



Company presentation  
15 February 2017



# Iceland at glance – strong and modern economy...

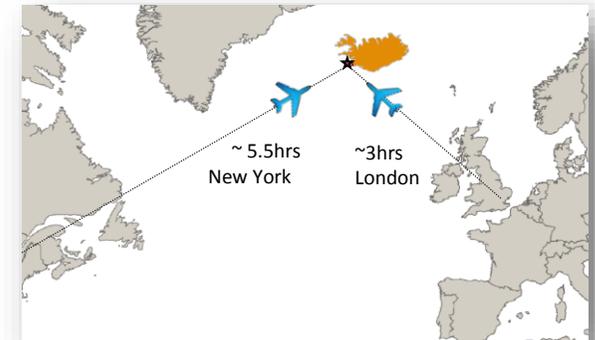
## Strong economy with further upsides

- Iceland became fully independent from Denmark in 1944
- The second half of the 20th century saw substantial economic growth driven primarily by the fishing industry
- The economy diversified greatly after the country joined the EEA in 1994
- Iceland's Scandinavian-type social-market economy combines a capitalist structure and free-market principles with an extensive welfare system

<b>State</b>	Republic
<b>Capital</b>	Reykjavik
<b>Life expectancy world rank 2016</b>	8
<b>Least corruption world rank 2016</b>	14
<b>Gender equality world rank 2015</b>	1
<b>Contribution of renewables to energy supply in OECD countries 2014</b>	1

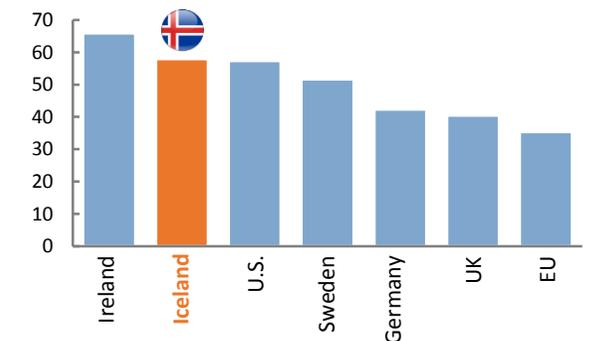
- 1944**  
Full independence from Denmark
- 1946**  
United Nations member
- 1948**  
OECD founding member
- 1949**  
NATO founding member
- 1970**  
Joined EFTA
- 1994**  
Access to European Economic Area (EEA)
- 1995**  
WTO member

## Central location



## GDP per capita among highest in the world

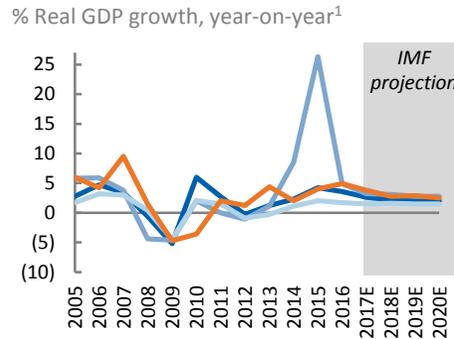
GDP per capita 2016, USD thousands<sup>1</sup>



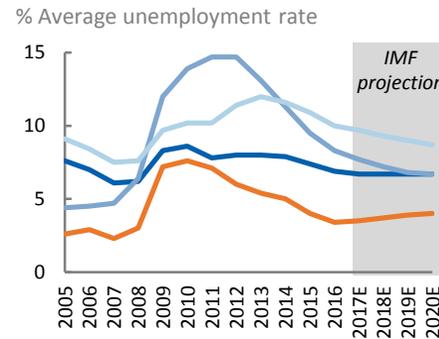
# with positive economic fundamentals...

- High standards of living
- Strong culture and heritage
- Modern public institutions and legislative framework
- Strong economic recovery post crisis
- Flexible and resilient economy
- Diversified economy built on 4 export pillars:
  - Tourism<sup>3</sup>
  - Seafood
  - Energy
  - Knowledge

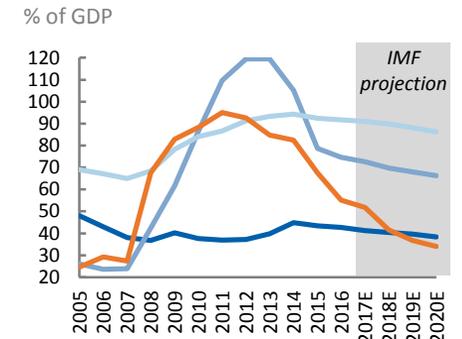
## Economic recovery since 2010 with strong outlook



## Unemployment rate significantly below other countries



## General government gross debt (% of GDP)

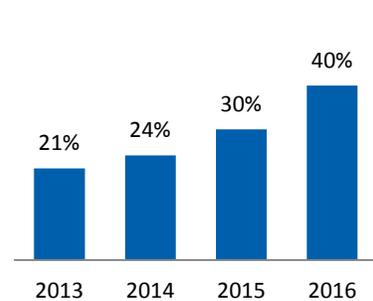


■ Sweden ■ Ireland ■ Euro Area ■ Iceland

## Accelerated growth in tourism contributing to exports and strength in GDP

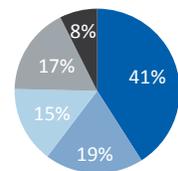
### Growth in Tourism

% Change year-on-year in # of tourists<sup>2</sup>



### Export Contribution by Industry

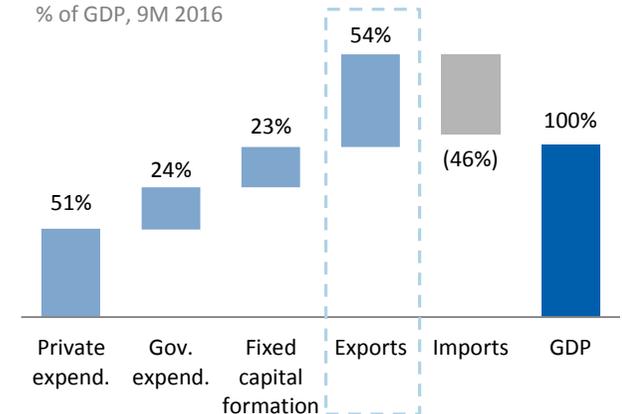
% contribution, 9M 2016



■ Tourism<sup>3</sup>  
 ■ Seafood  
 ■ Aluminum  
 ■ Other goods & services  
 ■ Other industrial

### Breakdown of GDP

% of GDP, 9M 2016



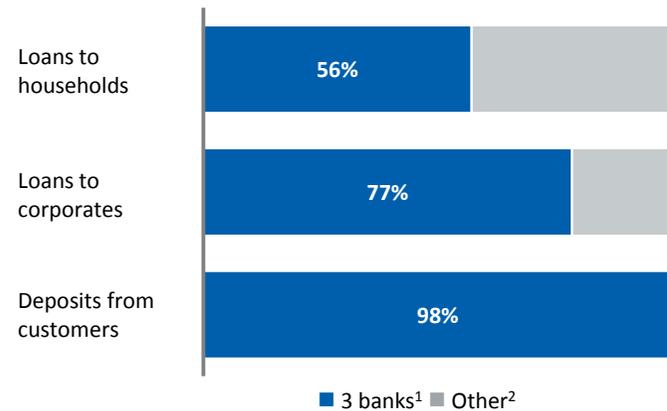
3 Source: Statistics Iceland, IMF  
 1. Based on real GDP national currency  
 2. Isavia  
 3. Defined as export if the industry is a source of foreign currency income

# ...supporting a growing and stable banking sector

- Highly consolidated banking sector concentrated around 3 main banks
  - Arion Bank - privately owned
  - Landsbankinn - government owned
  - Islandsbanki - government owned
- High correlation between GDP and banking sector growth
- Significant steps taken during the fall 2016 to ease capital controls
- While putting some pressure on deposits, the easing of capital controls comes with several opportunities for Arion Bank to benefit from increased range of assets available to investors

