

ARION BANK'S 3M 2018 FINANCIAL RESULTS

FIRST STEPS TOWARDS REDUCING THE BANK'S EXCESS CAPITAL

Arion Bank reported net earnings of ISK 1.9 billion for the first three months of 2018, compared with ISK 3.4 billion for the same period of 2017. Return on equity was 3.6%, compared with 6.3% for the first three months of 2017.

Total assets amounted to ISK 1,131.8 billion at the end of March 2018, compared with ISK 1,147.8 billion at the end of 2017. Shareholders' equity totalled ISK 204.1 billion, compared with ISK 225.6 billion at the end of 2017. Arion Bank has a strong financial position and during the period Arion Bank took the first steps towards reducing its equity by purchasing ISK 24.3 million of treasury stock, which represents 9.5% of the shares in the Bank, and by paying a dividend.

The Bank's capital ratio at the end of March was 23.6%, compared with 24.0% at the end of 2017. The CET1 ratio was 23.6% at the end of March, the same as at the end of 2017.

Highlights of the income statement and key income related performance indicators:

<i>In ISK million</i>	Q1 2018	Q1 2017	Diff	Diff%
Net interest income	6,908	7,161	(253)	(4%)
Net commission income	3,542	3,329	213	6%
Net financial income	1,340	1,231	109	9%
Net insurance income	143	447	(304)	(68%)
Share of profit of associates	(18)	(34)	16	(47%)
Other operating income	269	564	(295)	(52%)
Operating income	12,184	12,697	(514)	(4%)
Salaries and related expenses	(4,636)	(4,222)	(414)	10%
Other operating expenses	(3,996)	(3,834)	(162)	4%
Bank levy	(804)	(797)	(7)	1%
Net impairment	(99)	880	(979)	(111%)
Net earnings before taxes	2,649	4,724	(2,075)	(44%)
Income tax expense	(818)	(1,371)	553	(40%)
Discontinued operations, net of tax	118	0	118	-
Net earnings	1,949	3,353	(1,404)	(42%)

KPI's:

Return on equity (ROE)	3.6%	6.3%	-2.7%
Earnings per share (ISK)	0.97	1.68	-41.8%
Net interest margin (int. bearing assets)	2.6%	2.8%	-0.2%
Cost-to-income ratio	70.8%	63.5%	7.4%

Highlights of the balance sheet and key performance indicators:

<i>In ISK million</i>	31.03.2018	31.12.2017	Diff	Diff%
Loans to customers	782,255	765,101	17,154	2%
Other assets	349,513	382,653	(33,140)	(9%)
Liabilities	927,524	922,020	5,504	1%
Equity	204,245	225,734	(21,489)	(10%)
Loans to Deposits ratio	172.7%	165.5%		
RWA / Total assets	68.8%	66.8%		
CET 1 ratio	23.6%	23.6%		

For detailed information on the accounts please refer to Arion Bank's Consolidated Interim Financial Statements for the first three months of 2018 on the Bank's website, www.arionbanki.is.



HÖSKULDUR H. ÓLAFSSON, CEO OF ARION BANK

“The financial results for the first quarter of 2018 were slightly below expectations. Commission income and financial income both increased but the net interest margin decreased, partly as a result of the Bank’s strong liquidity and increasing competition on the credit market which has squeezed interest rates. Insurance income decreased at Vördur mainly due to vehicle claims during the winter. Revenue from the subsidiary Valitor continues to grow as the company expands internationally, but growth overseas also entails high costs and Valitor has had a negative impact on the financial results and cost level of the Group. The focus at Valitor will continue to be growth on its international markets. These markets present exciting opportunities and sustained growth could have a substantial effect on the company’s potential market value in the medium term. The Bank’s loan portfolio grew strongly and the quality of loans continues to be good. The Bank remains financially robust, a fact underlined by a capital ratio of 23.6%.

Arion Bank has attained a unique position on the Icelandic financial services market by pioneering a diverse range of cutting edge digital products. Our objective is to make the services we offer as simple and convenient for our customers as possible. Among the innovations launched in the first quarter were new digital processes for short-term loans and vehicle loans, while spreading out credit card bills and opening savings accounts has been made easier. Convenient banking enhances our customers' experience and also brings greater efficiency to our business. Nowadays 96% of our contact with customers is via digital channels. This clearly illustrates the extent to which financial services are evolving and we have been modifying our branch network to reflect this. The aim of the changes is to reinforce our core branches where companies and retail customers can obtain all the traditional financial services, while at the same time we are developing the smaller branches to match our experimental branch at Kringlan where the focus is on digital solutions.

