Arion Bank

Condensed Consolidated
Interim Financial Statements

1 January - 30 September 2019

Contents

Arion Bank in brief

9M 2019

2.6%
Return on equity

56.3%
Cost-to-income

21.6%
CET 1

Rating from S&P
Long term: BBB+
Short term: A-2
Outlook: Negative

FINANCE
UNEP INITIATIVE

Equal Pay Certification

IMARK
Marketing company of the year 2018

Arion Bank

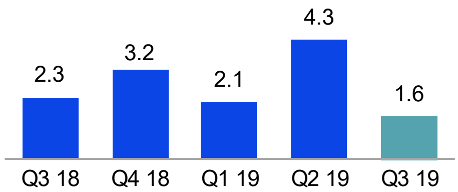
- Arion Bank is a leading universal relationship bank in Iceland which provides a full range of financial services.
- After a period of strong economic growth, a short recession is forecast following a downturn in tourism. The economy is expected to return to growth in 2020.
- The balance sheet remains strong with an equal split between retail and corporate loans, high capital ratios and strong asset quality.
- Arion Bank is the leading bank in digital solutions on the Icelandic market. In 2019 the Bank has launched six customer facing digital solutions.
- There is an increased focus on profitability through capital optimization, improved credit quality, digital solutions and automation and organizational efficiencies.

Key figures

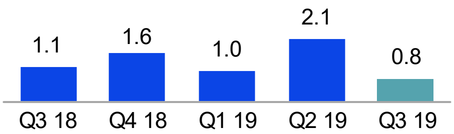
(ISK million)

	9M 2019	9M 2018
Net earnings	3,875	6,160
ROE	2.6%	2.3%
Net interest margin	2.7%	2.7%
Cost to income ratio	56.3%	50.3%
	30.9.2019	**31.12.2018**
Total assets	1,213,155	1,164,327
Loans to customers	812,481	833,826
Deposits	508,254	466,067
Borrowings	409,563	417,782
Stage 3 gross	2.7%	2.6%
Leverage ratio	12.8%	14.2%
Number of employees	802	904
EUR/ISK	135.10	133.20

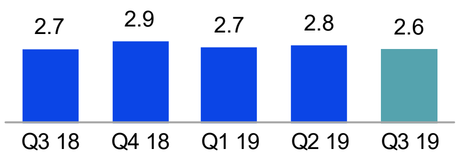
Return on equity (%)



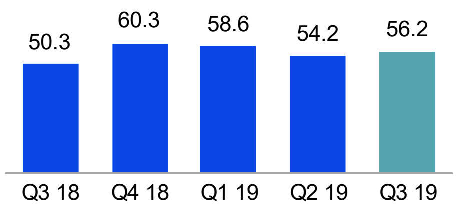
Net earnings (ISK billion)



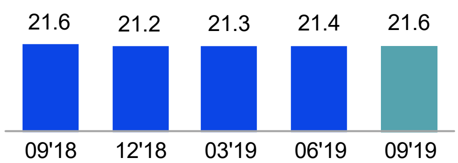
Net interest margin (%)



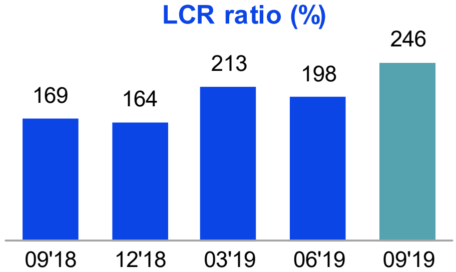
Cost-to-income ratio (%)



CET 1 ratio (%)



LCR 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 September 2019 include the Condensed Consolidated Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Operations during the period

Arion Bank reported net earnings from continuing operations of ISK 3,801 million and net earnings of ISK 761 million in the third quarter of 2019. Total equity amounted to ISK 196,056 million at the end of the period. Return on equity was 1.6% in the quarter but measured approximately 8.5% from continuing operations. Net earnings from continuing operations amounted to ISK 8,849 million and net earnings to ISK 3,875 million for the first nine months of 2019, with return on equity of approximately 6.5% and 2.6% for the period, respectively. The Group's capital ratio, including net earnings for the third quarter, was 23.6% and the CET1 ratio was 21.6%. The Group's capital ratio, as calculated under the Financial Undertakings Act No. 161/2002, was 23.5% and the CET1 ratio was 21.5%. This comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The Bank's liquidity position was also very strong at period end and well above the regulatory minimum.

The main change on the asset side of the Group's balance sheet from the end of June 2019 was a decrease in loans to customers of ISK 9.2 billion, mainly in loans to larger corporates, which is in line with Arion Bank's increasing focus on returns rather than the growth of the loan book. The main changes on the liabilities side during the quarter were increased deposits and a decrease in borrowings resulting from the partial prepayment of ISK 12 billion of structured covered bonds in July, the maturity of covered bonds of ISK 4.5 billion and a decrease of ISK 5 billion in issued bills during the third quarter.

The Bank continues to optimize its capital structure and issued ISK 4.8 billion of Tier 2 subordinated bonds during the quarter. At the end of September 2019 the total of issued Tier 2 bonds amounted to ISK 15.0 billion or 2.0% additional capital. The Bank now has the capacity to issue a further 0.7% of Tier 2 additional capital, or approximately ISK 6 billion, before the Tier 2 bucket in the capital structure is filled, assuming that the capital requirements and RWA density remain similar.

In July 2019 Standard & Poor's affirmed Arion Bank's long-term credit rating BBB but revised the outlook from stable to negative. The Bank's short-term credit rating remains A-2.

Operational outlook

On 26 September 2019 the Board of Directors of Arion Bank approved the introduction of a new organizational structure. The organizational changes are designed to help the Bank to achieve its financial targets and to adapt to an ever changing operating environment. The Bank will continue to provide its customers with high-quality services and will enhance its services to customers seeking the most cost-effective financing by acting as financial intermediary with third parties such as funds and other institutional investors. The number of divisions was reduced by two and the responsibility for various other tasks was relocated within the Bank with the aim of simplifying the business. There will be three business segments going forward: Retail Banking, Corporate & Investment Banking and Markets. There will also be three support units: Finance, Information Technology and Risk Management. The changes resulted in a reduction in the number of employees of approximately 12%. The one-off effect of this action was ISK 1,079 million, or approximately ISK 800 million net of tax, and was recognized in the third quarter of 2019.

In October Arion Bank prepaid in full the contractual covered bond issuance (Arion CB2), which was largely owned by the Housing Financing Fund (HFF), a total of ISK 62 billion. At the same time, the Bank sold a mortgage loan portfolio totalling ISK 48 billion to the HFF. Arion Bank will continue to service the loans. The prepayment of the bond and the agreement with the HFF will have a positive impact of approximately ISK 1.3 billion, net of tax, on the Bank's earnings in Q4 2019. The positive impacts are mostly due to a lower bank levy for 2019 and the realization of discounts that would otherwise have been recognized following the prepayment of the mortgages or in the period before the mortgages mature. The Bank will continue to receive income from the mortgages in accordance with the service and revenue sharing agreement with the HFF.

Arion Bank is in the process of potentially divesting the majority or all of the Bank's shareholding in Valitor Holding hf. The company is therefore categorized as held for sale in the Consolidated Interim Financial Statements, see Note 5. The sale process has taken more time than originally expected. Stakksberg ehf. (United Silicon) and Sólbjarg ehf. (TravelCo) are also categorized as held for sale. The divesting of Stakksberg ehf. has been delayed due to regulatory complications but the company is resolving this issue, and Arion Bank aims to conduct the sale process as soon as possible. Arion Bank is preparing the sale of Sólbjarg ehf. and intends to complete it over the next few months.

Endorsement and statement
by the Board of Directors and the CEO

Economic environment and outlook

According to preliminary figures, GDP growth measured 0.9% in the first half of 2019, slightly stronger than expected. Even though this figure does not indicate a recession, especially considering 2.7% GDP growth in Q2, the subcomponents of GDP show that the economy has slowed down markedly and the outlook for 2019 is still bearish due to adverse developments in the country's main export sectors. Following the bankruptcy of WOW air at the end of March, tourist arrivals have decreased YoY. A temporary decrease in exports in certain parts of the fisheries sector and a temporary reduction of capacity in the aluminum sector have also had a negative effect on exports. Households have been reacting by showing caution, resulting in slower private consumption growth. While rising unemployment is expected to dampen private consumption, increased purchasing power and rate cuts, which have buoyed the housing market, might soften the effects. Inflation is currently low in a historical context but above the Central Bank of Iceland's 2.5% inflation target. Recent collective wage agreements between unions and employers, with an emphasis on longer term purchasing power, working hours and housing initiatives, indicate economic stability over the next years.

Group ownership

At the end of September 2019 Taconic Capital was the largest shareholder of Arion Bank, with a holding of 23.53%, and Sculptor Capital Management was the second largest with a holding of 9.25%. In July the largest shareholder of the Bank, Kaupskil ehf., sold its entire shareholding to a group of international and domestic investors. For further information on the shareholders of Arion Bank, see Note 37.

Capital and RWAs

In April 2019 Arion Bank's share capital was reduced by ISK 186 million at nominal value, totalling 186 million shares, through the cancellation of the Bank's own shares. Arion Bank's share capital amounts to ISK 1,814 million after the reduction. Arion Bank also managed to reduce RWA density from 68.4% at the end of 2018 to 63%, mainly through the reduction of corporate loans, the sale of equity positions and by having a higher proportion of low risk liquid assets.

In September 2019 the Board of Directors of Arion Bank authorized the management of the Bank to initiate share buy-back programs in Iceland and Sweden to purchase own shares (including in the form of SDRs). This is in accordance with an authorization granted by Arion Bank's Annual General Meeting on 20 March 2019. The reduction of share capital is in line with the Bank's strategy of optimizing its capital structure. In September 2019 the FME approved the Bank's request to initiate the share buy-back program for up to 59,000,000 own shares (corresponding to 3.25% of issued share capital) for up to ISK 4.5 billion market value. Arion Bank will initiate share buy-back programs in Sweden and Iceland on 31 October 2019.

Governance

At the last Annual General Meeting (AGM) on 20 March 2019, six members were elected to serve on the Board of Directors until the next AGM, three women and three men. Furthermore, three Alternate Directors (two men and one woman) were elected, and they attend meetings of the Board of Directors in the event that a Director resigns or is unable to attend.

A shareholders' meeting of Arion Bank was held on 9 August 2019. Paul Richard Horner and Gunnar Sturluson were elected as new members of the Board of Directors and will serve until the Bank's next AGM. One of them replaces Benedikt Gíslason, now the CEO of the Bank, who resigned as a member of the Board of Directors before the end of his term of office.

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 September 2019 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 and cash flow of the Group for the period ended 30 September 2019 and its financial position as at 30 September 2019.

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 September 2019 and confirm them by means of their signatures.

Reykjavík, 30 October 2019

Board of Directors

Brynjólfur Bjarnason
Chairman

Gunnar Sturluson

Herdís Dröfn Fjeldsted

Liv Fiksdahl

Ólafur Örn Svansson

Paul Richard Horner

Steinunn Thórdardóttir

Chief Executive Officer

Benedikt Gíslason

Consolidated Interim Income Statement

	Notes	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Interest income		45,001	42,967	13,854	14,933
Interest expense		(22,377)	(21,617)	(6,472)	(7,724)
Net interest income	8	**22,624**	**21,350**	**7,382**	**7,209**
Fee and commission income		8,425	8,593	2,965	2,990
Fee and commission expense		(1,090)	(990)	(326)	(304)
Net fee and commission income	9	**7,335**	**7,603**	**2,639**	**2,686**
Net insurance income	10	2,163	1,885	1,087	984
Net financial income	11	2,723	3,076	934	569
Share of profit of associates	27	750	16	30	34
Other operating income	12	677	1,290	272	422
Other net operating income		**6,313**	**6,267**	**2,323**	**2,009**
Operating income		**36,272**	**35,220**	**12,344**	**11,904**
Salaries and related expenses	13	(11,565)	(10,694)	(4,130)	(3,129)
Other operating expenses	14	(8,855)	(8,985)	(2,810)	(2,864)
Operating expenses		**(20,420)**	**(19,679)**	**(6,940)**	**(5,993)**
Bank levy	15	(2,627)	(2,620)	(809)	(937)
Net impairment	16	(1,585)	(2,951)	484	(2,650)
Earnings before income tax		**11,640**	**9,970**	**5,079**	**2,324**
Income tax expense	17	(2,791)	(3,165)	(1,278)	(973)
Net earnings from continuing operations		**8,849**	**6,805**	**3,801**	**1,351**
Discontinued operations held for sale, net of income tax	18	(4,974)	(645)	(3,040)	(202)
Net earnings		**3,875**	**6,160**	**761**	**1,149**

Attributable to

Shareholders of Arion Bank hf.		3,875	5,549	761	1,151
Non-controlling interest		-	611	-	(2)
Net earnings		**3,875**	**6,160**	**761**	**1,149**

Earnings per share

Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	19	2.14	3.33	0.42	0.63

Comparative figures have been restated as the subsidiary Valitor Holding hf. has been classified as held for sale, see Note 5.