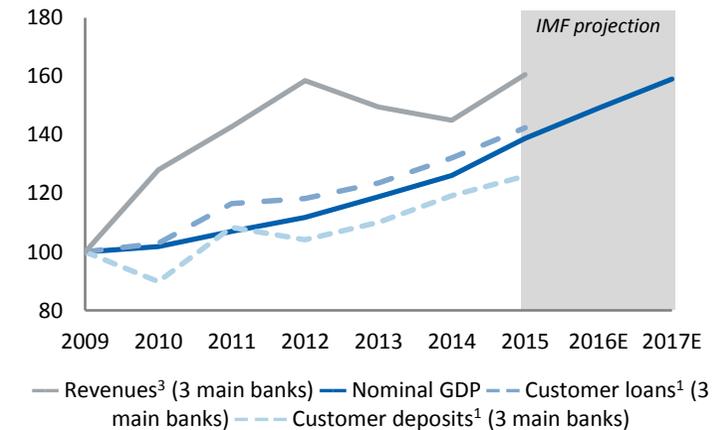
## The Icelandic banking sector is highly concentrated High correlation between GDP and banking sector growth

Market shares 2015, %

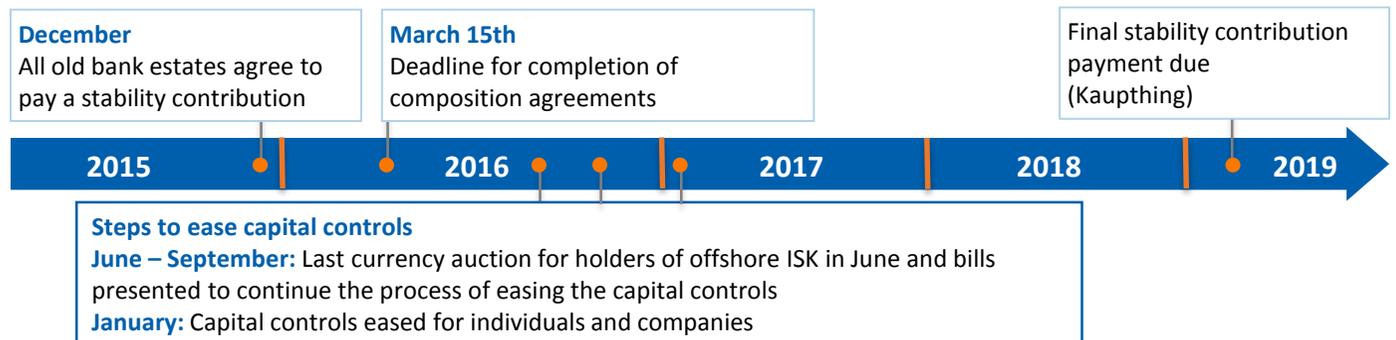


GDP Growth vs. Banking Sector

Indexed numbers based on 2009



## Easing of capital controls

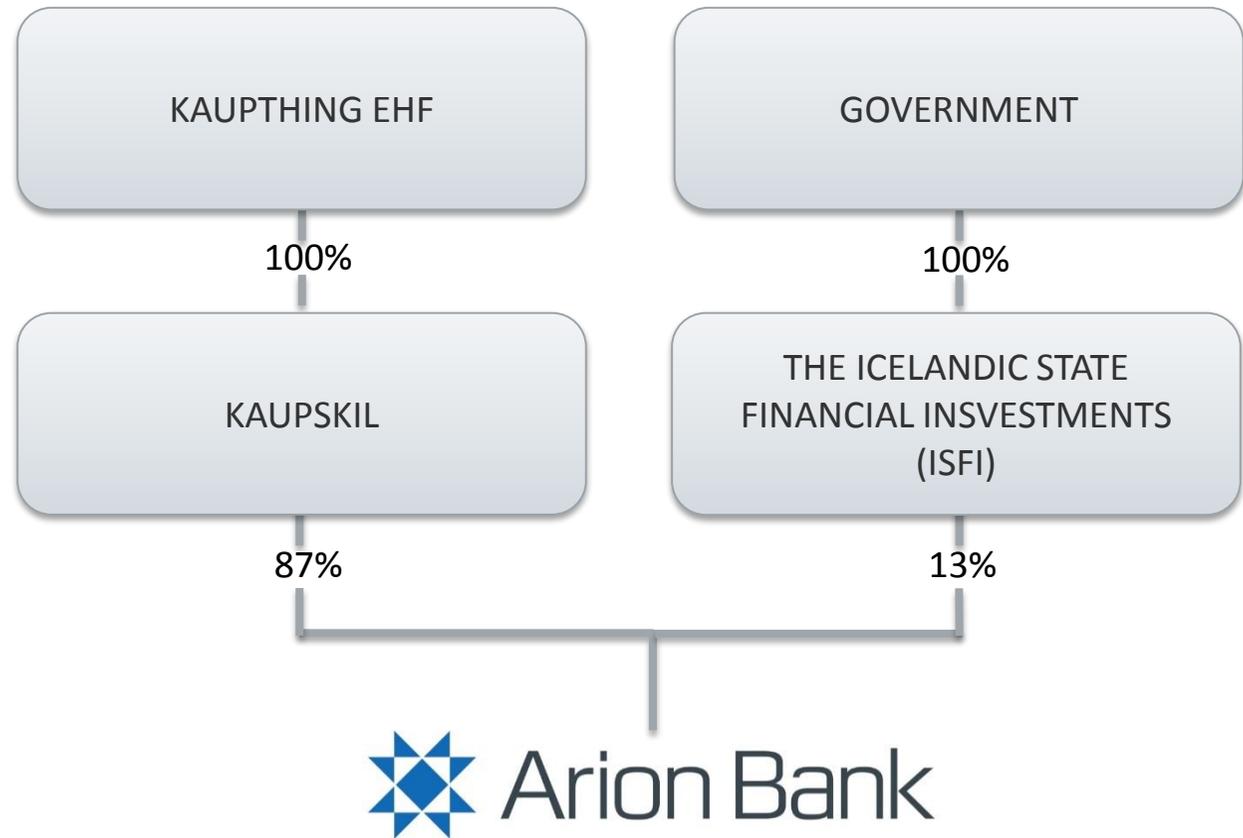


Source: The Ministry of Finance and Economic Affairs, annual reports, Company information  
 1. Arion, Landsbankinn, Islandsbanki: total loans to, and deposits from, individuals and corporates  
 2. Pension funds, international banks, Housing Financing Fund  
 3. Arion, Landsbankinn, Islandsbanki: net interest income, net fee and commission income (i.e., excluding other income)

# Ownership structure

Arion Bank is operated at arms length from its owners

- Arion Bank is owned by Kaupthing (87%) through its subsidiary Kaupskil
- The Government of Iceland has a 13% share through The Icelandic State Financial Investments
- Kaupskil appoints seven out of eight members to the Board of Directors of Arion Bank and the ISFI appoints the eight



# A leading universal relationship bank in Iceland with a differentiated and innovative approach



1. Capacent. Based on monthly customer survey (individuals) 2016. Q: What is your main retail bank?  
 2. SMEs are defined as corporates in Retail Bank with loans up to ISK 2 Bn  
 3. Management belief based on interim financial statement and company information. SMEs are covered by Retail Bank but included in the Corporate Banking market share  
 4. Vörður acquisition received approval from the Icelandic Competition Authority at the end of September 2016  
 5. FME  
 6. Based on 2015 annual accounts (Valitor, Borgun and Kortaþjónustustan)

# A universal relationship bank

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- Primary emphasis on **corporations** and **individuals** seeking a **variety of financial solutions**
- Focus on building and strengthening **long-term customer relationships** by delivering **excellent service and tailored solutions**
- Operations in the greater Reykjavík area as well as the largest urban areas around the country
- Contributes to a positive development of the Icelandic economy and society
- A leading position within the domestic financial market in terms of **return on equity, operational efficiency** and **service offerings**
- Provides financial **services outside of Iceland**, mainly to companies related to the **seafood industry in Europe and North America**



# Experienced management team

- Proven track record in strategy execution
- Low turnover rate
- Use of available incentivisation to create value
- Management and supporting team to execute on proposed strategy



## Höskuldur H. Ólafsson – Chief Executive Officer

- Former CEO at Valitor hf. – Visa Iceland (2006-2010)
- Previously Deputy CEO at Eimskip (listed, Iceland) after different management positions within the group
- Served on the boards of directors of numerous institutions in Iceland and abroad
- Cand. oecon. degree in business administration (Univ. of Iceland)



## Freyr Thórdarson – MD of Corporate Banking

- Senior Director Nordic Credit Portfolio at Kaupthing Bank's Resolution Committee
- Served on the boards of directors of several companies in Iceland and abroad and served on the board of directors of Arion Bank from 2012 to 2013 and was a member of the Board Credit Committee
- MBA (Reykjavík Univ.)



