determine that the credit risk on the asset has not increased significantly since initial recognition.

For a given exposure, the Group considers a significant increase in credit risk to have occurred if one of the following holds:

- the exposure's credit risk rating on reporting date is not in risk class 1 and has deteriorated by more than one risk rating compared to the credit risk rating at origination;
- the exposure's lifetime credit risk rating on reporting date is not in risk class 1 and has deteriorated by more than one risk grade (two or more) compared to the lifetime credit risk rating at origination. As the Group does not have the benefit of hindsight, this comparison is only used for exposures that originate on or after 1 January 2018;
- the number of days in arrears exceeds 30 days; or
- the exposure is on the Group's watch list.

The Group monitors the effectiveness of the criteria used to identify significant increases in credit risk by regular reviews to confirm that the criteria is capable of identifying significant increases in credit risk before an exposure is in default and there is no unwarranted volatility in loss allowance from transfers between 12-month ECL (stage 1) and lifetime ECL (stage 2).

Exposures in default

At each reporting date the Group assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired. Financial assets are impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the assets, and that the loss event has an impact on the future cash flows on the asset that can be estimated reliably.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, default or delinquency by a borrower, restructuring of a loan or advance by the Group on terms that the Group would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, the disappearance of an active market for a security, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group.

- the Group's aggregate exposure to the customer;
- the amount and timing of expected receipts and recoveries;
- the likely distribution available on liquidation or bankruptcy;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realizable value of collateral (or other credit mitigates) and likelihood of successful repossession; and
- the likely deduction of any costs involved in recovery of amounts outstanding.

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow. In some instances exposures do not require impairment, this is because there is a good level of collateral.

Impairment losses are recognized in net impairment and reflected in note 40. When an event occurring after the impairment was recognized causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through net impairment.

Expected credit loss measurement

The expected credit loss (ECL) calculations are based on three main components:

- probability of default (PD),
- loss given default (LGD); and
- exposure at default (EAD).

Each component is derived from internally generated models, apart from external credit ratings. The models are developed with statistical methods and/or expert judgement supported by historical data and adjusted for expected macro-economic effects.

The Group's PDs and PD term structures are based on both quantitative and qualitative factors and in some cases external ratings are used. PD's are re-assessed on a regular basis with different frequencies depending on the type of counterparty and/or exposure.

The LGD is an assessment of loss conditional on a default occurrence. The Group splits LGD into three components; the probability of cure, the expected recovery from liquidation of collateral, and the recovery rate for the unsecured part of the exposure. The collateral gap assessment is the outcome of The Group’s collateral allocation algorithm, where haircuts are applied to different types of collaterals. Such models are based on expert judgement, supported by historical data, and takes into account costs and the time value of money. Different haircuts are applied for different macro-economic scenarios in the ECL calculations.

Notes to the Condensed Consolidated Interim Financial Statements

45. Financial assets and financial liabilities - Classification and Measurement, continued

The EAD represents the expected exposure at the event of a default. For a given exposure, The Group derives the EAD from the contractual amortization schedule and taking into account the likelihood of pre-payments, drawdowns, rollovers, extensions and use of unused allowance in the period leading up to default. These behavioral estimates, which are based on historical observations and forward-looking forecasts, apply differently to each type of exposure.

The Group measures ECL considering the risk of default over the maximum contractual period (including any extension periods) over which it is exposed to credit risk. The maximum contractual period extends to the date at which the Group has the right to require repayment of an advance or terminate a loan commitment or guarantee. However, for overdrafts and credit card facilities that include both a loan and an undrawn commitment component, the Group measures ECL over a period longer than the maximum contractual period if the Group’s contractual ability to demand repayment and cancel the undrawn commitment does not limit the Group’s exposure to credit losses to the contractual notice period. These facilities do not have a fixed term or repayment structure. The Group can cancel them with immediate effect but this contractual right is not enforced in the normal day-to-day management, but only when the Group becomes aware of an increase in credit risk at the facility level. This longer period is estimated taking into account the credit risk management actions that the Group expects to take and that serve to mitigate ECL. These include a reduction in limits, cancellation of the facility and/or turning the outstanding balance into a loan with fixed repayment terms. The ECL calculations involve discounting using the exposures' effective interest rates.

Forward looking scenarios

The ECL for an exposure is the weighted average of the expected credit loss for different macro-economic scenarios provided by the Group's management. The Group currently considers three scenarios: 'base case', 'optimistic' and 'pessimistic' and assign its best estimate of likelihood of occurrence to each one. The development of macro-economic variables and the corresponding weights are based on expert judgement supported by historical data. The Group incorporates forward-looking macro-economic information into both its assessment of whether the credit risk of an instrument has increased significantly since its initial recognition (via the lifetime credit risk rating comparison) and its measurement of ECL as the PD term structures, LGD and EAD include macro-economic adjustments for each of the scenarios.

The predominant macro-economic variable used across all portfolios is the unemployment rate in Iceland, as measured by the Directorate of Labor. The default rate observed for the Group's exposures has been shown to be highly correlated with unemployment rate. Collateral haircuts are adjusted for different scenarios. Exit and pre-payment rates, which affects EAD, are dependent on refinancing spreads and due to the correlation between interest rates and unemployment rate they are adjusted for different scenarios.

Write-off of loans

Loans are written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralized loans, when the proceeds from the realization of collateral have been received.

Modifications

The original terms of a financial asset may be renegotiated or otherwise modified, resulting in changes to the contractual terms of the financial asset that affect the contractual cash flow. The treatment of such modifications is primarily based on the process undertaken to execute the renegotiation and the nature and extent of changes expected to result. Modifications which are performed for credit reasons, primarily related to troubled debt restructurings, are generally treated as modifications of the original financial asset. Modification which are performed for other than credit reasons are generally considered to be an expiry of the original cash flows; accordingly, such renegotiations are treated as a derecognition of the original financial asset and recognition of a new financial asset.

If a modification of terms does not result in derecognition of the financial asset, the carrying amount of the financial asset is recalculated as the present value of the renegotiated or modified contractual cash flows, discounted at the original effective interest rate and gain or loss is recognized. The financial asset continues to be subject to the same assessments for significant increase in credit risk relative to initial recognition and credit-impairment, as described above. A modified financial asset will migrate out of Stage 3 if the conditions that led to it being identified as credit-impaired are no longer present and relate objectively to an event occurring after the original credit-impairment was recognized. A modified financial asset will migrate out of Stage 2 when it no longer satisfies the relative thresholds set to identify significant increase in credit risk, which are based on changes in its lifetime PD, days past due and other qualitative considerations.

If a modification of terms results in derecognition of the original financial asset and recognition of the new financial asset, the new financial asset will generally be recorded in Stage 1, unless it is determined to be credit-impaired at the time of renegotiation. For the purposes of assessing for significant increase in credit risk, the date of initial recognition for the new financial asset is the date of modification.

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