The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Comprehensive Income

	Notes	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Net earnings		**3,875**	**6,160**	**761**	**1,149**
Net gain on financial assets carried at fair value through OCI, net of tax		527	152	218	149
Realized net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement	11	(121)	(110)	(38)	2
Changes to reserve for financial instruments at fair value through OCI		**406**	**42**	**180**	**151**
Exchange difference on translating foreign subsidiaries		(5)	209	(167)	197
Other comprehensive income that may be reclassified subsequently to the Income Statement		**401**	**251**	**13**	**348**
Total comprehensive income		**4,276**	**6,411**	**774**	**1,497**

Attributable to

Shareholders of Arion Bank		4,276	5,800	774	1,499
Non-controlling interest		-	611	-	(2)
Total comprehensive income		**4,276**	**6,411**	**774**	**1,497**

The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Financial Position

Assets	Notes	30.9.2019	31.12.2018
Cash and balances with Central Bank	20	121,554	83,139
Loans to credit institutions	21	31,766	56,322
Loans to customers	22	812,481	833,826
Financial instruments	23-25	161,781	114,557
Investment property	25	7,121	7,092
Investments in associates	27	848	818
Intangible assets	28	8,088	6,397
Tax assets	29	1	90
Assets and disposal groups held for sale	30	52,164	48,584
Other assets	31	17,351	13,502
Total Assets		**1,213,155**	**1,164,327**

Liabilities			
Due to credit institutions and Central Bank	24	8,292	9,204
Deposits	24	508,254	466,067
Financial liabilities at fair value	24	2,295	2,320
Tax liabilities	29	3,766	5,119
Liabilities associated with disposal groups held for sale	30	29,677	26,337
Other liabilities	32	40,210	30,107
Borrowings	24,33	409,563	417,782
Subordinated liabilities	24,34	15,042	6,532
Total Liabilities		**1,017,099**	**963,468**

Equity			
Share capital and share premium	36	59,000	59,010
Other reserves		10,919	14,822
Retained earnings		126,007	126,897
Total Shareholders' Equity		**195,926**	**200,729**
Non-controlling interest		130	130
Total Equity		**196,056**	**200,859**
Total Liabilities and Equity		**1,213,155**	**1,164,327**

The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Changes in Equity

	Share capital	Share premium	Gain in subs. & assoc., unrealized	Gain in securities, unrealized	Financial assets at fair value thr. OCI unrealized	Statutory reserve	Foreign currency trans-lation reserve	Retained earnings	**Total share-holders' equity**	Non-cont-rolling interest	**Total equity**
			Restricted reserves								
Equity 1 January 2019	1,814	57,196	12,373	417	87	1,637	308	126,897	**200,729**	130	**200,859**
Net earnings								3,875	**3,875**		**3,875**
Net fair value gain					527				**527**		**527**
Realized net gain transferred to the Income Statement					(121)				**(121)**		**(121)**
Translation difference							(5)		**(5)**		**(5)**
Total comprehensive income .	**-**	**-**	**-**	**-**	**406**	**-**	**(5)**	**3,875**	**4,276**	**-**	**4,276**
Dividend paid								(9,069)	**(9,069)**		**(9,069)**
Changes in treasury stock *	-	(10)							**(10)**		**(10)**
Changes in reserves			(4,664)	360				4,304	**-**		**-**
Equity 30 September 2019	**1,814**	**57,186**	**7,709**	**777**	**493**	**1,637**	**303**	**126,007**	**195,926**	**130**	**196,056**
Equity 31 December 2017	2,000	73,861	14,050	903	-	1,637	185	132,971	**225,606**	128	**225,734**
Impact of adopting IFRS 9				(108)	110			939	**941**		**941**
Restated opening balance	**2,000**	**73,861**	**14,050**	**795**	**110**	**1,637**	**185**	**133,910**	**226,548**	**128**	**226,676**
Net earnings								5,549	**5,549**	611	**6,160**
Net fair value gain					152				**152**		**152**
Realized net gain transferred to the Income Statement					(110)				**(110)**		**(110)**
Translation difference							209		**209**		**209**
Total comprehensive income .	**-**	**-**	**-**	**-**	**42**	**-**	**209**	**5,549**	**5,800**	**611**	**6,411**
Dividend paid								(16,184)	**(16,184)**		**(16,184)**
Purchase of treasury stock **	(190)	(16,949)							**(17,139)**		**(17,139)**
Own shares allocated to employees	4	288							**292**		**292**
Changes in reserves			(1,151)	(337)	108			1,380	**-**		**-**
Equity 30 September 2018	**1,814**	**57,200**	**12,899**	**458**	**260**	**1,637**	**394**	**124,655**	**199,317**	**739**	**200,056**

* In 2018 close to 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees stock grant programme, an employee who resigns within the vesting period of two years, returns the shares to the Bank.

** Refers to the changes in the holding of own shares related to the decision to accept an offer from Kaupskil ehf., a subsidiary of Kaupthing ehf., to buy back 9.5% of issued share capital in Arion Bank, or 190 million shares. The decision to accept the offer from Kaupskil ehf. is in line with the decision taken at a shareholders' meeting on 12 February 2018 to amend the Bank's articles of association with a temporary authorization for the Board of Directors to buy back shares issued by the Bank. Arion Bank paid ISK 90.087 a share, a total of ISK 17,139 million.

The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Cash flows

	2019 1.1.-30.9.	2018 1.1.-30.9.
Operating activities		
Net earnings	3,875	6,160
Non-cash items included in net earnings	(10,523)	(9,624)
Changes in operating assets and liabilities	16,467	(19,254)
Loans to credit institutions, excluding bank accounts	*17,562*	*(22,949)*
Loans to customers	*27,834*	*(46,453)*
Financial instruments and financial liabilities at fair value	*(48,239)*	*(3,603)*
Deposits	*32,217*	*12,808*
Borrowings	*(11,593)*	*32,162*
Other changes in operating assets and liabilities	*(1,314)*	*8,781*
Interest received	38,047	40,339
Interest paid	(12,483)	(13,797)
Dividend received	125	3,075
Income tax paid	(4,055)	(3,929)
Net cash from operating activities	**31,453**	**2,970**
Investing activities		
Net investment in associates	721	(60)
Net investment in intangible assets and property and equipment	(2,036)	(971)
Net investment in intangible assets and property and equipment at Valitor	-	(987)
Net cash to investing activities	**(1,315)**	**(2,018)**
Financing activities		
Issued subordinated liabilities	8,914	-
Dividend paid to shareholders of Arion Bank and purchase of treasury stock	(9,069)	(33,323)
Net cash used in financing activities	**(155)**	**(33,323)**
Net increase (decrease) in cash and cash equivalents	29,983	(32,371)
Cash and cash equivalents at beginning of the year	110,589	181,898
Effect of exchange rate changes on cash and cash equivalents	2,146	2,401
Cash and cash equivalents	**142,718**	**151,928**
Cash and cash equivalents		
Cash and balances with Central Bank	121,554	99,525
Bank accounts	31,489	62,817
Mandatory reserve deposit with Central Bank	(10,325)	(10,414)
Cash and cash equivalents	**142,718**	**151,928**

Comparative figures have been restated as the subsidiary Valitor Holding hf. was classified as held for sale in 2018, see Note 5. Cash and cash equivalents at Valitor amounting to ISK 14,469 million are included in Cash and cash equivalents at 30 September 2018.

The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

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Notes to the Condensed Consolidated Interim Financial Statements

General information

Arion Bank hf., the Parent Company, was established on 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion Bank hf. is located at Borgartún 19, Reykjavík. The Condensed Consolidated Interim Financial Statements for the period ended 30 September 2019 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

The Condensed Consolidated Interim Financial Statements were approved and authorized for publication by the Board of Directors of Arion Bank on 30 October 2019.

In preparing these Condensed Consolidated Interim Financial Statements, the Bank has applied the concept of materiality to the presentation and level of disclosure. Only essential and mandatory information is disclosed which is relevant to an understanding by the reader of these Condensed Consolidated Interim Financial Statements.

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 2018. The Annual Financial Statements are available at Arion Bank's website www.arionbanki.is.

The same accounting policies, presentation and methods of computation are followed in these Condensed Consolidated Interim Financial Statements as were applied in the Consolidated Financial Statements for the year ended 31 December 2018, except for IFRS 16 Leases, effective 1 January 2019, see Note 3.

Due to the reclassification of the subsidiary Valitor Holding hf. as an asset held for sale, in accordance with IFRS 5, comparative figures in the Consolidated Interim Income Statement have been restated, see Note 5.

Basis of measurement

The Condensed Consolidated Interim Financial Statements have been prepared on a historical cost basis except for assets and liabilities measured under IFRS 9. For further details on the accounting policy for assets and liabilities under IFRS 9, see Note 57 in the Annual Financial Statements 2018.

Functional and presentation currency

The 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 123.81 and 135.10 for EUR (31.12.2018: USD 116.34 and EUR 133.20).

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

3. Changes in accounting policies

Arion Bank initially adopted IFRS 16 Leases from 1 January 2019. The Group has not early adopted any standards, interpretations or amendments that have been issued but are not effective.

IFRS 16

The Group applied IFRS 16 Leases for the first time in 2019. IFRS 16 introduces new or amended requirements with respect to lease accounting in order to remove the distinction between operating and finance lease requirements and requiring the recognition of a right-of-use asset and a lease liability at commencement for all leases, except for short-term leases and leases of low value assets. The Group has applied IFRS 16 using the modified retrospective approach, with no restatement of comparative information. With the application of IFRS 16, the nature of expenses related to operating leases changes as the Group recognizes a depreciation charge for right-of-use assets and interest expense on lease liabilities. Previously, the Group recognized operating lease expense on a straight-line basis over the term of the lease. At initial application on 1 January 2019 the Group recognized lease liabilities of ISK 1 billion and a right-of-use asset in the same amount.

Notes to the Condensed Consolidated Interim Financial Statements

4. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Consolidated Interim 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.

5. The Group

Shares in the main subsidiaries in which Arion Bank holds a direct interest

			Equity interest	
	Operating activity	Currency	30.9.2019	31.12.2018
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%
Eignarhaldsfélagid Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland	Real estate	ISK	100.0%	100.0%
Eignabjarg ehf., Borgartún 19, Reykjavík, Iceland	Holding company	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., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland	Insurance	ISK	100.0%	100.0%

The subsidiaries Eignabjarg ehf. (holding company of Stakksberg ehf. and Sólbjarg ehf.) and Valitor Holding hf. are classified as held for sale, see Note 30.

Valitor Holding hf.

Arion Bank's shareholding in the subsidiary Valitor Holding hf. (Valitor) was 100% at 30 September 2019. The Bank is in the process of potentially divesting the Bank's shareholding in Valitor and has appointed Citi as a sales advisor. The Bank is aiming for having completed the sale of Valitor within the 12 months set as a requirement for classification as held for sale in accordance with IFRS.

In accordance with IFRS 5 Non-current assets and disposal groups held for sale, Valitor has been classified as asset held for sale in these Condensed Consolidated Interim Financial Statements, resulting in a change in the presentation in the Consolidated Interim Income Statement. Net earnings of Valitor are recognized in a single line item as Discontinued operations held for sale, net of income tax. The comparative figures in the Consolidated Interim Income Statement for the first nine months of 2018 have been restated.

Restated Consolidated Interim Income Statement for 1.1.-30.9.2018

	Published accounts	Valitor	Restated accounts
Interest income	43,652	(685)	42,967
Interest expense	(21,686)	69	(21,617)
Net interest income	**21,966**	**(616)**	**21,350**
Fee and commission income	24,789	(16,196)	8,593
Fee and commission expense	(12,509)	11,519	(990)
Net fee and commission income	**12,280**	**(4,677)**	**7,603**
Net financial income	2,849	227	3,076
Net insurance income	1,885	-	1,885
Share of profit of associates	18	(2)	16
Other operating income	1,310	(20)	1,290
Other net operating income	**6,062**	**205**	**6,267**
Operating income	**40,308**	**(5,088)**	**35,220**
Salaries and related expenses	(13,815)	3,121	(10,694)
Other operating expenses	(11,777)	2,792	(8,985)
Operating expenses	**(25,592)**	**5,913**	**(19,679)**
Bank levy	(2,620)	-	(2,620)
Net impairment	(2,969)	18	(2,951)
Earnings before income tax	**9,127**	**843**	**9,970**
Income tax expense	(3,078)	(87)	(3,165)
Net earnings from continuing operations	**6,049**	**756**	**6,805**
Discontinued operations held for sale, net of income tax	112	(756)	(645)
Net earnings	**6,161**	**-**	**6,160**

Prior to the restatement the operations of Valitor were presented as the operating segment Subsidiaries and other divisions, see Note 6.

Amounts are in ISK millions

5. The Group, continued

In the Consolidated Interim Statement of Financial Position the total assets of Valitor are recognized as Assets and disposal groups held for sale and the total liabilities as Liabilities associated with disposal groups held for sale, see Note 30.

Total assets and total liabilities of Valitor

	30.9.2019	31.12.2018
Assets		
Cash and balances with Central Bank	12,134	7,441
Loans to credit institutions	10,870	19,300
Loans to customers	2,079	2,258
Financial instruments	110	174
Investments in associates	59	58
Intangible assets	8,550	8,267
Tax assets	149	101
Other assets	3,015	2,404
	36,966	**40,003**
Liabilities		
Due to credit institutions and Central Bank	4	-
Financial liabilities at fair value	3	8
Tax liabilities	125	136
Other liabilities	22,674	26,185
Borrowings	5	8
Total Liabilities	**22,811**	**26,337**
Elimination within Arion Bank Group	(2,427)	2,116
Book value of Valitor	**11,728**	**15,782**

Income Statement of Valitor

1.1.-30.9.2019	Valitor	Elimination	Valitor contribution
Net interest income	511	32	543
Net fee and commission income	2,878	1,218	4,096
Net financial income	158	-	158
Other operating income	51	-	51
Operating income	**3,598**	**1,250**	**4,848**
Salaries and related expense	(3,854)	-	(3,854)
Other operating expense	(3,904)	-	(3,904)
Operating expenses	**(7,758)**	**-**	**(7,758)**
Net impairment	(92)	-	(92)
Earnings before income tax	**(4,252)**	**1,250**	**(3,003)**
Income tax expense	204	(107)	98
Net earnings	**(4,048)**	**1,143**	**(2,905)**

1.1.-30.9.2018	Valitor	Elimination	Valitor contribution
Net interest income	645	(29)	616
Net fee and commission income	4,078	599	4,677
Net financial income	(66)	(161)	(227)
Other operating income	181	(159)	22
Operating income	**4,838**	**250**	**5,088**
Salaries and related expense	(3,120)	(1)	(3,121)
Other operating expense	(2,792)	-	(2,792)
Operating expenses	**(5,912)**	**(1)**	**(5,913)**
Net impairment	(17)	(1)	(18)
Earnings before income tax	**(1,091)**	**248**	**(843)**
Income tax expense	87	-	87
Net earnings	**(1,004)**	**248**	**(756)**

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.

6. 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 services larger corporate clients, both in Iceland and abroad. Experienced account managers specializing in key economic sectors such as retail and services, seafood, energy and real estate are responsible for conducting larger transactions and developing strong business relationships with clients. The division provides a full range of lending products such as guarantees, deposit accounts, payment solutions and a variety of value-added digital solutions to meet the needs of the Bank's larger corporate clients. The Corporate Banking portfolio includes several larger international transactions, mainly in syndicates with other Icelandic banks and international banks.

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 current 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, using the online bank and the Arion Bank app as key channels. Retail Banking operates out of 20 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 Vördur tryggingar hf., which is an insurance company, Eignarhaldsfélagid Landey ehf., which holds the main part of investment property of the Group and the holding companies VISA Ísland ehf., BG12 slhf. and other smaller entities of the Group, as well as Market Making in domestic securities and currencies. The subsidiary Valitor Holding is classified as Disposal group held for sale. The subsidiary EAB 1 ehf. was sold in October 2018.

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.

Other information. At the beginning of 2019 the proportion of the loan book divided between Corporate Banking and Retail Banking changed. SME loans amounting to approx. ISK 49 billion were transferred from Retail Banking to Corporate Banking. At the same time 20 employees were transferred between the operating segments. As a result of these changes the figures are not fully comparable with those from 2018.