## Stefán Pétursson – Chief Financial Officer

- Previously CFO of Landsvirkjun (listed bonds, Lux and Iceland) 2002-2010 where he worked for almost 20 years incl. as treasurer and head of funding
- Currently a member of the board of directors of Valitor
- MBA (Babson College), cand.oecon in business administration (Univ. of Iceland)



## Ida B. Benediksdóttir – MD of Investment Banking

- Previously Head of Private Banking, Head of Corporate Communications at Arion Bank and divisional head in Treasury at Kaupthing Bank (joined in 1999)
- Served on the boards of directors of numerous companies (incl. AFL – savings bank and HB Grandi hf.)
- B.Sc. in business administration (Univ. of Iceland). M.Sc. in financial management (Rotterdam School of Mgt.), certified stockbroker



## Sigurjón Pálsson – Chief Operating Officer

- Head of the Work-Out team at Arion Bank (2009-2011)
- M&A in Kaupthing Bank's Investment Banking division
- Currently the Chairman of the board of both Landey ehf. and Stodir hf.
- Served on the boards of directors of various companies in Iceland and abroad
- M. Eng. in supply chain mgt. (MIT), M. Sc. in construction mgt. (KTH Stockholm), civil engineer (Univ. of Iceland), certified stockbroker



## Jónína S. Lárusdóttir – MD of Legal Division

- Previously Director of the General Office and Permanent Secretary at the Ministry of Commerce (served for 10 years)
- Currently a member of the board of directors of Valitor
- Served on and chaired numerous committees
- Master's degree incl. European competition law (LSE), faculty of law (Univ. of Iceland), qualified district court attorney



## Gísli S. Óttarsson – Chief Risk Officer

- Previously Head of Research and Dev. at Kaupthing Bank's risk mgt. division (joined in 2006)
- Formerly software designer and adviser for various engineering companies in the United States
- PhD in mechanical engineering (Univ. of Michigan), certified stockbroker



## Helgi Bjarnason – MD of Retail Banking

- Managing Director of Sjóvá Almennar, life insurance company (2006 - 2010)
- Currently chairman of the board of directors of Vördur insurance company and Vördur life (served as actuary for ten years), served on various boards of directors
- Cand. act. degree in actuarial mathematics (Univ. of Copenhagen)



## Margrét Sveinsdóttir – MD of Asset Management

- 30+ years experience in the financial sector (various positions within banking and asset management)
- Served on a number of boards of directors
- Currently chairman of fund companies in Luxembourg
- MBA (Babson College), cand.oecon degree in business administration (Univ. of Iceland) and certified stockbroker



## Raket Óttarsdóttir – Chief Information Officer

- Joined Kaupthing Bank in 2005 as an account manager in IT division and later head of Arion Bank's Project Office and then MD of Corporate Development and Marketing.
- Software designer and Head of Dev. at TM Software – Libra
- MBA (Duke Univ.), B.Sc. in computer science (Univ. of Iceland)

# Fully restructured bank, with potential for further value creation

## 2010-2012:

### “Restructuring of the bank and its customers”

- Operations consolidated under Arion Bank
- Clean and newly valued balance sheet post crisis
- Acquired loan portfolios from the old bank (fair value was a discount to the face value of the loans)
- Discount of loan portfolios progressively released
- Restructuring and systematically driven improvements in underlying asset quality

## 2013-2014:

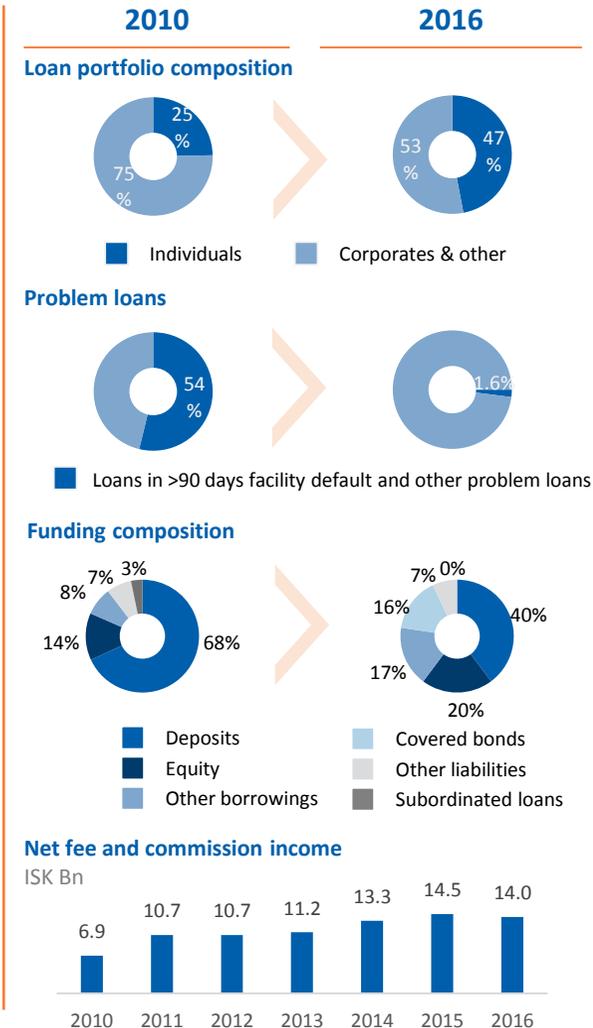
### “Streamlining and building of the business”

- Launched “lean banking initiative” and implemented changes to core banking operations
- Optimised branch network
- Built Icelandic market leadership in core products
- Further improvements in underlying asset qualities

## 2015+

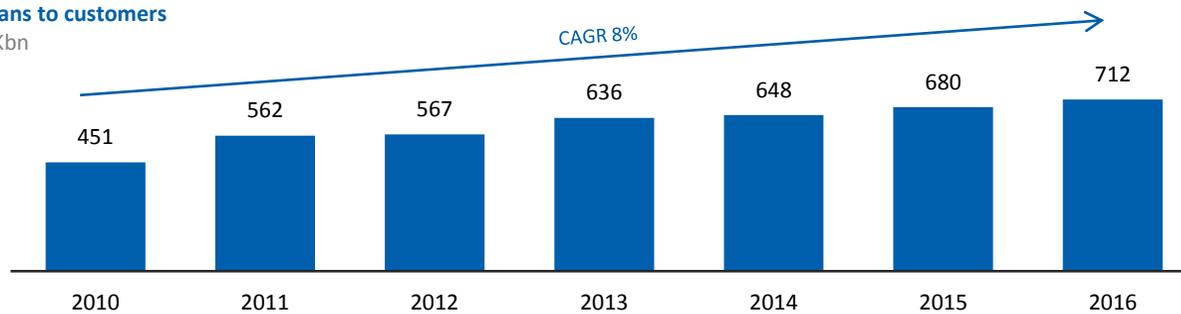
### “Strengthening market leadership and harvesting full value potential”

- Further strengthening market leadership and scaling of presence
- Harvesting value from operational efficiency and scaling of digitalisation
- Continued investments in IT infrastructure
- Driving commercial excellence in business divisions and actively exploring new business opportunities
- Optimising capital structure



## Loans to customers

ISKbn



# Strategic and innovative approach – proven track record

## First Mover in the Industry

- Pioneer on the Icelandic capital markets, leading 8 out of 13 IPOs since 2011
- Early adopter of next generation personal online and mobile banking
- Leader in mortgage product innovation supported by selective portfolio acquisitions
- First Icelandic bank to issue a benchmark euro bond since 2008
- Leader in project financing (silicon plants, tourism)
- Enabler of growth
  - Founder of business accelerator initiative - Startup Reykjavik
  - Host of fintech hackathon – innovate financial solutions