In recent years Arion Bank has accumulated a considerable amount of excess capital and in March the first step to reduce it was taken when the Bank bought back 9.5% of its own shares and paid a dividend to shareholders. The Bank still has substantial amounts of excess capital and capacity and will be able to pay out further dividends.

Changes in the shareholder base occurred during the period when the Icelandic government, the owner of 13% since 2010, sold its stake in the Bank. Icelandic investment funds came on board as shareholders when 24 funds acquired a total of 2.5% in the Bank. Changes to the Bank’s ownership structure have been underway for some time and Kaupthing has been examining various options for selling shares in the Bank. This work will continue and one of the options on the table is list the Bank on the stock market both in Iceland and internationally.”

HIGHLIGHTS OF THE FIRST QUARTER OF 2018

- In February Arion Bank hf. agreed to a buyback of 9.5% of issued share capital in Arion Bank from Kaupskil ehf., for a total amount of ISK 17 million. The decision to buy back these shares was in accordance with a decision made at a shareholders' meeting of Arion Bank on 12 February 2018.
- A dividend to the shareholders of Arion Bank amounting to ISK 7 billion was paid in March.
- In March, Arion Bank issued a new 5-year EUR 300 million bond. The bonds were sold at rates corresponding to a 0.65% margin over interbank rates.
- Arion Bank introduced several new digital solutions, including a new short-term loan application process on the Bank’s website and a new and fully digital car and vehicle funding solution.



INCOME STATEMENT

<i>In ISK million</i>	Q1 2018	Q1 2017	Diff	Diff%
Net interest income	6,908	7,161	(253)	(4%)
Net commission income	3,542	3,329	213	6%
Net financial income	1,340	1,231	109	9%
Net insurance income	143	447	(304)	(68%)
Share of profit of associates	(18)	(34)	16	(47%)
Other operating income	269	564	(295)	(52%)
Operating income	12,184	12,697	(514)	(4%)
Salaries and related expense	(4,636)	(4,222)	(414)	10%
Other operating expenses	(3,996)	(3,834)	(162)	4%
Bank levy	(804)	(797)	(7)	1%
Net impairment	(99)	880	(979)	(111%)
Net earnings before taxes	2,649	4,724	(2,075)	(44%)
Income tax expense	(818)	(1,371)	553	(40%)
Discontinued operations, net of tax	118	0	118	-
Net earnings	1,949	3,353	(1,404)	(42%)

Operating income amounted to ISK 12.2 billion for the first quarter of 2018, compared with ISK 12.7 billion for the same period in 2017. Net commission income increased between years, whereas net interest income and net insurance income decreased. Other operating income also decreased.

Net interest income decreased slightly between years. The net interest margin as a percentage of average interest-bearing assets was 2.6% during the first quarter of 2018, compared with 2.8% for the same period in 2017. Interest-bearing assets are approximately the same as for the first quarter 2017 but decreased by ISK 10.3 billion from year-end 2017. The lower interest margin is partly due to high amounts of cash and cash equivalents in foreign currency, which bear low interest rates, and to pressure on the Banks' interest rates in a highly competitive environment with decreasing interest rates, both for corporates and retail customers.

Net commission income increased by 6% between years, primarily due to increased activity in cards and payment solutions, which increased by 14% from the same period in 2017, and an increase in commission income due to a rise in lending activity, both new lending and prepayment of loans. Other commissions are similar to the same period last year.

Net financial income amounted to ISK 1,340 million, compared with ISK 1,230 million for the first quarter of 2017. Positive market changes in equity holdings are the main reason for the positive contribution from net financial income in both periods.

Net insurance income amounted to ISK 143 million, compared with ISK 447 million for the first quarter of 2017. The decrease is primarily due to higher car insurance claims, and the claims ratio in this category was the highest for a long time.

Other operating income was ISK 269 million during the period, compared with ISK 564 million during the same period in 2017. Profit from sale of assets during the first quarter of 2017 is the main reason for the decrease between years.

Operating expenses amounted to ISK 8,632 million during the period, compared with ISK 8,056 million in the same period in 2017. The Bank's cost-to-income ratio was 70.8% for the first quarter, compared with 63.5% for the same period in 2017. The cost-to-total assets ratio was 3.0% for the first quarter, unchanged from the same period in 2017.