At the beginning of 2019 the allocation of cost changed so that total expense is now allocated to the following operating segments: Asset Management, Corporate Banking, Investment Banking, Retail Banking and Treasury. Prior to the change cost relating to the Board of Directors, the CEO's Office and Compliance was not allocated to the operating segments. Comparative figures for 2018 have not been restated.

6. Operating segments, continued

1.1.-30.9.2019	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Subsidi- aries and Other divisions	Head- quarters and Elimination	Total
Net interest income	630	6,690	249	13,259	2,184	(244)	(144)	22,624
Net fee and commission income	2,500	943	1,256	3,617	(249)	(802)	70	7,335
Net insurance income	-	-	-	-	-	2,199	(36)	2,163
Net financial income	127	(228)	5	(117)	463	2,549	(76)	2,723
Share of profit of associates and net impairment	-	-	-	-	-	-	750	750
Other operating income (loss)	13	(14)	-	331	7	52	288	677
Operating income	3,270	7,391	1,510	17,090	2,405	3,754	852	36,272
Operating expense	(1,116)	(449)	(665)	(4,510)	(227)	(1,729)	(11,724)	(20,420)
Allocated expense	(978)	(2,559)	(577)	(4,967)	(779)	(13)	9,873	-
Bank levy	(134)	(591)	(34)	(915)	(952)	-	(1)	(2,627)
Net impairment	-	(5,118)	-	365	2	3,166	-	(1,585)
Earnings before income tax	1,042	(1,326)	234	7,063	449	5,178	(1,000)	11,640
Net seg. rev. from ext. customers	1,248	15,197	1,006	26,605	(13,444)	4,775	885	36,272
Net seg. rev. from other segments	2,022	(7,806)	504	(9,515)	15,849	(1,021)	(33)	-
Operating income	3,270	7,391	1,510	17,090	2,405	3,754	852	36,272
Depreciation and amortization	2	2	1	122	-	167	763	1,057
Total assets	68,122	314,504	21,636	536,349	507,151	96,795	(331,402)	1,213,155
Total liabilities	63,414	237,459	20,703	472,222	493,788	62,400	(332,887)	1,017,099
Allocated equity	4,708	77,045	933	64,127	13,363	34,395	1,485	196,056

1.1.-30.9.2018								
Net interest income	506	4,215	204	13,029	3,295	207	(106)	21,350
Net fee and commission income	2,568	825	1,331	3,653	(232)	(681)	139	7,603
Net insurance income	-	-	-	-	-	1,919	(34)	1,885
Net financial income	69	(147)	(4)	-	742	1,866	550	3,076
Share of profit of associates and net impairment	-	-	-	3	-	-	13	16
Other operating income	16	2	-	519	-	630	123	1,290
Operating income	3,159	4,895	1,531	17,204	3,805	3,941	685	35,220
Operating expense	(1,123)	(366)	(635)	(5,075)	(153)	(1,566)	(10,761)	(19,679)
Allocated expense	(623)	(2,147)	(498)	(4,735)	(761)	(6)	8,770	-
Bank levy	(129)	(538)	(36)	(919)	(998)	-	-	(2,620)
Net impairment	-	(3,461)	16	494	-	1	(1)	(2,951)
Earnings (loss) before income tax	1,284	(1,617)	378	6,969	1,893	2,370	(1,307)	9,970
Net seg. rev. from ext. customers	1,141	12,215	1,273	27,318	(11,878)	4,352	799	35,220
Net seg. rev. from other segments	2,018	(7,320)	258	(10,114)	15,683	(413)	(112)	-
Operating income	3,159	4,895	1,531	17,204	3,805	3,939	687	35,220
Depreciation and amortization	1	3	1	279	-	99	574	957
Total assets	76,371	283,734	17,796	577,633	531,876	94,739	(362,620)	1,219,529
Total liabilities	71,449	222,966	17,225	502,716	511,646	60,416	(366,945)	1,019,473
Allocated equity	4,922	60,768	571	74,917	20,230	34,323	4,325	200,056

Income taxes and discontinued operations held for sale are excluded from the profit and loss segment information.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Quarterly statements

7. Operations by quarters

2019	Q1	Q2	Q3	Total
Net interest income	7,434	7,808	7,382	22,624
Net fee and commission income	2,218	2,478	2,639	7,335
Net insurance income	253	823	1,087	2,163
Net financial income	766	1,023	934	2,723
Share of profit (loss) of associates and net impairment	727	(7)	30	750
Other operating income	310	95	272	677
Operating income	11,708	12,220	12,344	36,272
Salaries and related expense	(3,630)	(3,805)	(4,130)	(11,565)
Other operating expense	(3,232)	(2,813)	(2,810)	(8,855)
Operating expenses	(6,862)	(6,618)	(6,940)	(20,420)
Bank levy	(906)	(912)	(809)	(2,627)
Net impairment	(1,081)	(988)	484	(1,585)
Earnings before income tax	2,859	3,702	5,079	11,640
Income tax expense	(622)	(891)	(1,278)	(2,791)
Net earnings from continuing operations	2,237	2,811	3,801	8,849
Discontinued operations, net of tax	(1,219)	(715)	(3,040)	(4,974)
Net earnings	1,018	2,096	761	3,875

2018				
Net interest income	6,827	7,314	7,209	21,350
Net fee and commission income	2,205	2,712	2,686	7,603
Net insurance income	143	758	984	1,885
Net financial income	1,387	1,119	569	3,076
Share of profit (loss) of associates and net impairment	(20)	2	34	16
Other operating income	268	600	422	1,290
Operating income	10,810	12,505	11,904	35,220
Salaries and related expense	(3,616)	(3,949)	(3,129)	(10,694)
Other operating expense	(3,143)	(2,978)	(2,864)	(8,985)
Operating expenses	(6,759)	(6,927)	(5,993)	(19,679)
Bank levy	(804)	(879)	(937)	(2,620)
Net impairment	(135)	(166)	(2,650)	(2,951)
Earnings before income tax	3,112	4,533	2,324	9,970
Income tax expense	(890)	(1,302)	(973)	(3,165)
Net earnings from continuing operations	2,222	3,231	1,351	6,805
Discontinued operations, net of tax	(273)	(169)	(202)	(645)
Net earnings	1,949	3,062	1,149	6,160

The half-year results were reviewed by the Bank's auditors. Other 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

8. Net interest income

1.1.-30.9.2019	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total
Interest income				
Cash and balances with Central Bank	3,092	-	-	3,092
Loans	40,892	-	-	40,892
Securities	-	337	555	892
Other	125	-	-	125
Interest income	44,109	337	555	45,001
Interest expense				
Deposits	(9,502)	-	-	(9,502)
Borrowings	(12,517)	-	-	(12,517)
Subordinated liabilities	(267)	-	-	(267)
Other	(91)	-	-	(91)
Interest expense	(22,377)	-	-	(22,377)
Net interest income	21,732	337	555	22,624

1.1.-30.9.2018				
Interest income				
Cash and balances with Central Bank	3,636	-	-	3,636
Loans	38,414	225	-	38,639
Securities	-	233	247	480
Other	212	-	-	212
Interest income	42,262	458	247	42,967
Interest expense				
Deposits	(9,725)	-	-	(9,725)
Borrowings	(11,784)	-	-	(11,784)
Other	(108)	-	-	(108)
Interest expense	(21,617)	-	-	(21,617)
Net interest income	20,645	458	247	21,350

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

8. Net interest income, continued

1.7.-30.9.2019	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total
Interest income				
Cash and balances with Central Bank	1,062	-	-	1,062
Loans	12,389	-	-	12,389
Securities	-	137	247	384
Other	19	-	-	19
Interest income	13,470	137	247	13,854
Interest expense				
Deposits	(2,642)	-	-	(2,642)
Borrowings	(3,645)	-	-	(3,645)
Subordinated liabilities	(161)	-	-	(161)
Other	(24)	-	-	(24)
Interest expense	(6,472)	-	-	(6,472)
Net interest income	6,998	137	247	7,382

1.7.-30.9.2018	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total
Interest income				
Cash and balances with Central Bank	1,269	-	-	1,269
Loans	13,395	154	-	13,549
Securities	-	8	40	48
Other	67	-	-	67
Interest income	14,731	162	40	14,933
Interest expense				
Deposits	(3,426)	-	-	(3,426)
Borrowings	(4,240)	-	-	(4,240)
Other	(58)	-	-	(58)
Interest expense	(7,724)	-	-	(7,724)
Net interest income	7,007	162	40	7,209

Interest spread	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	2.7%	2.7%	2.6%	2.7%

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

9. Net fee and commission income

	1.1.-30.9.2019			1.1.-30.9.2018		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	2,932	(373)	2,559	2,945	(332)	2,613
Lending and financial guarantees	1,407	-	1,407	1,431	-	1,431
Collection and payment services	1,170	(71)	1,099	1,188	(69)	1,119
Cards and payment solution	1,180	(139)	1,041	999	(97)	902
Investment banking	685	(29)	656	936	(24)	912
Other	1,051	(478)	573	1,094	(468)	626
Net fee and commission income	8,425	(1,090)	7,335	8,593	(990)	7,603
	1.7.-30.9.2019			1.7.-30.9.2018		
Asset management	1,031	(118)	913	930	(107)	823
Lending and financial guarantees	500	-	500	481	-	481
Collection and payment services	401	(22)	379	414	(22)	392
Cards and payment solution	448	(31)	417	369	(30)	339
Investment banking	208	(4)	204	380	(6)	374
Other	377	(151)	226	416	(139)	277
Net fee and commission income	2,965	(326)	2,639	2,990	(304)	2,686

Asset management fees are earned by the Group for trust and fiduciary activities where the Group holds or invests assets on behalf of the customers.

Fee and commission income from lending and financial guarantees is mainly related to lending activities, extension fees, advisory services and documentation, notification and payment fees plus fees from the issuing of guarantees on behalf of customers.

Fee and commission income on collection and payment services is generated billing services, such as issuing invoices and payment collection notices, wire transfer services and other payment services.

Commission from cards and payment solutions is mainly from the Bank's issuance of credit and debit cards and other card related commission, e.g. yearly fee on cards and transaction fee.

Fee and commission income from investment banking activities includes miscellaneous corporate advisory services plus commission from capital markets relating to sales of shares, bonds and derivatives.

Other fee and commission income is mainly fees relating to FX transactions at branches and in ATMs, custody and market making on the Icelandic stock exchange.

10. Net insurance income

	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Earned premiums, net of reinsurers' share				
Premiums written	9,402	8,777	2,589	2,396
Premiums written, reinsurers' shares	(291)	(255)	(105)	(77)
Change in provision for unearned premiums	(849)	(925)	366	319
Earned premiums, net of reinsurers' share	8,262	7,597	2,850	2,638
Claims incurred, net of reinsurers' share				
Claims paid	(5,185)	(5,132)	(1,558)	(1,628)
Claims paid, reinsurers' share	144	73	29	16
Change in provision for claims	(986)	(642)	(214)	(35)
Changes in provision for claims, reinsurers' share	(72)	(11)	(20)	(7)
Claims incurred, net of reinsurers' share	(6,099)	(5,712)	(1,763)	(1,654)
Net insurance income	2,163	1,885	1,087	984

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

11. Net financial income

	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	2,440	2,199	(149)	166
Loss on prepayments of borrowings	(188)	-	-	-
Net (loss) gain on fair value hedge of interest rate swap	49	527	204	154
Realized gain on financial assets carried at fair value through OCI	164	148	52	(3)
Net foreign exchange (loss) gain	258	202	827	252
Net financial income	2,723	3,076	934	569

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

Equity instruments mandatorily measured at fair value	1,460	2,036	(335)	(69)
Debt instruments mandatorily measured at fair value	961	196	262	102
Derivatives	65	(29)	(76)	65
Loans	(46)	(4)	-	68
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	2,440	2,199	(149)	166

Net (loss) gain on fair value hedge of interest rate swap

Fair value change of interest rate swaps designated as hedging instruments	1,432	325	345	(393)
Fair value change on bonds issued by the Group attributable to interest rate risk	(1,383)	202	(141)	547
Net (loss) gain on fair value hedge of interest rate swap	49	527	204	154

12. Other operating income

Fair value changes on investment property	-	397	-	14
Net gain on assets held for sale	289	512	164	360
Other income	388	381	108	48
Other operating income	677	1,290	272	422

Net gain on assets held for sale

Income from real estates and other assets	378	660	187	414
Expense related to real estates and other assets	(89)	(148)	(23)	(54)
Net gain on assets held for sale	289	512	164	360

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

13. Personnel and salaries

	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Number of employees				
Average number of full-time equivalent positions during the period	887	931	854	919
Full-time equivalent positions at the end of the period	802	933	802	933
Number of employees at the parent company				
Average number of full-time equivalent positions during the period	778	824	742	810
Full-time equivalent positions at the end of the period	689	822	689	822
Salaries and related expense				
Salaries	9,203	8,285	3,273	2,414
Defined contribution pension plans	1,319	1,181	465	343
Salary-related expense	1,360	1,228	510	372
Capitalization of salaries due to implementation of core systems	(317)	-	(118)	-
Salaries and related expense	11,565	10,694	4,130	3,129
Salaries and related expense for the parent company				
Salaries	8,113	7,249	2,949	2,104
Defined contribution pension plans	1,162	1,033	422	299
Salary-related expense	1,193	1,080	444	315
Capitalization of salaries due to implementation of core systems	(317)	-	(118)	-
Salaries and related expense for the parent company	10,151	9,362	3,697	2,718

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

13. Personnel and salaries, continued

At the end of September 2019 a new organizational structure was introduced, resulting in a reduction in the number of employees of 12%, or approximately 100 people. Salary and salary related expenses of ISK 1,079 million were expensed in the third quarter of 2019 in respect of these redundancies.

Salary and salary related expenses of ISK 150 million were expensed in the second quarter of 2019 in respect of the resignation of Höskuldur H. Ólafsson, the Bank's former CEO.

In June 2018 Arion Bank adopted a share-based remuneration programme, when a limited stock grant was offered to all employees of the parent company, excluding internal control units, in connection with the IPO and listing of the Bank. Remuneration was paid in the form of deferred shares with a vesting period of two years. The Bank recognizes expenses related to the programme as salaries and related expenses, a total of ISK 651 million, over the vesting period, or approximately ISK 27 million per month from June 2018.

During the period the Group made a provision of ISK 19 million (9M 2018: ISK 367 million) for performance plan payments, including salary-related expense, for which the Bank made no provision (9M 2018: ISK 317 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policies for financial undertakings. At the end of the period the Group's accrual for performance plan payments amounted to ISK 420 million (31.12.2018: ISK 608 million), of which the Bank's accrual amounts to ISK 311 million (31.12.2018: ISK 452 million).