## Driving Efficiency and Digitalisation

- Clear leadership in rolling out new digital initiatives, enhancing and enabling further streamlining of operations
- Strengthened customer focus and decentralised credit decisions
- Innovator for personal online and mobile banking
- Extensive CRM system use by staff
- Lean banking programme (A plus)

## Diversified Portfolio of Businesses

- Long-standing leadership in asset management
- Four key subsidiaries complementing business divisions
- Operating independently with their products also partly distributed by other banks
- Arion Bank offers now a comprehensive financial products and services portfolio to both individuals and corporations

**VALITOR**  
Card payments

**okkar**   
Life insurance

 **STEFNIR**  
Fund management

 **vörður**  
Universal insurance company

# Retail bank

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Arion banki



# Retail bank overview

A leading and innovative Retail bank in Iceland

## Description

- Retail Bank provides comprehensive financial services to individuals and small- and medium-sized companies (SMEs)<sup>1</sup>
- Offering includes mortgage loans, savings and checking accounts, vehicle and equipment financing, payment cards, pension services, insurance and funds
- 358 FTEs<sup>2</sup> across 24 locations around the country

## Key Strengths

- Strong market position with particular strength in the important mortgage loans segment
- Integrated banking and insurance business
- Decentralised decision making close to the customer

2016

29%<sup>3</sup>

Strong market share in the retail business (individuals)

- Market share during the past three years ranges from 28% to 31%

124,622<sup>4</sup>

Large number of customers (individuals & SMEs)

24

Branches to cover key economic regions and client needs

ISK 460 Bn

Total lending volume to retail customers in 2016

ISK 300 Bn

Deposits from retail clients in 2016

Arion Bank's heritage

1800's



Numerous savings funds founded

1930



3 savings funds merge and Agricultural Bank is founded

2003



The Agricultural Bank and Kaupþing merge (later Kaupþing Bank)

2008-2016



Source: Company information

1. SMEs are defined as corporates in Retail Bank with loans up to ISK 2 Bn

2. Including HQ retail support units. Excluding summer FTEs in year end of 2016

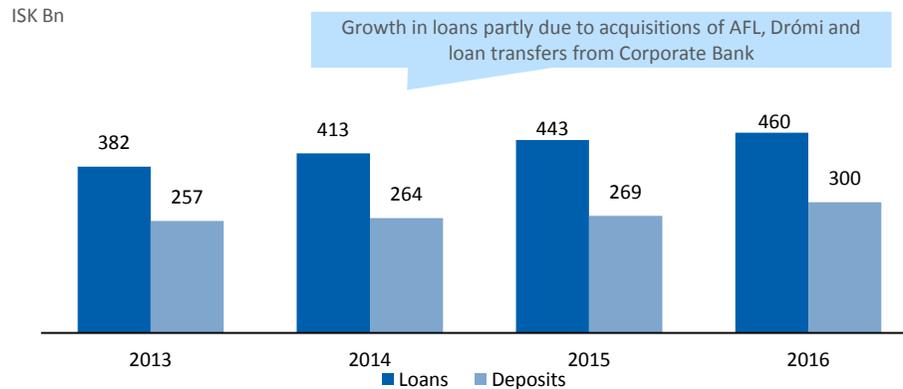
3. Capacent. Based on monthly customer survey (individuals) in 2016