Salaries and related expenses amounted to ISK 4,636 million for the first three months of 2018, an increase of 10% from the same period in 2017. The increase is mainly due to the increased number of employees at the subsidiary Valitor. The average salary per employee increased by approximately 3% between years, but at the same time the salary index in Iceland rose by approximately 7%. The reasons for this include the decrease in salary expenses at Valitor's foreign operation due to the strengthening of the krona, because an increasing proportion of Valitor's operation, the Bank's largest subsidiary, is located abroad. Full-time equivalent positions at the end of March totalled 1,299 at the Group, 95 more than at the end of 2017. The increase is largely a result



of Valitor's investments in the UK. The decrease in number of FTEs continues at the parent company, mainly due to the outsourcing of projects, e.g. the cash center, and the effect of the Bank's focus on increasing digitalization and automation.

Other operating expenses amounted to ISK 3,996 million during the first quarter of 2018, a 4% increase from the same period in 2017. The increase is partly related to higher IT expenses and professional services.

Net impairment was ISK 99 million for the first quarter, compared with a positive net impairment of ISK 880 million in the same period in 2017. Prepayments of mortgage loans and composition payments from corporate customers and final loan payments from bankrupt entities, which had previously been impaired, had a positive impact in 2017.

Income tax amounted to ISK 818 million during the first quarter of 2018, compared with ISK 1,371 million in the same period in 2017. Income tax, as reported in the interim financial statements, comprises 20% income tax on earnings and a special 6% financial tax on the earnings of financial undertakings of more than ISK 1 billion. The effective income tax rate was 30.9% for the first quarter of 2018, compared with 29.0% during the same period in 2017. The high tax rate is due to the high proportion of income from the parent company, which calculates an additional 6% tax on income above ISK 1 billion. Furthermore, the bank levy is not tax deductible and the effective income tax rate is therefore higher.

Earnings of operating segments

Arion Bank divides its operations into five profit centers plus subsidiaries and support units. The Bank's profit centers are Asset Management, Corporate Banking, Investment Banking, Retail Banking and Treasury.

All of the Bank's profit centers made a profit before income tax in the first quarter of 2018, except Corporate Banking.

<i>1.1.-31.3.2018</i> <i>In ISK million</i>	Asset Management	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other div., headq. and subsidiaries	Total
Net interest income	148	1,314	38	4,333	979	96	6,908
Net commission income	866	236	465	1,092	(82)	965	3,542
Other income	18	(161)	2	81	268	1,526	1,734
Operating income	1,032	1,389	505	5,506	1,165	2,587	12,184
Operating expenses	(601)	(888)	(392)	(3,451)	(329)	(2,971)	(8,632)
Bank levy	(46)	(170)	(10)	(278)	(300)	0	(804)
Net impairment	0	(376)	0	268	(29)	38	(99)
Net earnings before taxes	385	(45)	103	2,045	507	(346)	2,649

<i>1.1.-31.3.2017</i> <i>In ISK million</i>	Asset Management	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other div., headq. and subsidiaries	Total
Net interest income	146	1,656	69	3,974	1,096	219	7,160
Net commission income	838	176	333	996	(78)	1,065	3,330
Other income	48	236	(31)	179	(271)	2,046	2,207
Operating income	1,032	2,068	371	5,149	747	3,330	12,697
Operating expenses	(664)	(783)	(362)	(3,156)	(259)	(2,832)	(8,056)
Bank levy	(48)	(167)	(12)	(271)	(299)	0	(797)
Net impairment	0	819	14	20	55	(28)	880
Net earnings before taxes	320	1,937	11	1,742	244	470	4,724



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.

<i>In ISK million</i>	3M 2018	3M 2017	Difference
Net interest income	148	146	1.4%
Net commission income	866	838	3.3%
Other income	18	48	-
Operating income	1,032	1,032	0.0%
Operating expenses	(601)	(664)	(9.5%)
Bank levy	(46)	(48)	(4.2%)
Net earnings before taxes	385	320	20.3%

The operations of Asset Management are stable and net earnings are good. Assets under management at the end of March amounted to ISK 955 million and decreased by 3% from year-end 2017.