14. Other operating expense

	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
IT expense	3,215	2,942	1,075	1,006
Professional services	872	1,043	314	308
Housing expense	795	937	250	280
Other administration expense	2,346	2,467	636	728
Depositors' and Investors' Guarantee Fund	570	639	175	218
Depreciation of property and equipment	399	398	131	129
Depreciation of right of use asset	96	-	32	-
Amortization of intangible assets	562	559	197	195
Other operating expense	8,855	8,985	2,810	2,864

15. 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.

16. Net impairment

	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Net change in impairment of cash and balances with Central Bank	2	5	-	-
Net change in impairment of loans to credit institutions	13	(35)	1	(5)
Net change in impairment of loans to corporates	(1,234)	(724)	922	(1,106)
Net change in impairment of loans to individuals	364	1,137	(21)	14
Write offs on loans and recievebles to corporates	(983)	(1,616)	(309)	(4)
Write offs on loans and recievebles to individuals	(956)	(923)	(280)	(99)
Payments on loans and recivebles previously written off from corporates	20	32	1	1
Payments on loans and recivebles previously written off from indivilduals	123	119	46	68
Net change in impairment of financial instruments at FVOCI	1	(4)	1	12
Net change in impairment of loan commitments, guarantees and unused credit facilities	183	(1,770)	(129)	(1,711)
Net impairment on financial instruments	(2,467)	(3,779)	232	(2,830)
Increase in book value of loans to corporates	76	49	16	16
Increase in book value of loans to individuals	806	779	236	164
Other value changes of loans	882	828	252	180
Net impairment	(1,585)	(2,951)	484	(2,650)

Increase in book value of loans to individuals and corporates is mainly due to release of discount from loans acquired with discount during the years 2008 to 2013, both due to impairments and other discount rate than reflected in the interest rates of the loans. The discount release was primarily related to loans that were paid up during the period.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

17. Income tax expense

	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Current tax expense	2,598	3,282	1,150	988
Deferred tax expense	193	(117)	128	(15)
Income tax expense	2,791	3,165	1,278	973

Reconciliation of effective tax rate

	2019 1.1.-30.9.		2018 1.1.-30.9.	
Earnings before tax		11,640		9,970
Income tax using the Icelandic corporate tax rate	20.0%	2,328	20.0%	1,994
Additional 6% tax on Financial Undertakings	3.9%	456	5.8%	577
Non-deductible expenses	0.0%	3	0.1%	6
Tax exempt revenue	(6.3%)	(731)	(2.4%)	(244)
Non-deductible taxes	4.5%	525	5.3%	524
Tax incentives not recognized in the Income Statement	0.9%	110	2.5%	250
Other changes	0.9%	100	0.6%	58
Effective tax rate	24.0%	2,791	31.7%	3,165

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

Tax exempt revenues consist mainly of profit from equity positions.

Bank levy of 0.376% on liabilities exceeding ISK 50 billion is non-deductible.

18. Discontinued operations held for sale, net of income tax

	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Net loss from discontinued operations held for sale	(5,292)	(720)	(2,914)	(202)
Income tax expense	318	75	(126)	-
Discontinued operations held for sale, net of income tax	(4,974)	(645)	(3,040)	(202)
Discontinued operations held for sale, net of income tax				
Valitor Holding hf.	(2,905)	(756)	(971)	(202)
Stakksberg ehf.	(1,453)	112	(1,453)	-
Sólbjarg ehf.	(616)	-	(616)	-
Discontinued operations held for sale, net of income tax	(4,974)	(645)	(3,040)	(202)

For further information about Valitor Holding hf. see Note 5 and for Stakksberg ehf. and Sólbjarg ehf. see Note 30.

19. Earnings per share

	Continued operations		Discontinued operations		Net Earnings	
	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.1.-30.9.	2018 1.1.-30.9.	2019 1.1.-30.9.	2018 1.1.-30.9.
Net earnings attributable to the shareholders of Arion Bank	8,849	6,805	(4,974)	(645)	3,875	6,160
Weighted average number of outstanding shares	1,814	1,851	1,814	1,851	1,814	1,851
Basic earnings per share	4.88	3.68	(2.74)	(0.35)	2.14	3.33
	2019 1.7.-30.9.	2018 1.7.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.	2019 1.7.-30.9.	2018 1.7.-30.9.
Net earnings attributable to the shareholders of Arion Bank	3,801	1,351	(3,040)	(202)	761	1,149
Weighted average number of outstanding shares	1,814	1,814	1,814	1,814	1,814	1,814
Basic earnings per share	2.10	0.74	(1.68)	(0.11)	0.42	0.63

There were no instruments at the end of the period that could potentially dilute basic earnings per share (2018: none).

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Notes to the Consolidated Interim Statement of Financial Position

20. Cash and balances with Central Bank

	30.9.2019	31.12.2018
Cash on hand	4,350	5,059
Cash with Central Bank	106,879	67,492
Mandatory reserve deposit with Central Bank	10,325	10,588
Cash and balances with Central Bank	121,554	83,139

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

21. Loans to credit institutions

Bank accounts	31,489	38,038
Money market loans	277	17,101
Other loans	-	1,183
Loans to credit institutions	31,766	56,322

22. Loans to customers

	Individuals		Corporates		Total	
30.9.2019	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	16,081	15,312	17,714	17,097	33,795	32,409
Credit cards	12,650	12,379	1,367	1,327	14,017	13,706
Mortgage loans	349,673	349,228	23,765	23,710	373,438	372,938
Other loans	33,604	32,006	367,221	361,422	400,825	393,428
Loans to customers	412,008	408,925	410,067	403,556	822,075	812,481
31.12.2018						
Overdrafts	14,536	13,616	19,200	18,267	33,736	31,883
Credit cards	12,958	12,706	1,348	1,305	14,306	14,011
Loans to customers at fair value	-	-	4,812	4,812	4,812	4,812
Mortgage loans	343,119	342,469	23,417	23,351	366,536	365,820
Other loans	33,560	31,692	390,767	385,608	424,327	417,300
Loans to customers	404,173	400,483	439,544	433,343	843,717	833,826

The total book value of pledged loans that were pledged against amounts borrowed was ISK 232 billion at the end of the period (31.12.2018: ISK 203 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk Management Disclosures.

23. Financial instruments

	30.9.2019	31.12.2018
Bonds and debt instruments	115,386	71,451
Shares and equity instruments with variable income	19,182	20,265
Derivatives	6,244	6,241
Securities used for economic hedging	20,969	16,600
Financial instruments	161,781	114,557

Amounts are in ISK millions

24. Financial assets and financial liabilities

30.9.2019 Financial assets	Amortized cost	Fair value through OCI	Manda-torily at fair value thr. P/L	Total
Loans				
Cash and balances with Central Bank	121,554	-	-	121,554
Loans to credit institutions	31,766	-	-	31,766
Loans to customers	812,481	-	-	812,481
Loans	965,801	-	-	965,801
Bonds and debt instruments				
Listed	-	96,447	17,135	113,582
Unlisted	-	1,340	464	1,804
Bonds and debt instruments	-	97,787	17,599	115,386
Shares and equity instruments with variable income				
Listed	-	-	9,176	9,176
Unlisted	-	-	7,477	7,477
Bond funds with variable income, unlisted	-	-	2,529	2,529
Shares and equity instruments with variable income	-	-	19,182	19,182
Derivatives				
OTC derivatives	-	-	3,157	3,157
Derivatives used for hedge accounting	-	-	3,087	3,087
Derivatives	-	-	6,244	6,244
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	10,834	10,834
Bonds and debt instruments, unlisted	-	-	243	243
Shares and equity instruments with variable income, listed	-	-	9,888	9,888
Shares and equity instruments with variable income, unlisted	-	-	4	4
Securities used for economic hedging	-	-	20,969	20,969
Other financial assets				
Accounts receivable	3,705	-	-	3,705
Other financial assets	4,928	-	-	4,928
Other financial assets	8,633	-	-	8,633
Financial assets	974,434	97,787	63,994	1,136,215
Financial liabilities				
Due to credit institutions and Central Bank	8,292	-	-	8,292
Deposits	508,254	-	-	508,254
Borrowings	409,563	-	-	409,563
Subordinated liabilities	15,042	-	-	15,042
Short position in bonds	-	-	237	237
Short position in equity, used for economic hedging	-	-	28	28
Derivatives	-	-	2,030	2,030
Other financial liabilities	11,395	-	-	11,395
Financial liabilities	952,546	-	2,295	954,841

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

24. Financial assets and financial liabilities, continued

31.12.2018	Amortized cost	Fair value through OCI	Mandatorily at fair value thr. P/L	Total
Financial assets				
Loans				
Cash and balances with Central Bank	83,139	-	-	83,139
Loans to credit institutions	56,322	-	-	56,322
Loans to customers	829,014	-	4,812	833,826
Loans	968,475	-	4,812	973,287
Bonds and debt instruments				
Listed	-	51,329	17,274	68,603
Unlisted	-	2,459	389	2,848
Bonds and debt instruments	-	53,788	17,663	71,451
Shares and equity instruments with variable income				
Listed	-	-	7,270	7,270
Unlisted	-	-	9,867	9,867
Bond funds with variable income, unlisted	-	-	3,128	3,128
Shares and equity instruments with variable income	-	-	20,265	20,265
Derivatives				
OTC derivatives	-	-	5,020	5,020
Derivatives used for hedge accounting	-	-	1,221	1,221
Derivatives	-	-	6,241	6,241
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	10,010	10,010
Shares and equity instruments with variable income, listed	-	-	6,587	6,587
Shares and equity instruments with variable income, unlisted	-	-	3	3
Securities used for economic hedging	-	-	16,600	16,600
Other financial assets				
Accounts receivable	3,751	-	-	3,751
Other financial assets	2,056	-	-	2,056
Other financial assets	5,807	-	-	5,807
Financial assets	974,282	53,788	65,581	1,093,651
Financial liabilities				
Due to credit institutions and Central Bank	9,204	-	-	9,204
Deposits	466,067	-	-	466,067
Borrowings	417,782	-	-	417,782
Subordinated liabilities	6,532	-	-	6,532
Short position in bonds	-	-	488	488
Short position in equity, used for economic hedging	-	-	37	37
Derivatives	-	-	1,795	1,795
Other financial liabilities	6,130	-	-	6,130
Financial liabilities	905,715	-	2,320	908,035

Amounts are in ISK millions

24. Financial assets and financial liabilities, continued

Bonds and debt instruments measured at fair value, specified by issuer		Mandatorily	
30.9.2019	FVOCI	FVPL	Total
Financial and insurance activities	6,851	6,013	12,864
Public sector	83,688	10,271	93,959
Corporates	7,248	1,315	8,563
Bonds and debt instruments at fair value	97,787	17,599	115,386
31.12.2018			
Financial and insurance activities	2,962	7,364	10,326
Public sector	44,084	8,724	52,808
Corporates	6,742	1,575	8,317
Bonds and debt instruments designated at fair value	53,788	17,663	71,451

The total amount of pledged bonds was ISK 6.5 billion at the end of the period (31.12.2018: ISK 5.9 billion). Pledged bonds comprised Icelandic and foreign Government Bonds and corporate 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.

25. Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of assets and liabilities by valuation technique:

Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;
Level 2: valuation techniques for which all significant inputs are market observable, either directly or indirectly; and
Level 3: valuation techniques which include significant inputs that are not based on observable market data.

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

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

30.9.2019

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	106,551	8,812	23	115,386
Shares and equity instruments with variable income	4,849	12,660	1,673	19,182
Derivatives	-	3,157	-	3,157
Derivatives used for hedge accounting	-	3,087	-	3,087
Securities used for economic hedging	20,722	247	-	20,969
Investment property	-	-	7,121	7,121
Assets at fair value	132,122	27,963	8,817	168,902
Liabilities at fair value				
Short position in bonds	237	-	-	237
Short position in equity, used for economic hedging	28	-	-	28
Derivatives	-	2,030	-	2,030
Liabilities at fair value	265	2,030	-	2,295

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

25. Fair value hierarchy, continued

31.12.2018

Assets at fair value	Level 1	Level 2	Level 3	Total
Loans to customers	-	4,812	-	4,812
Bonds and debt instruments	61,909	9,500	42	71,451
Shares and equity instruments with variable income	3,980	14,956	1,329	20,265
Derivatives	-	5,020	-	5,020
Derivatives used for hedge accounting	-	1,221	-	1,221
Securities used for economic hedging	16,597	3	-	16,600
Investment property	-	-	7,092	7,092
Assets at fair value	82,486	35,512	8,463	126,461
Liabilities at fair value				
Short position in bonds	488	-	-	488
Short position in equity, used for economic hedging	37	-	-	37
Derivatives	-	1,795	-	1,795
Liabilities at fair value	525	1,795	-	2,320

There were no transfers between Level 1 and Level 2 during the period (2018: Transfers from Level 2 to Level 1 amounted to ISK 496 million).

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 24 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.

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.

Amounts are in ISK millions

25. Fair value hierarchy, continued

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

In some 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		
30.9.2019	property	Bonds	Shares	Total
Balance at the beginning of the year	7,092	42	1,329	8,463
Net fair value changes	-	20	84	104
Additions	29	-	263	292
Disposals	-	(27)	(3)	(30)
Transfers out of Level 3	-	(12)	-	(12)
Balance at the end of the period	7,121	23	1,673	8,817
31.12.2018				
Balance at the beginning of the year	6,613	39	1,130	7,782
Net fair value changes	471	10	56	537
Additions	284	-	210	494
Disposal	(276)	(7)	(1)	(284)
Transfers out of Level 3	-	-	(66)	(66)
Balance at the end of the period	7,092	42	1,329	8,463

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

	Investment	Financial assets		
1.1.-30.9.2019	property	Bonds	Shares	Total
Net financial income	-	20	84	104
Effects recognized in the Income Statement	-	20	84	104
1.1.-30.9.2018				
Net financial income	-	7	(33)	(26)
Other operating income	397	-	-	397
Effects recognized in the Income Statement	397	7	(33)	371

Amounts are in ISK millions

25. Fair value hierarchy, continued

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

30.9.2019	Carrying value	Fair value	Unrealized gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	121,554	121,554	-
Loans to credit institutions	31,766	31,766	-
Loans to customers	812,481	816,455	3,974
Other financial assets	8,633	8,633	-
Financial assets not carried at fair value	974,434	978,408	3,974
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	8,292	8,292	-
Deposits	508,254	508,254	-
Borrowings	409,563	422,686	(13,123)
Subordinated liabilities	15,042	15,121	(79)
Other financial liabilities	11,395	11,395	-
Financial liabilities not carried at fair value	952,546	965,748	(13,202)

31.12.2018			
Financial assets not carried at fair value			
Cash and balances with Central Bank	83,139	83,139	-
Loans to credit institutions	56,322	56,322	-
Loans to customers	829,014	837,153	3,327
Other financial assets	5,807	5,807	-
Financial assets not carried at fair value	974,282	982,421	3,327
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	9,204	9,204	-
Deposits	466,067	466,067	-
Borrowings	417,782	426,390	(8,608)
Subordinated liabilities	6,532	6,454	78
Other financial liabilities	6,130	6,130	-
Financial liabilities not carried at fair value	905,715	914,245	(8,530)

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.