4. Finalta, Mckinsey and company definition of active customers. Arion Bank 2016

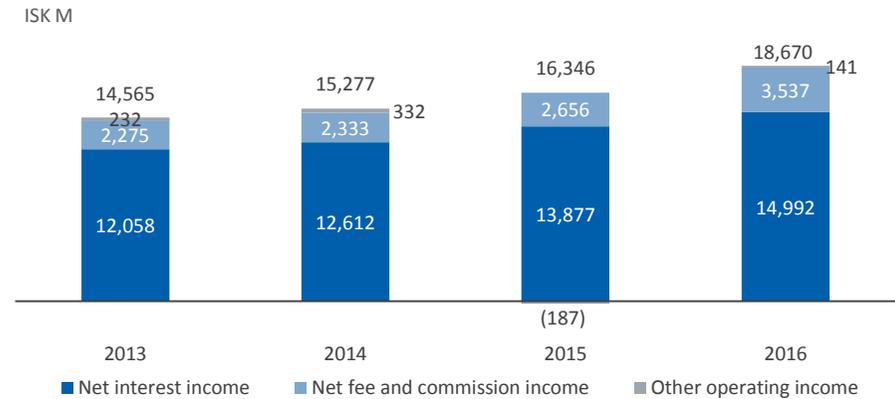
# Key financials<sup>1</sup>

## Growing portfolio and improving bottom line

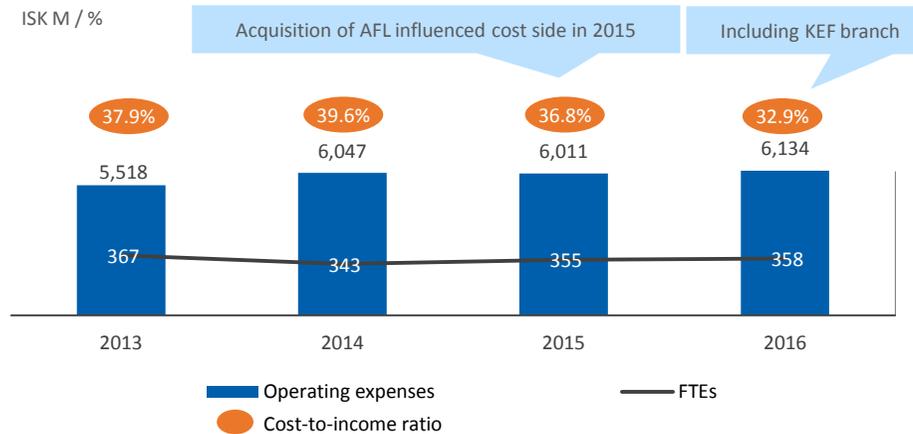
### Balance sheet



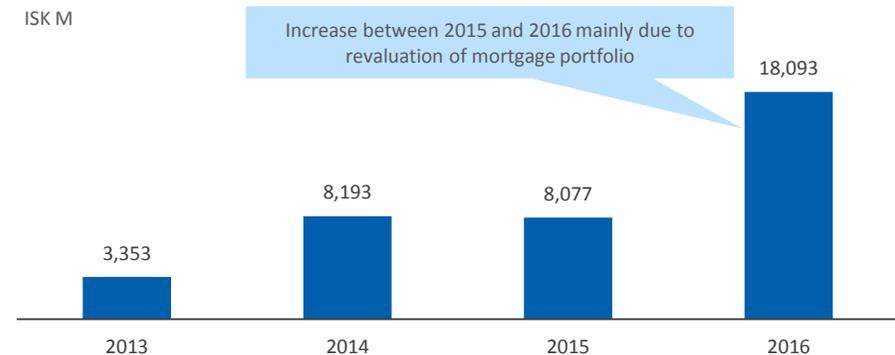
### Operating income



### Improved operating efficiency



### Earnings before tax



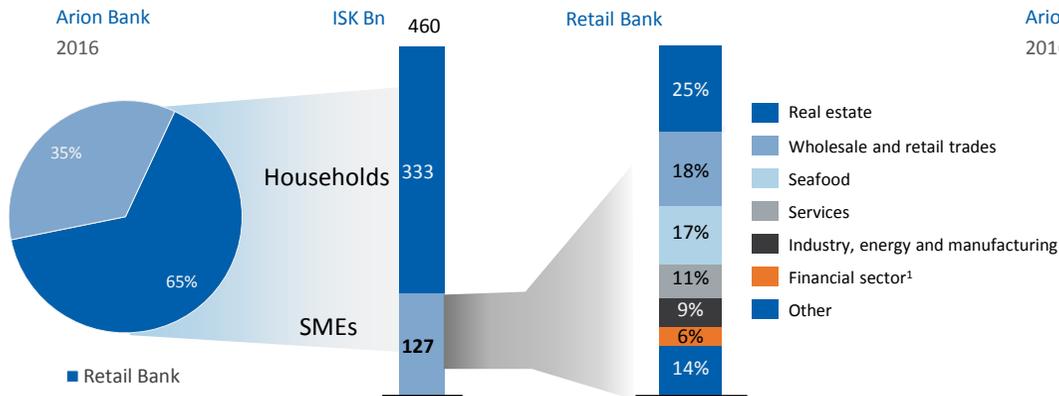
Source: Company information

1. Including ABMIIF (Arion Bank Mortgages Institutional Investor Fund)

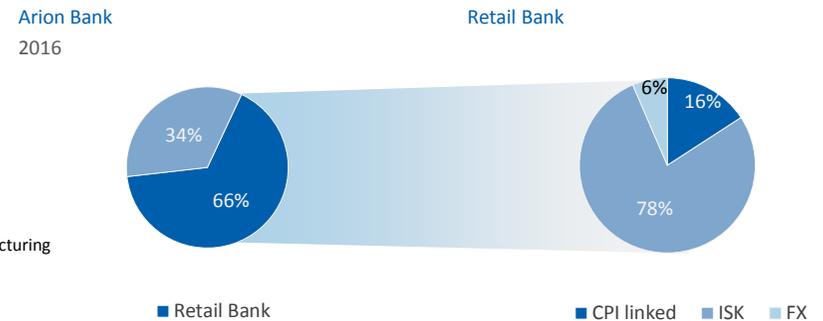
# Retail bank in group context

Largest group contributor and well diversified loan book

## Loan book split

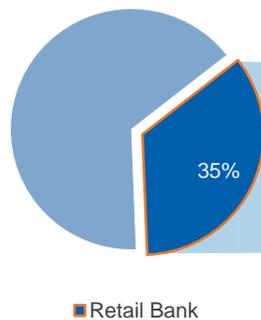


## Deposits split

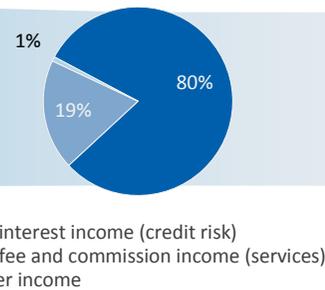


## Operating income contribution

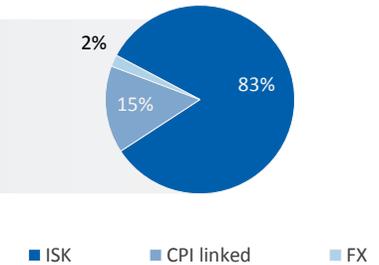
Retail Bank % of the Group  
2016



Product split  
% 2016



Net interest income split  
% 2016



# Flexible and optimised branch network

Optimisation in the branch network is an ongoing project

- Arion Bank branch locations have an agricultural heritage background
  - Strategic positioning in key tourism areas
- In 2009 Arion Bank had branches in 40 locations - in 2017 the locations are 24
- Arion Bank is the only bank in rural areas in 11 out of 16 locations
  - 8 branches in the greater Reykjavík Area
  - 16 branches in rural areas
  - 9 branches are located in major tourist towns
  - Recently launched the only branch at Keflavik airport
- Emphasis on decentralisation to bring decision power closer to the customer
- Focus on customer relationships – addressing different areas with different needs
- Self-service implementation through ATMs, Arion Bank app and online banking have been successful
- Since 2013, total branch sq. meters have been reduced by 2,771
  - 1,063 sqm. in 2016
- Optimisation in the branch network is an ongoing project

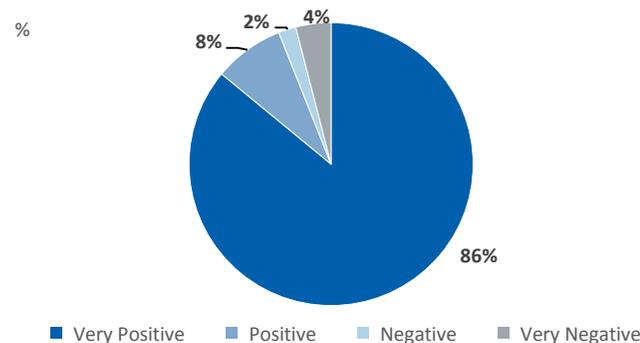
## Arion Bank branches around Iceland



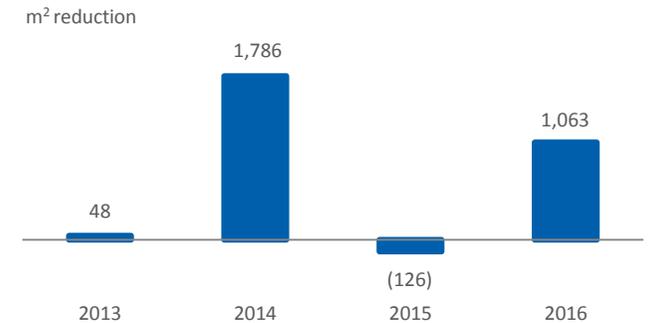
## Tourism hot spots in Iceland<sup>1</sup>



## Branch customer satisfaction<sup>2</sup>



## Reduction in branch size



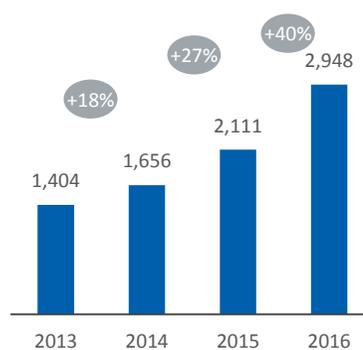
Source: Company information  
 1. Icelandic Tourist Board, report 2016  
 2. Customer satisfaction in Arion Bank branches 2016. Customer ranks service before leaving the branch

# Channel diversification

## Digitalisation driving efficiency

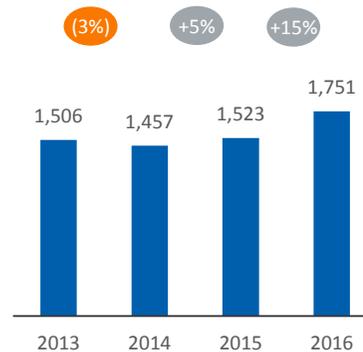
- Major changes in customer behaviour in recent years
- Full upside potential to be unlocked through changing customer mindset transitioning away from branches as the preferred channel
- The plan is to produce a steady decline in low value transactions handled in the branches
- Focus on using channels to further increase efficiency
- The new generation of ATMs is enabling customers to save time by depositing and withdrawing cash as well as paying bills themselves
- Greater emphasis on customer experience through Arion Bank app
- By focusing on digitalising processes, Arion Bank has reduced internal lead time in customer onboarding by 88%
- New digital initiatives launched in Q4 2016, i.e., mortgage process

### Opening account – digital sales

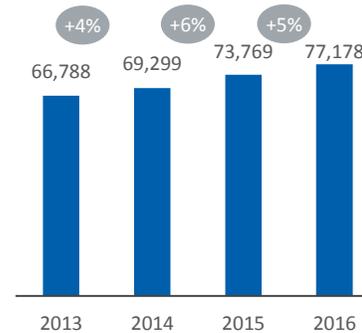


### Number of interactions through ATMs

000s

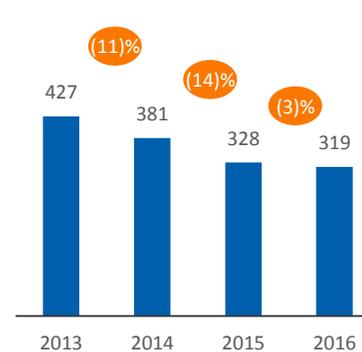


### Active online bank users<sup>1</sup>



### Number of calls to the call centre

000s

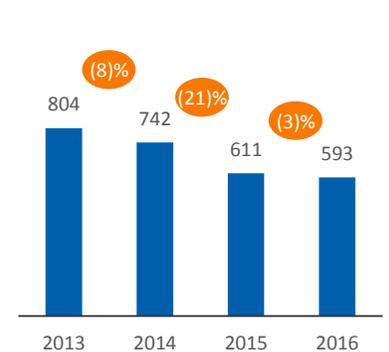


### Active Arion Bank app users<sup>1</sup>



### Number of visits to branches

000s



# Strategic initiatives

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Good track record and successful implementation