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

<i>In ISK million</i>	3M 2018	3M 2017	Difference
Net interest income	1,314	1,656	(20.7%)
Net commission income	236	176	34.1%
Other income	(161)	236	(168.2%)
Operating income	1,389	2,068	(32.8%)
Operating expenses	(888)	(783)	13.4%
Bank levy	(170)	(167)	1.8%
Net impairment	(376)	819	-
Net earnings before taxes	(45)	1,937	(102.3%)

The net interest margin at Corporate Banking is slightly lower in the first quarter, compared with the same period 2017, as a result of increasing competition in the corporate market and decreasing interest rates. Net commission income increased in line with the increasing level of activity in the market. Other income is mainly from valuation change on foreclosed assets. The negative net valuation changes in the loan portfolio can be primarily attributed to impairments on loans and claims against a number of corporates, but during the same period in 2017 claims were recovered from bankrupt estates and composition agreements which yielded a net positive change.



Investment Banking is composed of Capital Markets, Corporate Finance and Research. Investment Banking provides a full range of investment banking products and services, including equity and fixed income brokerage, initial public offerings, capital markets and M&A advisory to a broad range of customers, including corporate customers, professional investors, asset management companies and pension funds. Arion Research provides independent analysis of financial markets and the domestic economy.

<i>In ISK million</i>	3M 2018	3M 2017	Difference
Net interest income	38	69	(44.9%)
Net commission income	465	333	39.6%
Other income	2	(31)	-
Operating income	505	371	36.1%
Operating expenses	(392)	(362)	8.3%
Bank levy	(10)	(12)	(16.7%)
Net impairment	0	14	-
Net earnings before taxes	103	11	836.4%

There has been an increase in activities at Investment Banking in the first quarter of 2018 compared with the same period last year. The division has continued to be actively engaged in internal projects at the Bank, such as resolving complex recovery cases, but has also increased the number of transactions in which it is involved on the market. Revenues from the brokerage of shares and bonds by Capital Markets have been strong and the Bank has been at the forefront in trading on NASDAQ Iceland in recent years.

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

<i>In ISK million</i>	3M 2018	3M 2017	Difference
Net interest income	4,333	3,974	9.0%
Net commission income	1,092	996	9.6%
Other income	81	179	(54.7%)
Operating income	5,506	5,149	6.9%
Operating expenses	(3,451)	(3,156)	9.3%
Bank levy	(278)	(271)	2.6%
Net impairment	268	20	1,240.0%
Net earnings before taxes	2,045	1,742	17.4%

Operating income increased by 6.9% between the first quarter of 2017 and the first quarter of 2018. The increase in operating income is mainly due to loan book growth, both in loans to retail customers and SMEs, as well as the strong focus over the last few years on fee generating operations. Operating expenses increased between years, in line with the increase in activities. The positive outcome in net impairment is mainly due to prepayments of mortgages as the interest environment is favorable for customers.



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

<i>In ISK million</i>	3M 2018	3M 2017	Difference
Net interest income	979	1,096	(10.7%)
Net commission income	(82)	(78)	5.1%
Other income	268	(271)	(198.9%)
Operating income	1,165	747	56.0%
Operating expenses	(329)	(259)	27.0%
Bank levy	(300)	(299)	0.3%
Net impairment	(29)	55	(152.7%)
Net earnings before taxes	507	244	107.8%

Operating income from Treasury increased slightly from the first quarter 2017 to the first quarter 2018, mainly due to positive mark to market changes on derivatives which are used for hedging but are not in hedge accounting. Operating expenses increased, in particular due to professional services.

BALANCE SHEET

Arion Bank's **total assets** decreased slightly from year-end 2017.

<i>In ISK million</i>	31.03.2018	31.12.2017	Diff	Diff%
Cash & balances with CB	97,934	139,819	(41,884)	(30%)
Loans to credit institutions	94,961	86,609	8,353	10%
Loans to customers	782,255	765,101	17,154	2%
Financial assets	106,415	109,450	(3,035)	(3%)
Investment property	6,749	6,613	136	2%
Investments in associates	743	760	(18)	(2%)
Intangible assets	13,498	13,848	(350)	(3%)
Other assets	29,214	25,555	3,659	14%
Total assets	1,131,769	1,147,754	(15,986)	(1%)

Cash and cash balances with the Central Bank amounted to ISK 97,934 million at the end of the period, compared with ISK 139,819 million at the end of 2017. The decrease is partly due to the buyback of own shares and dividend payments totalling ISK 24.3 billion during the period.