Amounts are in ISK millions

25. Fair value hierarchy, continued

Derivatives	Notional	Fair value	
30.9.2019	value	Assets	Liabilities
Forward exchange rate agreements	35,013	213	374
Fair value hedge of interest rate swap	148,610	3,088	-
Interest rate and exchange rate agreements	67,001	989	1,316
Bond swap agreements	9,494	9	114
Share swap agreements	405	1,944	222
Options - purchased agreements	10,202	1	4
Derivatives	270,725	6,244	2,030
31.12.2018			
Forward exchange rate agreements	60,940	901	406
Fair value hedge of interest rate swap	146,520	1,221	-
Interest rate and exchange rate agreements	109,698	2,749	1,252
Bond swap agreements	7,526	18	45
Share swap agreements	7,455	1,340	84
Options - purchased agreements	834	12	8
Derivatives	332,973	6,241	1,795

Fair value hedge of interest rate swap

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, with identical cash flows to the borrowings. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate euro bonds, see Note 33, arising from changes in interest rates. On 1 January 2018 the Group adopted 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 58 in the Annual Financial Statements 2018.

					Gain/loss
	Notional	Maturity	Fair value		on FV
30.9.2019		date	Assets	Liabilities	changes
Interest rates swaps - EUR	108,080	1-5 years	3,005	-	43
Interest rates swaps - EUR	40,530	6-12 months	83	-	101
31.12.2018					
Interest rates swaps - EUR	146,520	1-5 years	1,221	-	1,182

		Accumulated		Gain/loss
	Book	fair value		on FV
30.9.2019	value	Assets	Liabilities	changes
EUR 500 million - issued 2016/18 - 5 years	68,262	43	-	(102)
EUR 300 million - issued 2017 - 3 years	40,583	-	13	9
EUR 300 million - issued 2018 - 3 years	41,569	-	1,063	(48)
Hedged borrowings	150,414	43	1,076	(141)
31.12.2018				
EUR 500 million - issued 2016/18 - 5 years	65,845	640	-	(161)
EUR 300 million - issued 2017 - 3 years	40,034	1	-	(19)
EUR 300 million - issued 2018 - 3 years	40,328	-	343	(329)
Hedged borrowings	146,207	641	343	(509)

The effectiveness of each hedge is measured regularly with linear regression. The relationship between fair value changes of an interest rate swap on the one hand and a borrowing on the other hand is examined. In all cases the effectiveness is within limits, or between 93-105%.

Amounts are in ISK millions

26. 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				
30.9.2019	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	13,046	(189)	12,857	(10,872)	-	1,985	-	12,857
Derivatives	4,054	-	4,054	(906)	-	3,148	2,190	6,244
Total assets	17,100	(189)	16,911	(11,778)	-	5,133	2,190	19,101
31.12.2018								
Reverse repurchase agreements	12,026	(50)	11,976	(10,387)	-	1,589	-	11,976
Derivatives	4,082	-	4,082	(840)	-	3,242	2,159	6,241
Total assets	16,108	(50)	16,058	(11,227)	-	4,831	2,159	18,217

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the Balance Sheet				
30.9.2019	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	11,061	(189)	10,872	(10,872)	-	-	-	10,872
Derivatives	960	-	960	(906)	-	54	1,070	2,030
Total liabilities	12,021	(189)	11,832	(11,778)	-	54	1,070	12,902
31.12.2018								
Repurchase agreements	10,437	(50)	10,387	(10,387)	-	-	-	10,387
Derivatives	878	-	878	(840)	-	38	917	1,795
Total liabilities	11,315	(50)	11,265	(11,227)	-	38	917	12,182

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

27. Investments in associates

The Group's interest in its principal associates	30.9.2019	31.12.2018
Audkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	25.4%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	-	35.8%
JCC ehf., Borgartún 19, Reykjavík, Iceland	33.3%	33.3%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	20.0%	20.0%
220 Fjördur ehf., Fjardargata 13-15, Hafnarfjördur, Iceland	37.4%	37.4%

Investments in associates

Carrying amount at the beginning of the year	818	760
Acquisitions	19	85
Transfers to assets held for sale	-	(55)
Disposals	(739)	-
Share of profit of associates and profit from sale	750	27
Investment in associates	848	818

In March 2019 Arion Bank sold its entire shareholding in Farice ehf. The sale generated a profit of ISK 732 million and is recognized in the Consolidated Interim Income Statement.

Amounts are in ISK millions

28. Intangible assets

Intangible assets comprise the 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 acquired (i.e. software licenses).

Infrastructure, which is capitalized as an intangible asset, is related to the asset management operation and branding of the insurance operation. The business activity is based on years of developing 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. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The lifetime of these agreements is based on the experience of the Group and the industry. As a result, these 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 and bringing the software into service. Expenditure on internally developed software is recognized as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and when it can reliably measure the costs to complete the development. The capitalized costs of internally developed software include external expenses directly attributable to developing the software and salary and salary related expenses of implementation of core systems. Capitalized costs of software are amortized over its useful life. Computer software licenses and internally developed software 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 6-15 years and undefined	Finite 3-10 years
Amortization method	Impairment test	Straight-line basis over 6-15 years and impairment test	Straight-line basis over 3-10 years
Internally generated or acquired	Acquired	Acquired	Acquired and internally generated

30.9.2019	Goodwill	Infra- structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	669	2,383	787	2,558	6,397
Additions	-	-	-	1,936	1,936
Additions, capitalized salaries	-	-	-	317	317
Amortization	-	-	(45)	(517)	(562)
Intangible assets	669	2,383	742	4,294	8,088

31.12.2018	Goodwill	Infra- structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	4,315	3,705	1,492	4,336	13,848
Additions	-	-	-	1,372	1,372
Transfers to assets and disposal groups held for sale	(3,646)	(1,322)	(445)	(2,645)	(8,058)
Amortization	-	-	(260)	(505)	(765)
Intangible assets	669	2,383	787	2,558	6,397

Goodwill is recognized in the segment Subsidiaries and other divisions, see Note 6.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

29. Tax assets and tax liabilities

	30.9.2019		31.12.2018	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	3,193	-	4,650
Deferred tax	1	573	90	469
Tax assets and tax liabilities	1	3,766	90	5,119

30. Assets and disposal groups held for sale and associated liabilities

Assets and disposal groups held for sale	30.9.2019	31.12.2018
Valitor Holding hf.	36,966	40,003
Eignabjarg ehf., a holding company of Stakksberg ehf. and Sólbjarg ehf.	13,363	6,516
Disposal groups held for sale	50,329	46,519
Real estate	1,787	2,021
Other assets	48	44
Assets and disposal groups held for sale	52,164	48,584

Liabilities associated with disposal groups held for sale		
Valitor Holding hf.	22,811	26,337
Eignabjarg ehf., a holding company of Stakksberg ehf. and Sólbjarg ehf.	6,866	-
Liabilities associated with disposal groups held for sale	29,677	26,337

For further information about Valitor Holding hf., see Note 5.

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

Sólbjarg ehf., a subsidiary of Eignabjarg ehf.

On 20 June 2019 Arion Bank acquired all shares in TravelCo hf. (hereafter "TravelCo" or the "Company") following the enforcement of pledges . Sólbjarg ehf, of which the Bank is the beneficial owner, is the holding company of TravelCo. TravelCo was established following the collapse of Primera Air ehf. and Primera Travel Group hf. and owns and runs tour operators in Scandinavia and Iceland. This action primarily represents a change in ownership and does not affect the daily operations or services of the tour operators which remain unchanged. Arion Bank's goal in acquiring the company was to safeguard the continued operation of the tour operators as well as the Bank's interests. Arion Bank is in the process of divesting all of the Bank's shareholding in TravelCo and the company is therefore classified as held for sale in accordance with IFRS 5.

Stakksberg ehf., a subsidiary of Eignabjarg ehf.

On 22 January 2018 United Silicon was declared bankrupt following serious operational problems which resulted in its operating license being temporarily suspended, following a failed attempt at reaching a composition arrangement 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 38. The assets of the silicon plant are currently managed by Stakksberg ehf., which is held by the Bank through the 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, with measures including the securing of 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. Stakksberg ehf. is currently engaged in the final stages of concluding a new environmental impact assessment for the plant. The proposed remedial actions fully fit within the scope of the current local plan for Stakksberg's plot in Helguvík. Nevertheless Reykjanesbær will be required to amend the current local plan to reflect building licenses which have already been issued by Reykjanesbær. The Bank's objective is to divest Stakksberg ehf. on the basis of this preparatory work. Stakksberg is therefore classified as held for sale in accordance with IFRS 5.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

31. Other assets

	30.9.2019	31.12.2018
Property and equipment	5,363	5,797
Right of use asset	911	-
Accounts receivable	3,705	3,751
Unsettled securities trading	3,705	92
Investment for life assurance policyholders where risk is held by policyholder	962	833
Sundry assets	2,705	3,029
Other assets	17,351	13,502

Right of use asset

Addition due to the adoption of IFRS 16 Leases 1 January 2019	984	-
Indexation	23	-
Depreciation	(96)	-
Right of use asset	911	-

Right of use asset consists of real estates for own use.

32. Other liabilities

	30.9.2019	31.12.2018
Accounts payable	1,457	633
Unsettled securities trading	4,602	34
Depositors' and Investors' Guarantee Fund	170	226
Technical provision	15,151	13,324
Technical provision for life assurance policyholders were investment risk is held by policyholder	962	833
Withholding tax	237	1,590
Bank levy	6,013	3,386
Accrued expenses	3,887	3,018
Prepaid income	1,473	1,599
Impairment of off balance items	389	717
Lease liability	920	-
Sundry liabilities	4,949	4,747
Other liabilities	40,210	30,107

Technical provision	Technical provision	Reinsurers' share	Total 30.9.2019	Technical provision	Reinsurers' share	Total 31.12.2018
Claims reported and loss adjustment expenses	7,747	120	7,867	6,871	(192)	6,679
Claims incurred but not reported	1,303	113	1,416	1,193	(113)	1,080
Claims outstanding	9,050	233	9,283	8,064	(305)	7,759
Provision for unearned premiums	6,101	5	6,106	5,260	(3)	5,257
Own technical provision	15,151	238	15,389	13,324	(308)	13,016

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.

Lease liability	30.9.2019	31.12.2018
Addition due to the adoption of IFRS 16 Leases 1 January 2019	984	-
Indexation	18	-
Interest expense	34	-
Lease payments	(116)	-
Lease liability	920	-

Amounts are in ISK millions

33. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	30.9.2019	31.12.2018
ARION CBI 19, ISK 4,500 million	2013	2019	At maturity	Fixed, CPI linked, 2.50%	-	4,743
ARION CB 19, ISK 2,740 million	2016	2019	At maturity	Fixed, 5.50%	1,361	1,746
ARION CBI 21, ISK 10,220 million	2014	2021	At maturity	Fixed, CPI linked, 3.50%	10,231	9,950
ARION CB 22, ISK 28,720 million	2015	2022	At maturity	Fixed, 6.50%	28,051	28,503
ARION CB 24 ISK 19,240 million	2019	2024	At maturity	Fixed, 6.00%	16,318	-
ARION CBI 25, ISK 37,940 million	2017	2025	At maturity	Fixed, CPI linked, 3.00%	40,303	39,333
ARION CBI 26 ISK 12,960 million	2019	2026	At maturity	Fixed, CPI linked, 2.00%	12,332	-
ARION CBI 29, ISK 25,220 million	2014	2029	At maturity	Fixed, CPI linked, 3.50%	27,782	27,029
ARION CBI 48 ISK 11,680 million	2018	2048	Amortizing	Fixed, CPI linked, 2.50%	10,515	10,606
Statutory covered bonds					146,893	121,910
ARION CB 2, ISK 51,125 million	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	61,713	79,399
Structured Covered bonds					61,713	79,399
Total Covered bonds					208,606	201,309
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	-	19,376
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	-	1,037
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	-	3,601
SEK 100 million	2017	2019	At maturity	Fixed, 0.29%	-	1,310
NOK 800 million	2015	2020	At maturity	Floating, NIBOR +2.95%	11,026	10,846
NOK 320 million	2016	2020	At maturity	Floating, NIBOR +1.95%	4,394	4,326
EUR 300 million *	2017	2020	At maturity	Fixed, 0.75%	40,583	40,034
SEK 300 million	2017	2020	At maturity	Floating, 3 month STIBOR +1.35%	3,790	3,936
SEK 250 million	2017	2020	At maturity	Floating, 3 month STIBOR +0.75%	3,151	3,276
EUR 500 million *	2016	2021	At maturity	Fixed, 1.625%	68,262	65,845
EUR 13 million	2019	2021	At maturity	Floating, 3. EURIBOR +0.58%	1,757	-
NOK 750 million	2019	2022	At maturity	Floating, NIBOR +1.82%	10,275	-
SEK 150 million	2019	2022	At maturity	Floating, 3 month STIBOR +1.33%	1,895	-
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,452	3,423
EUR 300 million *	2018	2023	At maturity	Fixed, 1.00%	41,569	40,328
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,457	3,432
Senior unsecured bonds					193,611	200,770
Bills issued					7,149	15,505
Other borrowings					197	198
Other loans / bills					7,346	15,703
Borrowings					409,563	417,782

* 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 25.

The book value of listed bonds was ISK 402 billion at the end of the period (31.12.2018: ISK 402 billion). The market value of those bonds was ISK 415 billion (31.12.2018: ISK 411 billion). The Group repurchased own debts during the period for the amount of ISK 3 billion (2018: ISK 22 billion) with minor effects on the Consolidated Interim Income Statement.

34. Subordinated liabilities

Currency, original nominal value	Issued	Maturity	Maturity type	Terms of interest	30.9.2019	31.12.2018
SEK 500 million *	2018	2028	At maturity	Floating, 3 month STIBOR +3.10% .	6,291	6,532
ARION T2I 30 ISK 3.020 million	2019	2030	At maturity	Fixed, CPI linked, 3.875%	3,039	-
ARION T2 30 ISK 880 million	2019	2030	At maturity	Fixed, 6.75%	892	-
NOK 300 million	2019	2029	At maturity	Floating, NIBOR +3.65%	4,139	-
EUR 5 million	2019	2031	At maturity	Fixed, 3.24%	681	-
Subordinated liabilities					15,042	6,532

* The notes are eligible as Tier 2 capital under the Icelandic Financial Undertakings Act No. 161/2002. The notes are callable by the issuer on 22 November 2023 and on every interest payment date thereafter.