<b>Retail branch optimisation</b>	<ul style="list-style-type: none"><li>▪ Focus on good customer service with less cost and adjusting to rapid changes in customer needs</li><li>▪ Recent actions to reduce opening hours and the total size of branches by either moving to smaller branches, renting out part of the excess space, closing or merging certain branches</li><li>▪ Implementation of multipurpose ATMs in branches and staff to direct customers to either branch staff or ATM depending on intended transaction</li></ul>
<b>New branches in strategic locations</b>	<ul style="list-style-type: none"><li>▪ New branch opened at the Keflavik airport – the only bank branch at the airport</li><li>▪ Flagship branch opened in Borgartún financial area by merging two branches</li><li>▪ Developed a new digital branch concept for Kringlan mall branch</li></ul>
<b>Initiatives</b>	<ul style="list-style-type: none"><li>▪ Digitalising processes, such as customer onboarding and mortgage loans</li><li>▪ European Investment Fund cooperation in SME lending at lower rates</li><li>▪ Market leader for new developments in mortgage loans</li></ul>
<b>Further expansion of wide product offerings</b>	<ul style="list-style-type: none"><li>▪ Synergies of Vörður, a universal insurance company in Iceland</li><li>▪ Enlargement of vehicle and equipment financing</li></ul>

# Capture market opportunities based on leading franchise

Strong customer focus and diverse product offerings

## Objectives

<b>Mortgages</b>	<ul style="list-style-type: none"><li>▪ Retain leading position among the three largest banks and pension funds by market share</li></ul>
<b>SME</b>	<ul style="list-style-type: none"><li>▪ Continue growth in market share</li></ul>
<b>Decreasing cost</b>	<ul style="list-style-type: none"><li>▪ Better service at lower costs</li></ul>
<b>Digitalisation</b>	<ul style="list-style-type: none"><li>▪ Reduce low value transactions in branches and in call centre and encourage customers to use self-service channels (save time and money)</li></ul>
<b>Product offerings</b>	<ul style="list-style-type: none"><li>▪ Diversified offerings from Arion Bank</li><li>▪ Give customers tailored choices</li><li>▪ Revamp existing loyalty programs</li></ul>

## Key take-aways

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- ✓ Strong and stable market position with particular strength in the mortgage loans segment
- ✓ Full market coverage with good opportunities ahead, i.e., insurance products
- ✓ Solid income base – new income opportunities through Keflavik airport branch (tourism)
- ✓ Investing in advanced digital solutions for clients – omni-channel, service and cost goals
- ✓ Efficiency through lean banking (A plus)
- ✓ Strong growth in SME lending – opportunities ahead in vehicle and equipment financing
- ✓ Experienced management team with success in executing challenging projects

# Valitor

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# Valitor snapshot

A growth company in the international markets

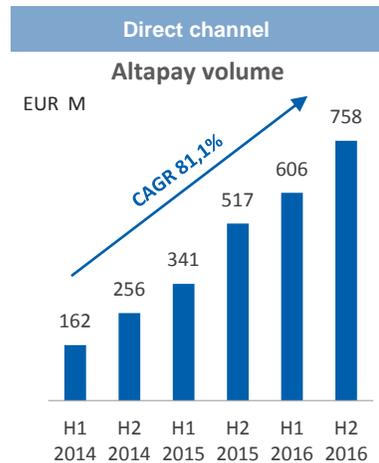
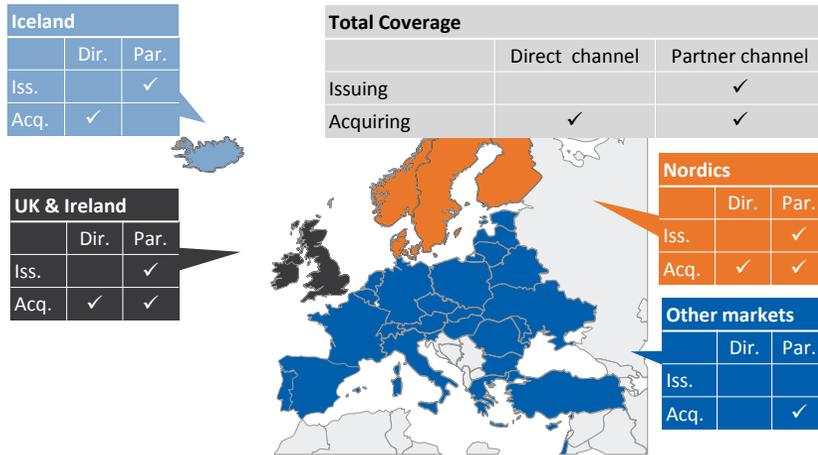
## Overview

- Established in 1983, Valitor is the 2nd largest card payments company in Iceland<sup>1</sup>, providing both card acquiring and issuing services
- Expanded internationally since 2003 as one of the first companies to receive European cross-border licence in card payments
  - Acquiring: Offer e-commerce and card present merchant payment solutions through direct channel and partner channel
  - Issuing: Offer issuing and payment processing solutions to domestic and international partners
- Developed proprietary payment software solutions from an early stage enabling differentiation strategy in acquiring and issuing
- Valitor has delivered double digit growth annually by following a clear strategy implemented in 2012
- Group member of Visa EU since 1983 and principal member of MasterCard since 2009
- PCI-DSS level 1 security certification since 2011
- Over 250 committed, service-oriented and experienced employees

270 m <sup>2</sup>	▪ Transactions processed in 2016
350 m <sup>2</sup>	▪ Transactions run-rate
ISK 650 Bn <sup>2</sup>	▪ Of acquiring transactions processed in 2015
ISK 1,100 Bn <sup>2</sup>	▪ Of acquiring transactions processed in 2016
17,000	▪ Merchants and corporate customers in acquiring
362,000	▪ Payment facilitators sub-merchants
10	▪ Issuing partners
15	▪ Acquiring partners

# Successful international strategy driving growth

## Significant, but selective European penetration



### Description

- Principal partner to fintech leaders and renowned payment companies
- Valitor typically supplies back-end processing both in acquiring and issuing

### Characteristics

- Enables fast growth in processing volume and revenue
- Scale benefits enhances position in competitive market
- Focus on innovative partners, offer complex and flexible solutions and nurture long-term relationships
- Recognised brand in the European payments industry

### Direct channel

- End-to-end e-commerce and card present solutions
- Full-service one-stop payment solutions

- AltaPay: e-commerce payment platform in the Nordics
- Markadis: direct channel in the UK and Ireland
- Leverage end-to-end value chain to maximise margin and customer retention
- Develop and offer differentiating solutions to merchants
- Supported by acquisition strategy

### Partners



### Valitor Brands



### Partners



# Corporate banking



# Corporate banking overview

A well-positioned Icelandic corporate bank

## Description

- Full service corporate bank, targeted at larger corporates across all industry sectors through dedicated industry sector teams
- Relationship based model benefiting from and providing synergies across Arion Bank's divisions (e.g., investment banking and private banking)
- Well-diversified lending portfolio across all main Icelandic industries with emphasis on top 100 companies in Iceland
- Long-standing relationships with leading corporate clients enable a strong competitive position
- Team of experienced banking professionals working out of HQ (28 FTEs) organised by product and industry coverage to ensure strong expertise

## Key Strengths

- Intimate, long-standing relationships and exposure to growing sectors, such as energy, real estate and trade and services
- Proven ability to handle large and complex deals (clubs / syndicates) bringing the whole bank to the table
- Established positioning in the seafood industry

## 2016

24%	Strong market share in corporate lending incl. SME 2016 <sup>(1)</sup> Stable market share over the last three years with 22%-24% share
165 <sup>(2)</sup>	Large customers serviced from the branch in HQs
28	Size of the team (FTEs) working out of HQs
13	Number of branches with a dedicated corporate service presence (out of 24 branches in total)
ISK 248 Bn <sup>(3)</sup>	Total lending to corporate banking clients 2016
ISK 30.4 Bn	Deposits from corporate banking clients across all divisions of Arion Bank 2016

1. Source: Interim financial statements and company information on total domestic corporate lending in Iceland. SMEs are covered by Retail Bank but included in Corporate Bank market share