Loans to customers totalled ISK 782,255 million at the end of the period, representing a 2.2% increase from year-end 2017. Loans to corporates increased by 2.0% during the period. Loans to individuals increased by 2.5%, primarily mortgage loans despite strong competition from the pension funds in that market.

Financial assets amounted to ISK 106,415 million at the end of the period, compared with ISK 109,450 million at the end of 2017. The composition of financial assets has changed due to the sale of international debt funds and the acquisition of bonds, all related to liquidity management.



Liabilities slightly decreased from year-end 2017. **Equity** decreased due to the purchase of treasury stock and dividend payments during the period, totalling ISK 24.3 billion. Net earnings for the period and the effects of the adoption of IFRS 9 partly offset the decrease.

<i>In ISK million</i>	31.03.2018	31.12.2017	Diff	Diff%
Due to credit institutions & CB	7,880	7,370	510	7%
Deposits from customers	453,059	462,161	(9,102)	(2%)
Financial liabilities at fair value	3,130	3,601	(471)	(13%)
Other liabilities	62,600	63,890	(1,290)	(2%)
Borrowings	400,855	384,998	15,857	4%
Shareholders equity	204,117	225,606	(21,489)	(10%)
Non-controlling interest	128	128	0	0%
Total liabilities and equity	1,131,769	1,147,754	(15,985)	(1%)

Borrowings amounted to ISK 400,855 million at the end of March 2018. In March, Arion Bank issued a new 5-year EUR 300 million bond on the international markets (ISK 37 billion). The bonds were sold at rates corresponding to a 0.65% margin over interbank rates. The bond issue was partly used to repay a 3-year bond in the amount of EUR 200 million. The Bank has also continued to issue covered bonds in the Icelandic market, a total of approximately ISK 7 billion in the first quarter of 2018.

Shareholders' equity amounted to ISK 204,117 million at the end of March 2018, compared with ISK 225,605 million at the end of 2017. The decrease is explained by a buyback of shares and dividend payments during the first quarter of 2018, which is partly offset by an increase in equity due to the adoption of IFRS 9 and the financial results for the period. The CET 1 ratio was 23.6% at the end of March 2018, which is unchanged from year-end 2017.

KEY PERFORMANCE INDICATORS

	Q1 2018	2017	Q1 2017
Return on equity (ROE)	3.6%	6.6%	6.3%
Return on total assets (ROA)	0.7%	1.3%	1.2%
Net interest margin (int. bearing assets)	2.6%	2.9%	2.8%
Net interest margin (total assets)	2.4%	2.7%	2.7%
Cost-to-income ratio	70.8%	56.1%	63.5%
Cost-to-Total assets ratio	3.0%	2.7%	3.0%
Effective tax rate	30.9%	28.4%	29.4%
CAD ratio	23.6%	24.0%	28.0%
CET 1 ratio	23.6%	23.6%	27.3%
Share of stage 3 loans, gross	3.2%	-	-
Gross impaired loans/Gross loans	-	1.6%	2.4%
RWA/Total assets	68.8%	66.8%	66.4%
Loans to deposit ratio	172.7%	165.5%	151.4%
The Group's average number of employees	1,290	1,250	1,209
The Group's employees at the end of the period	1,299	1,284	1,204
The Parent's average number of employees	832	830	833
The Parent's employees at the end of the period	832	844	827



FINANCIAL TARGETS

In late 2016 Arion Bank approved the following medium-term targets, for the next four to five years.

- **CET 1** Reduce to circa 17%
- **Loan growth** Prudent lending in line with economic growth
- **RoE** Exceed 10%
- **Dividend policy** Pay-out ratio of circa 50% on net earnings attributable to shareholders
- **Cost to Income ratio** Reduce to circa 50%

CONFERENCE CALL IN ENGLISH

Arion Bank will be hosting a conference call in English on Thursday 3 May at 1:00 pm GMT (3:00 pm CET), where Stefán Pétursson, Chief Financial Officer, will discuss the highlights of the Bank's financial results. People interested in participating can contact ir@arionbanki.is to obtain dial-in information.

For further information please contact Haraldur Gudni Eidsson of Arion Bank's Communications division at haraldur.eidsson@arionbanki.is, tel. +354 444 7108, or Sture Stolen in Investor Relations at ir@arionbanki.is.

FINANCIAL CALENDAR FOR 2018

The Bank's Interim Financial Statements are scheduled for publication as stated below.

Second quarter 2018	1 August 2018
Third quarter 2018	31 October 2018

This calendar may be subject to change.