Amounts are in ISK millions

35. Pledged assets

Pledged assets against liabilities	30.9.2019	31.12.2018
Assets, pledged as collateral against borrowings	251,875	239,164
Assets, pledged as collateral against loans from credit institutions and short positions	6,540	5,927
Pledged assets against liabilities	258,415	245,091

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 252 billion at the end of the period (31.12.2018: ISK 239 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 209 billion at the end of the period (31.12.2018: ISK 201 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.

36. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 1,814 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.

	Share capital	Share premium	30.9.2019	Share capital	Share premium	31.12.2018
Shares outstanding at the beginning of the year	1,814	57,196	59,010	2,000	73,861	75,861
Purchase of treasury stock	-	-	-	(190)	(16,949)	(17,139)
Employees stock grant	-	(10)	(10)	4	284	288
Shares outstanding at the end of the period	1,814	57,186	59,000	1,814	57,196	59,010
Own shares at period-end	-			186		
- as proportion of issud share capital	-			9.3%		

Share premium is the amount above nominal value that shareholders have paid for shares issued by Arion Bank hf. At the Annual General Meeting of Arion Bank hf. on 20 March 2019 a motion was passed to reduce the company's share capital by ISK 186 million at nominal value, by cancelling the company's own shares. The reduction took place in April 2019. The company's share capital was reduced from ISK 2,000 million to ISK 1,814 million at nominal value, divided into an equal number of shares and with one vote attached to each share. The meeting also authorized the Board of Directors to acquire, on behalf of the Bank, up to 10% of issued share capital in the Bank. The authorization remains in effect until the Bank's Annual General Meeting in 2020 or 15 September 2020, whichever occurs first. In September 2019 the Board of Directors approved to authorize the management of the Bank to initiate share buy-back programs in Iceland and Sweden to purchase own shares.

In 2018 Arion Bank acquired own shares following the decision to accept an offer from Kaupskil ehf., a subsidiary of Kaupthing ehf., to buy back 9.5% of issued share capital in Arion Bank, or 190 million shares. Arion Bank paid ISK 90.087 a share, a total of ISK 17,139 million.

According to a decision made by the Board of Directors, own shares were allocated to employees in connection with the Bank's IPO and listing in 2018. In total approximately 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees' stock grant programme, an employee who resigns within the vesting period of two years, returns the shares to the Bank.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Other information

37. Shareholders of Arion Bank

	30.9.2019	31.12.2018
Taconic Capital (through TCA New Sidecar s.á.r.l.)	23.53%	9.99%
Sculptor Capital Management	9.25%	6.58%
Gildi lífeyrissjódur	6.78%	2.52%
Lansdowne partners	5.02%	2.95%
Stodir hf.	4.96%	0.61%
Goldman Sachs International	3.74%	3.47%
Lífeyrissjódur starfsmanna ríkisins	3.58%	0.53%
Eaton Vance funds	3.19%	3.35%
Lífeyrissjódur verzlunarmanna	2.73%	0.38%
Íslandsbanki hf.	2.51%	0.88%
Stefnir rekstrarfélag hf.	2.46%	0.51%
Frjálsi lífeyrissjódurinn	2.02%	0.09%
Stapi Lífeyrissjódur	1.81%	1.37%
Artemis	1.52%	1.69%
Hvalur hf.	1.45%	0.00%
MainFirst Bank AG	1.09%	0.63%
Birta lífeyrissjódur	1.05%	0.21%
Landsbankinn hf.	1.04%	0.64%
Júpíter rekstrarfélag hf.	1.02%	0.99%
Arion banki hf.	0.02%	9.31%
Attestor Capital	0.00%	7.35%
Miton Asset Management funds	0.00%	1.37%
Kaupskil ehf. (subsidiary of Kaupthing hf.)	0.00%	32.67%
Other shareholders with less than 1% shareholding	21.23%	11.92%
	100.00%	100.00%

At year end 2018 Kaupskil ehf. was the largest shareholder of Arion Bank with a shareholding of 32.67% and Taconic Capital the second largest shareholder with a 9.99% shareholding. In 2019 Kaupskil ehf. sold its entire shareholding to a group of international and domestic investors. Taconic Capital increased its shareholding in 2019 to 23.53% and is at period end the largest shareholder of Arion Bank.

38. 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 one of the cases. 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 District Court acquitted the Bank of all claims with a judgment in September 2018. The plaintiffs have appealed the judgment to the Court of Appeal. A conclusion is expected before the end of the year. The second case awaits the result of this first case. The Bank believes that it will be acquitted of the plaintiffs' claims in both cases and has therefore not made any provision.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

38. Legal matters, continued

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, claiming damages in the amount of ISK 922 million plus interest from the same defendants. The Court of Appeal dismissed the case 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. In November 2018 EC-Clear brought a new lawsuit against the same defendants regarding the same matter of dispute, demanding the acknowledgement of liability for damages. EC-Clear was the largest shareholder in Kortathjónustan and according to the writ EC-Clear is now the owner of alleged liability claims against the defendants. The District Court dismissed the case in February 2019. EC-Clear appealed the dismissal to the Court of Appeal, which dismissed the case with a ruling in April 2019. In October 2019 EC-Clear brought a new lawsuit against the same defendants regarding the same matter of dispute, claiming damages in the amount of ISK 922 million plus interest from the same defendants, and demanding the acknowledgement of liability for damages. Should the defendants be found liable for damages, they would be jointly responsible. Therefore the Bank has not made any provision.

Other legal matters

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 secured 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. A hearing has not yet been scheduled. 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.

39. Events after the reporting period

No event has arisen after the reporting period and up to the approval of these Consolidated Interim Financial Statements that require additional disclosures.

Notes to the Condensed Consolidated Interim Financial Statements

Off balance sheet information

40. Commitments

Financial guarantees, unused credit facilities and undrawn loan commitments	30.9.2019	31.12.2018
Financial guarantees	15,491	15,124
Unused overdrafts	45,405	48,320
Undrawn loan commitments	72,258	79,130
Financial guarantees, unused credit facilities and undrawn loan commitments	133,154	142,574

41. Assets under management and under custody

Assets under management	1,056,735	970,633
Assets under custody	1,484,639	1,422,327

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.

Related party

42. Related party

The Group has a related party relationship with entities with an influence over the Group as the largest shareholders of Arion Bank, which are on 30 September 2019 Taconic Capital (23.53%) and Sculptor Capital Management (9.25%). On 31 December 2018 Kaupskil ehf. (32.67%) and Taconic Capital (9.99%), the Board of Directors of Kaupskil ehf. and Kaupthing ehf., being the parent company of Kaupskil ehf. and legal entities controlled by them, were defined as related parties.

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

30.9.2019	Assets	Liabilities	Net balance
Board of Directors and key Management personnel	155	(488)	(333)
Associates and other related parties	-	(15)	(15)
Balances with related parties	155	(503)	(348)

31.12.2018			
Shareholders with control over the Group	70	(1,022)	(952)
Board of Directors and key Management personnel	246	(257)	(11)
Associates and other related parties	21	(71)	(50)
Balances with related parties	337	(1,350)	(1,013)

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 on risk management and capital adequacy is provided in the Annual Financial Statements for 2018 and in the Pillar 3 Risk Disclosures for 2018. The Pillar 3 Risk Disclosures 2018 are available on the Bank's website, www.arionbanki.is.

43. 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 derivatives, 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 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. The quality of collateral is evaluated in the lending process with regards to specialization, location, age and condition and possibilities for reuse.

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 values are capped by the related exposure amount. Comparative figures have not been updated.

Notes to the Condensed Consolidated Interim Financial Statements

43. 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

		Collateral				
30.9.2019	Maximum exposure	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	121,554	-	-	-	-	-
Loans to credit institutions	31,766	-	-	-	-	-
Loans to customers at amortized cost	812,481	18,562	590,183	58,880	71,455	739,080
Individuals	*408,925*	*200*	*369,480*	*13*	*11,122*	*380,815*
Corporates	*403,556*	*18,362*	*220,703*	*58,867*	*60,333*	*358,265*
Real estate activities and construction	*132,264*	*2,237*	*124,290*	*54*	*2,741*	*129,322*
Fishing industry	*81,181*	*22*	*12,706*	*58,414*	*7,869*	*79,011*
Information and communication technology	*19,030*	*324*	*3,630*	-	*4,627*	*8,581*
Wholesale and retail trade	*56,104*	*213*	*26,260*	*4*	*24,109*	*50,586*
Financial and insurance activities	*30,872*	*15,433*	*5,839*	-	*4,869*	*26,141*
Industry, energy and manufacturing	*41,013*	*82*	*29,043*	-	*7,344*	*36,469*
Transportation	*11,381*	*1*	*1,015*	*313*	*3,062*	*4,391*
Services	*17,333*	*43*	*8,669*	*82*	*5,182*	*13,976*
Public sector	*6,946*	*7*	*2,242*	-	*303*	*2,552*
Agriculture and forestry	*7,432*	-	*7,009*	-	*227*	*7,236*
Other assets with credit risk	8,633	-	-	-	-	-
Financial guarantees	15,491	1,882	7,007	1,548	2,846	13,283
Undrawn loan commitments and unused overdrafts	117,663	-	-	-	-	-
Fair value through OCI	97,787	-	-	-	-	-
Government bonds	*83,688*	-	-	-	-	-
Corporate and finance bonds	*14,099*	-	-	-	-	-
Balance at the end of the period	1,205,375	20,444	597,190	60,428	74,301	752,363
31.12.2018						
Cash and balances with Central Bank	83,139	-	-	-	-	-
Loans to credit institutions	56,322	-	-	-	-	-
Loans to customers at amortized cost	829,014	18,324	590,513	59,143	83,469	751,449
Individuals	*400,483*	*837*	*363,615*	*18*	*11,027*	*375,497*
Corporates	*428,531*	*17,487*	*226,898*	*59,125*	*72,442*	*375,952*
Real estate activities and construction	*140,955*	*1,280*	*136,935*	*22*	*2,484*	*140,721*
Fishing industry	*84,128*	*11*	*9,452*	*57,978*	*10,771*	*78,212*
Information and communication technology	*20,635*	*550*	*3,562*	-	*6,618*	*10,730*
Wholesale and retail trade	*65,824*	*349*	*29,196*	*15*	*29,257*	*58,817*
Financial and insurance activities	*38,806*	*15,152*	*6,470*	*685*	*9,001*	*31,308*
Industry, energy and manufacturing	*35,406*	*61*	*23,801*	-	*7,520*	*31,382*
Transportation	*11,958*	*17*	*1,055*	*307*	*1,673*	*3,052*
Services	*16,531*	*64*	*7,407*	*118*	*4,535*	*12,124*
Public sector	*6,829*	*3*	*2,031*	-	*315*	*2,349*
Agriculture and forestry	*7,459*	-	*6,989*	-	*268*	*7,257*
Other assets with credit risk	5,807	-	-	-	-	-
Financial guarantees	15,124	1,574	4,408	1,949	4,652	12,583
Undrawn loan commitments and unused overdrafts	127,450	-	-	-	-	
Fair value through OCI	53,788	-	-	-	-	
Government bonds	*44,084*	-	-	-	-	-
Corporate and finance bonds	*9,704*	-	-	-	-	-
Balance at the end of the period	1,224,432	19,898	594,921	61,092	88,121	764,032

Amounts are in ISK millions

43. 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 appraisal or official property valuation from the Icelandic Property Registry. For credit impaired loans the value of collateral is based on the most recent appraisal.

	30.9.2019		31.12.2018	
	Gross carrying amount	Thereof credit impaired	Gross carrying amount	Thereof credit impaired
Less than 50%	137,717	1,390	148,995	1,516
50-70%	129,105	2,760	132,893	2,499
70-90%	76,886	1,306	58,422	1,209
90-100%	13,818	378	12,773	482
100%-110%	5,287	142	3,904	97
More than 110%	10,625	821	9,543	656
Not classified	-	-	6	-
Balance at the end of the period	373,438	6,797	366,536	6,459

At the end of the period the gross carrying amount of assets in stage 3 are ISK 20,130 million (31.12.2018: ISK 18,175 million) with ISK 13,376 million in collateral (31.12.2018: ISK 12,881 million), there of ISK 11,183 million in real estates (31.12.2018: 11,045 million).

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 464 million (31.12.2018: ISK 827 million) and in other assets ISK 17 (31.12.2018: ISK 31 million). The assets are held for sale, see Note 30.

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 maintaining 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 57 in the Annual Financial Statements 2018.

The following tables 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.

Amounts are in ISK millions

43. Credit risk, continued

Credit quality profile by rating class

30.9.2019	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI
Loans to credit institutions, securities and cash			
Investment grade	121,554	31,477	97,787
Non-investment grade	-	311	-
Gross carrying amount	121,554	31,788	97,787
Loss allowance	-	(22)	(8)
Book value	121,554	31,766	97,779

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 0 to 1 (Grades AAA to BBB-)	318,909	95	-	40	319,044
Risk class 2 (Grades BB+ to BB-)	242,605	43,870	-	-	286,475
Risk class 3 (Grades B+ to B-)	120,609	42,884	-	6	163,499
Risk class 4 (Grades CCC+ to CCC-)	14,286	15,330	-	189	29,805
Risk class 5 (DD)	-	-	20,130	522	20,652
Unrated	2,390	210	-	-	2,600
Gross carrying amount	698,799	102,389	20,130	757	822,075
Loss allowance	(1,240)	(1,094)	(7,053)	(207)	(9,594)
Book value	697,559	101,295	13,077	550	812,481
Loans to customers - Individuals					
Risk class 0 to 1 (Grades AAA to BBB-)	218,867	-	-	40	218,907
Risk class 2 (Grades BB+ to BB-)	128,610	7,476	-	-	136,086
Risk class 3 (Grades B+ to B-)	30,029	4,709	-	6	34,744
Risk class 4 (Grades CCC+ to CCC-)	5,969	7,592	-	189	13,750
Risk class 5 (DD)	-	-	7,756	522	8,278
Unrated	241	2	-	-	243
Gross carrying amount	383,716	19,779	7,756	757	412,008
Loss allowance	(685)	(369)	(1,822)	(207)	(3,083)
Book value	383,031	19,410	5,934	550	408,925
Loans to customers - Companies and sovereign					
Risk class 0 to 1 (Grades AAA to BBB-)	100,042	95	-	-	100,137
Risk class 2 (Grades BB+ to BB-)	113,995	36,394	-	-	150,389
Risk class 3 (Grades B+ to B-)	90,580	38,175	-	-	128,755
Risk class 4 (Grades CCC+ to CCC-)	8,317	7,738	-	-	16,055
Risk class 5 (DD)	-	-	12,374	-	12,374
Unrated	2,149	208	-	-	2,357
Gross carrying amount	315,083	82,610	12,374	-	410,067
Loss allowance	(555)	(725)	(5,231)	-	(6,511)
Book value	314,528	81,885	7,143	-	403,556

Loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Risk class 0 to 1 (Grades AAA to BBB-)	57,878	1	-	57,879
Risk class 2 to 4 (Grades BB+ to CCC-)	54,288	10,955	1,726	66,969
Unrated	8,173	133	-	8,306
Gross carrying amount	120,339	11,089	1,726	133,154
Loss allowance	(258)	(252)	(40)	(550)
Book value	120,081	10,837	1,686	132,604

Amounts are in ISK millions

43. Credit risk, continued

31.12.2018	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI
Loans to credit institutions, securities and cash			
Investment grade	83,141	55,954	53,795
Non-investment grade	-	403	-
Gross carrying amount	83,141	56,357	53,795
Loss allowance	(2)	(35)	(7)
Book value	83,139	56,322	53,788

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 0 to 1 - (Grades AAA to BBB-)	370,832	78	-	-	370,910
Risk class 2 - (Grades BB+ to BB-)	265,361	18,521	-	41	283,923
Risk class 3 - (Grades B+ to B-)	107,897	24,582	-	87	132,566
Risk class 4 - (Grades CCC+ to CCC-)	15,287	11,318	-	48	26,653
Risk class 5 - (DD)	-	-	18,175	3,640	21,815
Unrated	1,977	1,061	-	-	3,038
Gross carrying amount	761,354	55,560	18,175	3,816	838,905
Loss allowance	(1,415)	(931)	(6,301)	(1,244)	(9,891)
Book value	759,939	54,629	11,874	2,572	829,014
Loans to customers - Individuals					
Risk class 0 to 1 (Grades AAA to BBB-)	222,003	-	-	-	222,003
Risk class 2 (Grades BB+ to BB-)	118,271	4,831	-	41	123,143
Risk class 3 (Grades B+ to B-)	32,562	3,255	-	87	35,904
Risk class 4 (Grades CCC+ to CCC-)	8,368	5,390	-	48	13,806
Risk class 5 (DD)	-	-	8,467	815	9,282
Unrated	32	3	-	-	35
Gross carrying amount	381,236	13,479	8,467	991	404,173
Loss allowance	(739)	(311)	(2,408)	(233)	(3,691)
Book value	380,497	13,168	6,059	758	400,482
Loans to customers - Companies and sovereign					
Risk class 0 to 1 (Grades AAA to BBB-)	148,829	78	-	-	148,907
Risk class 2 (Grades BB+ to BB-)	147,090	13,690	-	-	160,780
Risk class 3 (Grades B+ to B-)	75,335	21,327	-	-	96,662
Risk class 4 (Grades CCC+ to CCC-)	6,919	5,928	-	-	12,847
Risk class 5 (DD)	-	-	9,708	2,825	12,533
Unrated	1,945	1,058	-	-	3,003
Gross carrying amount	380,118	42,081	9,708	2,825	434,732
Loss allowance	(676)	(620)	(3,893)	(1,011)	(6,200)
Book value	379,442	41,461	5,815	1,814	428,532

Loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Risk class 0 to 1 - (Grades AAA to BBB-)	78,151	1	-	78,152
Risk class 2 to 4 - (Grades BB+ to CCC-)	55,751	6,589	1,676	64,016
Unrated	368	38	-	406
Gross carrying amount	134,270	6,628	1,676	142,574
Loss allowance	(147)	(485)	(57)	(689)
Book value	134,123	6,143	1,619	141,885

Amounts are in ISK millions

43. Credit risk, continued

The following tables reconciles the opening and closing allowance balance for loans to customers at amortized cost and loan commitments, guarantees and unused credit facilities 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, impairment of interest income due to impaired debt instruments 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 period there were no significant changes to the models used to estimate expected credit loss.

During the reporting period changes were made to the probability weights of the different macro-economic scenarios used for impairment calculations to reflect the expected development of unemployment over the next years. The updated probability weights are based on the newly revised economic outlook from Arion Bank's Research Department.

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*Impairment loss allowance **	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	1,607	1,416	6,358	1,244	10,625
Transfers of financial assets:					
Transfers to Stage 1 (12-month ECL)	1,639	(1,283)	(356)	-	-
Transfers to Stage 2 (lifetime ECL)	(514)	603	(89)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(100)	(1,031)	1,131	-	-
Net remeasurement of loss allowance **	(1,404)	1,728	1,873	642	2,839
New financial assets, originated or purchased	794	242	1,485	-	2,521
Derecognitions and maturities	(467)	(325)	(1,613)	(1,675)	(4,080)
Write-offs ***	(19)	(9)	(1,757)	(96)	(1,881)
Foreign exchange difference	7	5	61	92	165
Impairment loss allowance ****	1,543	1,346	7,093	207	10,189
Impairment loss allowances for assets only carrying 12-month ECL	30	-	-	-	30
Total Impairment loss allowance	1,573	1,346	7,093	207	10,219

* These amounts are a combination of all impairments, including an allowance for loan commitments and guarantees presented as a liability in these Financial Statements.

** During the reporting period the loss allowance balance for stage 3 loans was raised by ISK 581 million due to unwinding of interest income.

*** During the reporting period an amount of ISK 1.815 million was written off but is still subject to enforcement activities subject to Icelandic law.

**** Loss allowance for all assets other than cash, bonds and loans to credit institutions.

Impairment loss allowance for loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	1,415	931	6,301	1,244	9,891
Transfers of financial assets					
Transfers to Stage 1 (12-month ECL)	1,436	(1,080)	(356)	-	-
Transfers to Stage 2 (lifetime ECL)	(474)	563	(89)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(98)	(575)	673	-	-
Net remeasurement of loss allowance	(1,274)	1,342	1,471	642	2,181
New financial assets, originated or purchased	475	69	1,459	-	2,003
Derecognitions and maturities	(231)	(145)	(705)	(1,675)	(2,756)
Write-offs	(17)	(6)	(1,757)	(96)	(1,876)
Foreign exchange differences	8	(5)	56	92	151
Total loss allowance for loans to customers	1,240	1,094	7,053	207	9,594

Amounts are in ISK millions

43. Credit risk, continued

30.9.2019

Impairment loss allowance for loans to customers - Individuals	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	740	313	2,406	232	3,691
Transfers of financial assets					
Transfers to Stage 1 (12-month ECL)	811	(637)	(174)	-	-
Transfers to Stage 2 (lifetime ECL)	(258)	329	(71)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(70)	(326)	396	-	-
Net remeasurement of loss allowance	(632)	747	200	67	382
New financial assets, originated or purchased	199	2	10	-	211
Derecognitions and maturities	(88)	(54)	(174)	-	(316)
Write-offs	(17)	(6)	(786)	(93)	(902)
Foreign exchange differences	-	1	15	1	17
Total loss allowance for individuals	685	369	1,822	207	3,083

Impairment loss allowance for loans to customers - Companies and sovereign	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	675	618	3,895	1,012	6,200
Transfers of financial assets					
Transfers to Stage 1 (12-month ECL)	625	(443)	(182)	-	-
Transfers to Stage 2 (lifetime ECL)	(216)	234	(18)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(28)	(249)	277	-	-
Net remeasurement of loss allowance	(642)	595	1,271	575	1,799
New financial assets, originated or purchased	276	67	1,449	-	1,792
Derecognitions and maturities	(143)	(91)	(531)	(1,675)	(2,440)
Write-offs	-	-	(971)	(3)	(974)
Foreign exchange differences	8	(6)	41	91	134
Total loss allowance for companies and sovereign	555	725	5,231	-	6,511

Impairment loss allowance for loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Balance at the beginning of the year	147	485	57	689
Transfers				
Transfers to 12-month ECL	203	(203)	-	-
Transfers to lifetime ECL	(40)	40	-	-
Transfers to credit impaired	(2)	(456)	458	-
Net remeasurement of loss allowance	(130)	386	402	658
New financial commitments originated	319	173	26	518
Derecognitions and maturities	(236)	(180)	(908)	(1,324)
Write-offs	(2)	(3)	-	(5)
Foreign exchange differences	(1)	10	5	14
Total loss allowance for loan commit., guarantees and unused credit facilitis ...	258	252	40	550

Large exposures

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 and Regulation (EU) No 575/2013. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible credit risk mitigation.

The Group has one large exposure totalling ISK 23.6 billion (13.3% of eligible capital) at the end of the period, before taking into account eligible credit risk mitigation (31.12.2018: no large exposure). The total exposure is ISK 22.6 billion (12.7% of eligible capital) after taking into account eligible credit risk mitigation.

Amounts are in ISK millions

44. 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 market making 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 aims to manage and limit market exposures and imbalances between assets and liabilities in accordance with its strategic goals for net profit.

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 cash flow profile of which has been largely matched by that of the Group's structured covered bonds issues, which serves as a hedge against repricing risk. The Group has been able to manage relatively small interest fixing gaps.

Due to favorable refinancing spreads, prepayments and/or refinancing of loans have been considerable over the past few years, resulting in reduced average duration of fixed rates for the Bank's assets. 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 25, and are therefore different from the amounts shown in these Consolidated 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. The assets and liabilities of Valitor holding hf. are not included in the figures as they are classified as held for sale.

30.9.2019	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	117,204	-	-	-	-	117,204
Loans to credit institutions	31,766	-	-	-	-	31,766
Loans to customers	560,005	54,301	161,914	7,851	32,384	816,455
Financial instruments	40,140	23,662	28,215	1,449	4,341	97,807
Assets	749,115	77,963	190,129	9,300	36,725	1,063,232
Liabilities						
Due to credit institutions and Central Bank	8,292	-	-	-	-	8,292
Deposits	429,898	62,013	13,822	1,443	1,078	508,254
Borrowings	102,246	42,171	174,507	58,655	45,107	422,686
Subordinated loans	8,836	-	-	2,850	3,355	15,041
Liabilities	549,272	104,184	188,329	62,948	49,540	954,273
Derivatives and other off-balance sheet items (net position)	(148,666)	40,607	107,379	3,457	-	2,777
Net interest gap	51,177	14,386	109,179	(50,191)	(12,815)	111,736

Amounts are in ISK millions

44. Market risk, continued

31.12.2018	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Total assets	647,069	99,494	179,700	8,458	95,903	1,030,624
Total liabilities	(483,493)	(53,519)	(203,267)	(45,808)	(122,106)	(908,193)
Derivatives and other off-balance sheet items (net position)	(185,255)	40,259	150,397	(2,484)	-	2,917
Net interest gap	(21,679)	86,234	126,830	(39,834)	(26,203)	125,348

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 primarily based on contractual interest rate adjustments where it is simplistically assumed that all rates are equally sensitive to the presumed change in market rates. As of 30 September 2019, behavioral maturity assumptions are however applied for non-maturing deposits and a zero percentage floor is applied to krona deposit interest rates.

	30.9.2019		31.12.2018	
NPV change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(3,975)	4,986	(4,544)	4,872
ISK, Non index-linked	(138)	829	624	(139)
Foreign currencies	(24)	(10)	700	(708)
NII change				
ISK, CPI index-linked	(720)	707	(828)	828
ISK, Non index-linked	(1,224)	814	(90)	90
Foreign currencies	348	(348)	232	(232)

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.

	30.9.2019		31.12.2018	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	135	(118)	123	(111)
ISK, Non index-linked	175	(163)	62	(54)
Foreign currencies	(73)	70	13	(13)

Amounts are in ISK millions

44. Market risk, continued

Indexation risk

A significant part of the Group's balance sheet is linked to the Icelandic Consumer Price Index (CPI). For index-linked instruments, principal and interest payments are adjusted proportionally to 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. The imbalance has markedly decreased in the past year due to prepayments of indexed loans while indexed liabilities have increased.

Book value and maturity profile of indexed assets and liabilities

30.9.2019	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	15,488	68,017	246,277	329,782
Financial instruments	13,556	-	-	13,556
Assets, CPI index-linked	29,044	68,017	246,277	343,338
Liabilities, CPI index-linked				
Deposits	73,775	13,483	2,513	89,771
Borrowings	1,468	16,656	144,950	163,074
Subordinated liabilities	-	-	3,039	3,039
Other	873	210	1,439	2,522
Off-balance sheet position	1,026	6,635	145	7,806
Liabilities, CPI index-linked	77,142	36,984	152,086	266,212
Net on-balance sheet position	(47,072)	37,668	94,336	84,932
Net off-balance sheet position	(1,026)	(6,635)	(145)	(7,806)
CPI Balance	(48,098)	31,033	94,191	77,126

31.12.2018	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	30,455	79,761	246,605	356,821
Financial instruments	12,791	-	-	12,791
Off-balance sheet position	532	(995)	-	(463)
Assets, CPI index-linked	43,778	78,766	246,605	369,149
Liabilities, CPI index-linked				
Deposits	72,766	12,735	2,367	87,868
Borrowings	6,482	17,567	147,209	171,258
Other	875	208	1,420	2,503
Off-balance sheet position	895	4,999	1,082	6,976
Liabilities, CPI indexed linked	81,018	35,509	152,078	268,605
Net on-balance sheet position	(36,877)	49,251	95,609	107,983
Net off-balance sheet position	(363)	(5,994)	(1,082)	(7,439)
CPI Balance	(37,240)	43,257	94,527	100,544

Amounts are in ISK millions

44. Market risk, continued

Currency risk

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

Breakdown of assets and liabilities by currency

30.9.2019

Financial assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	120,137	511	327	154	109	53	263	121,554
Loans to credit institutions	2,174	11,280	9,904	723	1,429	1,954	4,302	31,766
Loans to customers	656,210	108,731	34,177	3,271	4,391	242	5,459	812,481
Financial instruments	65,611	28,235	43,571	35	46	24,244	39	161,781
Other financial assets	8,252	154	80	-	4	3	140	8,633
Financial assets	852,384	148,911	88,059	4,183	5,979	26,496	10,203	1,136,215
Financial liabilities								
Due to credit inst. and Central Bank	4,111	1,141	3,040	-	-	-	-	8,292
Deposits	418,079	37,704	42,881	1,968	2,242	3,185	2,195	508,254
Financial liabilities at fair value	1,298	566	268	63	-	62	38	2,295
Other financial liabilities	5,557	1,130	3,214	130	847	34	483	11,395
Borrowings	215,952	152,171	-	-	-	32,603	8,837	409,563
Subordinated liabilities	3,931	681	-	-	-	4,139	6,291	15,042
Financial liabilities	648,928	193,393	49,403	2,161	3,089	40,023	17,844	954,841
Net on-balance sheet position	203,456	(44,482)	38,656	2,022	2,890	(13,527)	(7,641)	
Net off-balance sheet position	(2,385)	35,008	(38,927)	(6,562)	(7,830)	13,162	7,534	
Net position	201,071	(9,474)	(271)	(4,540)	(4,940)	(365)	(107)	
Non-financial assets								
Investment property	7,121	-	-	-	-	-	-	7,121
Investments in associates	848	-	-	-	-	-	-	848
Intangible assets	8,088	-	-	-	-	-	-	8,088
Tax assets	1	-	-	-	-	-	-	1
Assets and disposal groups held for sale	23,899	16,145	976	6,263	3,932	238	711	52,164
Other non financial assets	8,243	171	28	263	(1)	11	3	8,718
Non-financial assets	48,200	16,316	1,004	6,526	3,931	249	714	76,940
Non-financial liabilities and equity								
Tax liabilities	3,766	-	-	-	-	-	-	3,766
Liabilities associated with disposal groups held for sale	16,343	8,725	82	2,181	1,028	335	983	29,677
Other non-financial liabilities	28,915	46	12	-	2	-	(160)	28,815
Shareholders' equity	195,926	-	-	-	-	-	-	195,926
Non-controlling interest	130	-	-	-	-	-	-	130
Non-financial liabilities and equity	245,080	8,771	94	2,181	1,030	335	823	258,314
Management reporting of currency risk *	4,191	(1,929)	639	(195)	(2,039)	(451)	(216)	

Amounts are in ISK millions

44. Market risk, continued

31.12.2018

	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Financial assets	824,049	152,259	74,734	5,713	8,519	18,126	10,251	1,093,651
Financial liabilities	(628,862)	(203,148)	(25,565)	(2,316)	(1,965)	(24,062)	(22,117)	(908,035)
Net on-balance sheet position	195,187	(50,889)	49,169	3,397	6,554	(5,936)	(11,866)	
Net off-balance sheet position	5,071	44,881	(48,840)	(7,403)	(10,536)	5,963	10,864	
Net position	200,258	(6,008)	329	(4,006)	(3,982)	27	(1,002)	
Non-financial assets	45,884	9,964	1,029	7,611	4,005	555	1,628	70,676
Non-financial liabilities and equity	(249,704)	(1,324)	(813)	(3,378)	(578)	(400)	(95)	(256,292)
Management reporting of currency risk *	(3,562)	2,632	545	227	(555)	182	531	

* 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.