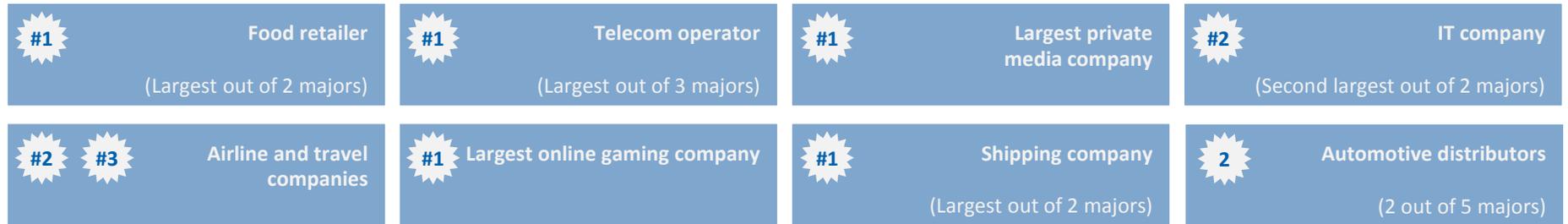
2. Counted by customer groups (as opposed to company identification number)

3. Including bond instruments

# Arion Bank's Corporate Bank is trusted by market leaders

Credentials in major industry sectors and across clients<sup>1</sup>

## Retail and Services Clients



## Seafood Clients



## Real Estate, Energy and Project Finance

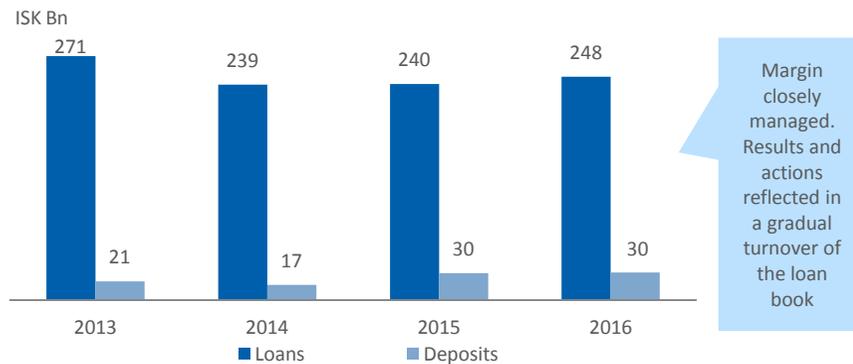


1. Company information (Corporate Bank)  
2. Source: Directorate of Fisheries  
3. Without state recourse

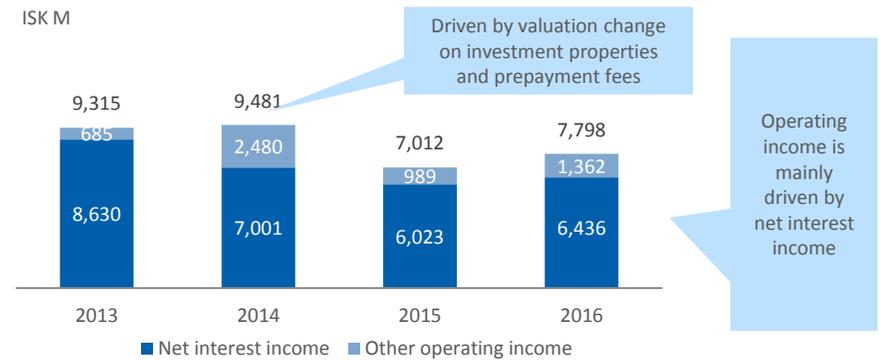
# Key financials<sup>1</sup>

Steady increase of loan volume, platform stabilised in 2015 and ready for future growth

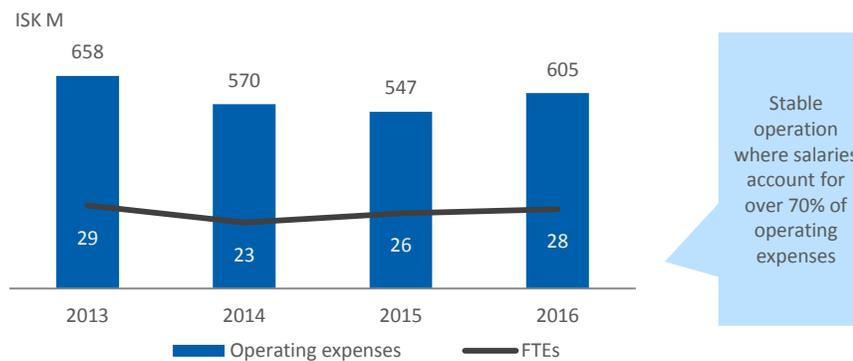
## Balance sheet<sup>2</sup>



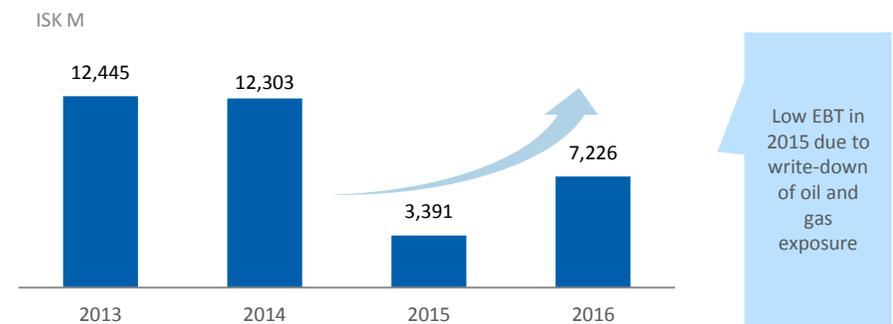
## Operating income



## Operating expenses



## Earnings before tax



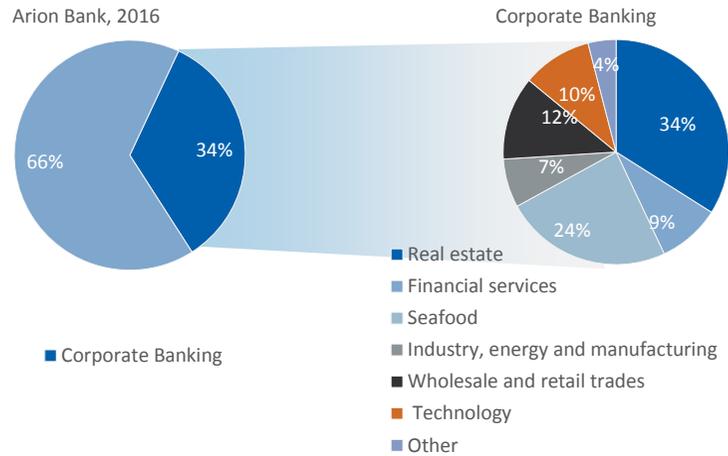
Source: Company information

1. Arion Bank on a standalone basis, including loans to subsidiaries
2. Including lending to independent subsidiaries and bond instruments