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).

	30.9.2019		31.12.2018	
Currency	-10%	+10%	-10%	+10%
EUR	193	(193)	(263)	263
USD	(64)	64	(55)	55
GBP	20	(20)	(23)	23
DKK	204	(204)	56	(56)
NOK	45	(45)	(18)	18
Other	22	(22)	(53)	53

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 31 and 24 respectively.

Sensitivity analysis of equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices that affect the Consolidated Interim Financial 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.

	30.9.2019		31.12.2018	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(292)	292	(231)	231
Banking book - listed	(613)	613	(487)	487
Banking book - unlisted	(333)	333	(617)	617

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 25 provides a breakdown of the Group's derivative positions by type.

Amounts are in ISK millions

45. 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.

A primary source of funding for the Group is from 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 71% 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 flow of assets and liabilities

30.9.2019	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Book value
Financial assets								
Cash and balances with CB	-	116,403	5,239	-	-	-	121,642	121,554
Loans to credit institutions	28,440	3,326	-	-	-	-	31,766	31,766
Loans to customers	2,889	129,076	98,139	320,515	639,937	-	1,190,556	812,481
Financial instruments	17,877	34,894	30,141	45,082	12,569	29,073	169,636	161,781
Derivatives - assets leg	-	*31,066*	*5,691*	*50,925*	*1,220*	-	*88,902*	*82,629*
Derivatives - liabilities leg	-	*(29,125)*	*(5,747)*	*(44,730)*	*(1,168)*	-	*(80,770)*	*(76,385)*
Other financial instruments	*17,877*	*32,953*	*30,197*	*38,887*	*12,517*	*29,073*	*161,504*	*155,537*
Other financial assets	339	4,899	2,574	821	-	-	8,633	8,633
Financial assets	49,545	288,598	136,093	366,418	652,506	29,073	1,522,233	1,136,215
Financial liabilities								
Due to credit inst. and Central Bank	8,357	-	-	-	-	-	8,357	8,292
Deposits	372,519	65,276	63,036	13,964	8,565	-	523,360	508,254
Financial liabilities at fair value	-	1,038	1,603	2,145	6	-	4,792	2,295
Derivatives - assets leg	-	*(39,971)*	*(21,706)*	*(8,392)*	*(526)*	-	*(70,595)*	*(68,988)*
Derivatives - liabilities leg	-	*40,743*	*23,309*	*10,537*	*532*	-	*75,121*	*71,018*
Short position bonds and derivatives	-	*237*	-	-	-	-	*237*	*237*
Short position securities used for economic hedging	-	*28*	-	-	-	-	*28*	*28*
Other financial liabilities	122	8,701	324	601	1,648	-	11,396	11,395
Borrowings	-	14,072	69,143	222,569	185,871	-	491,655	409,563
Subordinated liabilities	-	153	588	2,460	17,980	-	21,181	15,042
Financial liabilities	380,998	89,240	134,694	241,739	214,070	-	1,060,741	954,841
Net position for assets and liab.	(331,453)	199,358	1,399	124,679	438,436	29,073	461,492	181,374
Off-balance sheet items								
Financial guarantees	49	661	3,843	8,829	2,109	-	15,491	15,491
Unused overdraft	-	45,405	-	-	-	-	45,405	45,405
Undrawn loan commitments	-	62,837	8,627	794	-	-	72,258	72,258
Off-balance sheet items	49	108,903	12,470	9,623	2,109	-	133,154	133,154
Net contractual cash flow	(331,502)	90,455	(11,071)	115,056	436,327	29,073	328,338	48,220

Amounts are in ISK millions

45. Liquidity and Funding risk, continued

31.12.2018	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Book value
Financial assets	55,046	224,391	151,214	378,223	664,122	31,668	1,504,664	1,093,651
Financial liabilities	(344,919)	(107,484)	(77,951)	(266,915)	(209,127)	-	(1,006,396)	(908,035)
Net position for assets and liab.	(289,873)	116,907	73,263	111,308	454,995	31,668	498,268	185,616
Off-balance sheet items	(4,225)	(103,563)	(25,621)	(7,375)	(1,790)	-	(142,574)	(142,574)
Net contractual cash flow	(294,098)	13,344	47,642	103,933	453,205	31,668	355,694	43,042

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.

30.9.2019	ISK	Foreign currency	Total
Available stable funding	706,393	213,432	919,825
Required stable funding	608,601	138,401	747,002
Foreign currency balance		(13,834)	
Net stable funding ratio	116%	144%	123%

31.12.2018			
Available stable funding	681,074	215,434	896,508
Required stable funding	615,717	134,082	749,799
Foreign currency balance		(7,102)	
Net stable funding ratio	111%	155%	120%

Amounts are in ISK millions

45. Liquidity and Funding risk, continued

Liquidity coverage ratio

The Liquidity Coverage Ratio (LCR) is one 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 precisely, 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, traded on an active market 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 Holding hf.

30.9.2019	ISK	Foreign currency	Total
Liquid assets level 1 *	132,864	83,774	216,638
Liquid assets level 2	295	-	295
Liquid Assets	133,159	83,774	216,933
Deposits	87,914	40,278	128,192
Borrowings	4,950	124	5,074
Other cash outflows	8,724	2,634	11,358
Cash outflows	101,588	43,036	144,624
Short-term deposits with other banks **	5	29,091	29,096
Other cash inflows	23,641	3,837	27,478
Cash inflows	23,646	32,928	56,574
Liquidity coverage ratio (LCR) ***	171%	779%	246%

31.12.2018			
Liquid assets level 1 *	75,340	48,806	124,146
Liquid assets level 2	-	-	-
Liquid Assets	75,340	48,806	124,146
Deposits	91,008	33,983	124,991
Borrowings	4,413	109	4,522
Other cash outflows	9,229	10,347	19,576
Cash outflows	104,650	44,439	149,089
Short-term deposits with other banks **	4,011	56,527	60,538
Other cash inflows	10,719	2,314	13,033
Cash inflows	14,730	58,841	73,571
Liquidity coverage ratio (LCR) ***	84%	439%	164%

* 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 foreign covered bonds also classify as Level 1 assets and receive 93% weight.

** Short-term deposits with 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

Notes to the Condensed Consolidated Interim Financial Statements

45. Liquidity and Funding risk, continued

Composition of liquid assets

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

30.9.2019	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	132,270	327	511	580	133,688
Short-term deposits in other banks	5	7,873	10,949	10,269	29,096
Domestic bonds eligible as collateral at the Central Bank	11,499	-	-	-	11,499
Foreign government bonds	-	37,182	19,579	19,090	75,851
Covered bonds with a minimum rating of AA-	-	-	1,362	5,063	6,425
Liquidity reserve	143,774	45,382	32,401	35,002	256,559
31.12.2018					
Cash and balances with Central Bank	88,687	222	833	838	90,580
Short-term deposits in other banks	4,012	14,141	16,265	26,120	60,538
Domestic bonds eligible as collateral at the Central Bank	4,844	-	-	-	4,844
Foreign government bonds	-	21,152	21,961	757	43,870
Covered bonds with a minimum rating of AA-	-	-	1,340	1,625	2,965
Liquidity reserve	97,543	35,515	40,399	29,340	202,797

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.

LCR categorization - amounts and LCR outflow weights

	Deposits maturing within 30 days					
30.9.2019	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Individuals	126,954	11%	47,163	5%	75,140	249,257
Small and medium enterprises	50,782	11%	5,269	5%	6,491	62,542
Corporations	67,173	40%	900	20%	7,772	75,845
Sovereigns, central banks and PSE	16,343	40%	-	-	1,321	17,664
Pension funds	44,350	100%	-	-	15,859	60,209
Domestic financial entities	20,088	100%	-	-	28,907	48,995
Foreign financial entities	2,034	100%	-	-	-	2,034
Total	327,724		53,332		135,490	516,546
31.12.2018						
Individuals	126,196	11%	51,232	5%	69,000	246,428
Small and medium enterprises	48,961	11%	4,836	5%	5,417	59,214
Corporations	48,033	40%	852	20%	7,605	56,490
Sovereigns, central banks and PSE	14,052	40%	-	-	5,067	19,119
Pension funds	45,671	100%	-	-	10,038	55,709
Domestic financial entities	22,494	100%	-	-	12,630	35,124
Foreign financial entities	3,187	100%	-	-	-	3,187
Total	308,594		56,920		109,757	475,271

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

Amounts are in ISK millions

46. 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 thr Icelandic Financial Undertakings Act No. 161/2002 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 Vördur tryggingar hf. should be viewed independently from capital adequacy for the Group's consolidated situation.

Valitor Holding hf. has been classified as held for sale in these Consolidated Interim Financial Statements. This does not affect the Group's capital adequacy calculations. For disclosure, assuming a cash sale of the subsidiary at book value, the Group's capital adequacy ratio would increase from 23.5% to 25.5%. The sale of Valitor would result in reduction in the Group's regulatory own funds adjustments, with positive effect on capital adequacy.

Own funds	30.9.2019	31.12.2018
Total equity	196,056	200,859
Deductions related to the consolidated situation	(9,927)	(8,986)
Non-controlling interest not eligible for inclusion in CET1 capital	(130)	(130)
Common Equity Tier 1 capital before regulatory adjustments	185,999	191,743
Intangible assets	(14,117)	(12,152)
Tax assets	(151)	(191)
Indirect holdings of own CET1 instruments	-	(190)
Cash flow hedges	(3,087)	(1,221)
Additional value adjustments	(168)	(126)
Forseeable dividend and interim profit not eligible for inclusion *	(6,057)	(9,069)
Common equity Tier 1 capital	162,419	168,794
Non-controlling interest not eligible for inclusion in CET1 capital	130	130
Tier 1 capital	162,549	168,924
Subordinated liabilities	15,042	6,532
Tier 2 capital	15,042	6,532
Total own funds	177,591	175,456

Risk-weighted assets		
Credit risk, loans	590,880	639,788
Credit risk, securities and other	54,705	50,112
Counterparty credit risk	3,457	4,405
Market risk due to currency imbalance	5,127	4,280
Market risk other	11,168	8,928
Credit valuation adjustment	2,863	2,228
Operational risk	86,957	86,957
Total risk-weighted assets	755,157	796,698

Capital ratios		
CET1 ratio	21.5%	21.2%
Tier 1 ratio	21.5%	21.2%
Capital adequacy ratio	23.5%	22.0%
CET1 ratio, including interim profit not eligible for inclusion	21.6%	
Tier 1 ratio, including interim profit not eligible for inclusion	21.6%	
Capital adequacy ratio, including interim profit not eligible for inclusion	23.6%	

* The foreseeable dividend is 50% of the accumulated net earnings in 2019 which is in accordance with the Bank's dividend policy, in addition to purchase of own shares of ISK 4.5 billion to be executed in Q4 2019.

Capital ratios of the parent company	30.9.2019	31.12.2018
CET1 ratio	24.1%	23.5%
Tier 1 ratio	24.1%	23.5%
Capital adequacy ratio	26.1%	24.3%

Amounts are in ISK millions

46. Capital management, continued

The following table outlines the implementation of the capital buffer requirements in accordance with the Icelandic Financial Undertakings Act No. 161/2002, as prescribed by the Financial Stability Council (FSC) and approved by the FME.

Capital buffer requirement, % of RWA	Current	1.2.2020
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 *	1.75%	2.00%
Combined capital buffer requirement	9.25%	9.50%

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

30.9.2019	CET1	Tier 1	Total
Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.7%	2.3%	3.1%
Combined buffer requirement *	9.0%	9.0%	9.0%
Regulatory capital requirement	15.2%	17.3%	20.1%
Available capital	21.5%	21.5%	23.5%

Capital requirement, % of RWA, 1.2.2020

Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.7%	2.3%	3.1%
Combined buffer requirement *	9.2%	9.2%	9.2%
Regulatory capital requirement	15.4%	17.5%	20.3%
Available capital	21.5%	21.5%	23.5%

* The effective countercyclical capital buffer is determined by calculating the weighted average of the corresponding buffer levels of each country, the weights being the total risk weighted exposures for credit risk against counterparties residing in those countries. The systemic risk buffer only applies to domestic exposures and is calculated using the same weighting method.

** The SREP result based on the Group's Financial Statement at 31.12.2018. The Pillar 2 requirement is 3.1% of risk-weighted assets based on the Group's prudential consolidation under CRR, which excludes Vördur tryggingar hf.

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 the Icelandic Financial Undertakings Act No. 161/2002.

	30.9.2019	31.12.2018
On-balance sheet exposures	1,152,208	1,106,368
Derivative exposures	8,858	8,239
Securities financing transaction exposures	8,436	8,194
Off-balance sheet exposures	103,916	68,316
Total exposure	1,273,418	1,191,117
Tier 1 capital	162,549	168,924
Leverage ratio	12.8%	14.2%

Amounts are in ISK millions

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