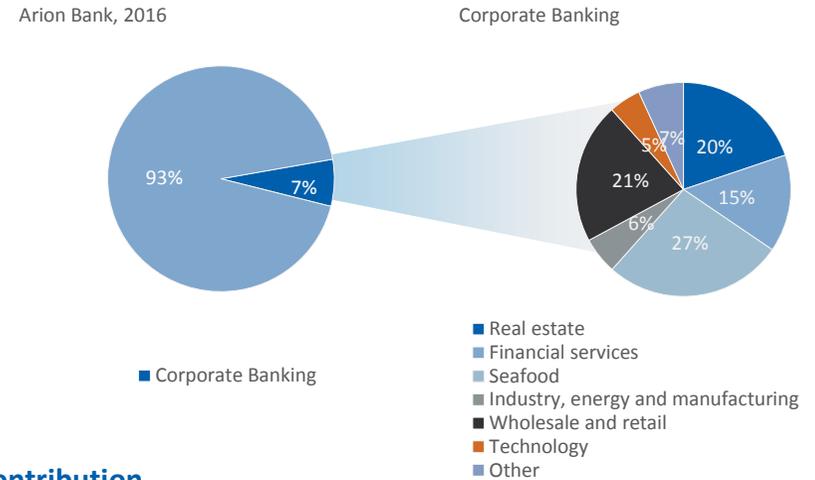
# Corporate Banking in group context

Well diversified corporate loan book

## Loan book split

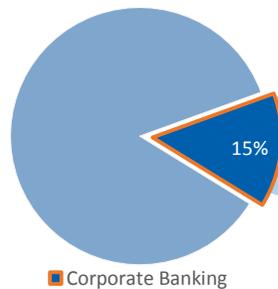


## Deposits split



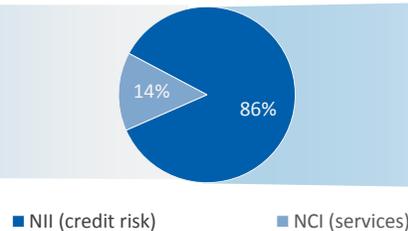
## Operating income contribution

Corporate Banking % of the Group  
2016



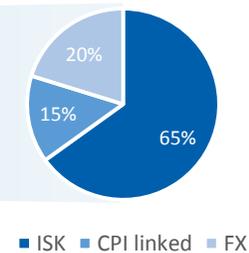
Total: ISK 53,439 M

Product split  
%



Total: ISK 7,518 M

Net interest income split  
%



Total: ISK 6,436 M

# Corporate Banking in Iceland

## Stable market share

### Corporate lending demand at high levels

- Iceland is a relatively young and growing economy with a projected average GDP growth of 4%<sup>1</sup> and increasing investment demand
- Icelandic corporates are healthy with improving credit scores (corporate sector debt represented 93% of GDP<sup>2</sup>)
- But margin pressures over the past 3 years<sup>3</sup>, driven by competition from local pension funds, following a yield reduction in the local real estate backed bond market<sup>4,8</sup>
- Foreign banks increasingly consider entering the Icelandic corporate banking market, especially in the seafood industry
- Positive outlook given current consumer and business confidence at the highest levels post crisis, followed by stronger corporate earnings and a growing demand for credit
- FX lending only offered from banks with FX funding access

### Implications for Arion Bank

- Benefits expected from growth in energy related and seafood industries (which require FX that Arion Bank can offer), easing of capital controls and continued consolidation trends in seafood, commercial real estate and tourism industries
- Corporate demand for credit extension expected to outstrip supply in 2016 and 2017, resulting in less margin pressure in the short term
- Credit quality improving as shown by strong reduction trends in problem loans and defaults (improved internal credit ratings of clients)
- Further opportunities in the niche international seafood lending space expected to emerge with a beneficial risk-reward profile

1. Source: Arion research – economic forecast issued 15 March 2016

2. Central Bank of Iceland

3. Company information

4. Lower bond yields and limited issuance of government debt make corporate debt more attractive for the pension funds, which compete with a cost structure very different to the banks

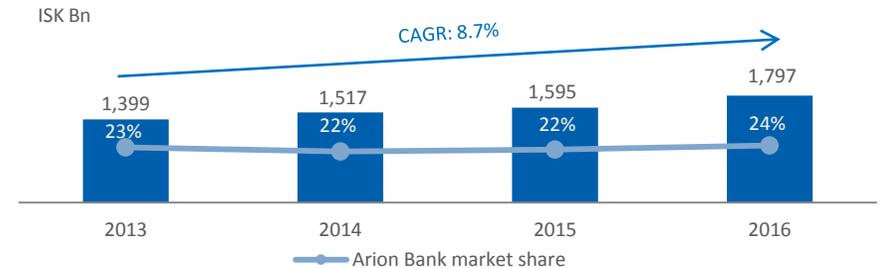
5. Company information. Total numbers include Arion Bank, Landsbankinn, Islandsbanki, Housing Financing Fund, Kvika and pension funds

6. Central Bank of Iceland

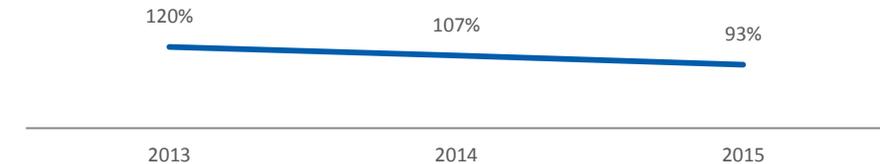
7. Company information from internal credit rating

8. There are two main reasons for the decrease in the interest margin: 1) price competition on the market and 2) changes to the loan book where loans with higher margins were paid off or transferred to other divisions of the Bank. It should be noted that the Bank's net interest margin has remained relatively stable in recent years and the total margin is hedged.

### Growing Icelandic total bank corporate lending<sup>5</sup>

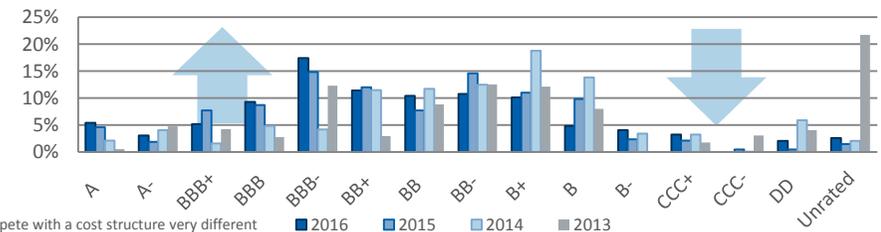


### Decreasing corporate debt as % of GDP<sup>6</sup>



### Improving clients internal credit scores<sup>7</sup>

Excl. non-rated loans



# Leveraging universal relationship banking services

## Leadership in complex transactions

	Enterprise Value	Description	Cross-selling approach	Successful cross-selling	Key achievement
	<ul style="list-style-type: none"> <li>\$78 m</li> </ul>	<ul style="list-style-type: none"> <li>Silicon smelter and silicon metal plant</li> </ul>	<ul style="list-style-type: none"> <li>Successful win of equity raise and identified hedging needs</li> <li>Over the course of the arrangement process demand for FX services and further financing was identified</li> </ul>	<ul style="list-style-type: none"> <li>CB and IB</li> </ul>	<ul style="list-style-type: none"> <li>Deliver the whole bank and deploy entire product suite</li> </ul>
	<ul style="list-style-type: none"> <li>€77 m</li> </ul>	<ul style="list-style-type: none"> <li>The largest fishing and fish processing company in Iceland</li> <li>Listed on Nasdaq Iceland</li> <li>Financing new-build of two multi-purpose vessels and partly refinancing existing debts</li> </ul>	<ul style="list-style-type: none"> <li>The syndicate offered significant reduction in interest cost to the client while maintaining acceptable margins for Arion Bank</li> <li>Cross-selling of FX products</li> </ul>	<ul style="list-style-type: none"> <li>CB and IB</li> </ul>	<ul style="list-style-type: none"> <li>Leverage strong relationship to react to market developments</li> <li>Maintain Arion Bank's position in the local market</li> </ul>
	<ul style="list-style-type: none"> <li>\$110 m</li> </ul>	<ul style="list-style-type: none"> <li>Project finance of a 5 star boutique hotel by Marriott next to Harpa, the concert hall and conference centre in Reykjavik</li> </ul>	<ul style="list-style-type: none"> <li>IB executed equity raise</li> <li>Stefnir formed an investment consortium and FX trades in addition to hedging instruments were required</li> </ul>	<ul style="list-style-type: none"> <li>CB, IB and Stefnir</li> </ul>	<ul style="list-style-type: none"> <li>Ability to handle large volume transactions with complicated financing structures</li> </ul>
	<ul style="list-style-type: none"> <li>€170 m</li> </ul>	<ul style="list-style-type: none"> <li>In 2013, Scandinavian banks began targeting Icelandic seafood corporations</li> <li>Foreign banks with competitive advantage in form of significantly lower funding cost</li> <li>3 transactions with the total amount of €170 m</li> <li>Inc. 3 new build of vessels</li> </ul>	<ul style="list-style-type: none"> <li>Arion Bank, alongside DNB, started offering club/syndicated facilities</li> <li>As a result 3 deals were closed</li> <li>Incl. 1 new major seafood client and 2 refinancings for existing clients</li> </ul>	<ul style="list-style-type: none"> <li>Syndicate</li> </ul>	<ul style="list-style-type: none"> <li>The syndicates offered significant reduction in interest cost to the client while maintaining acceptable margins for Arion Bank</li> <li>Arion Bank turned a real competitive threat into an opportunity, resulting in win-win situation for parties involved</li> </ul>

# Strategy and focus areas

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## Objectives

<b>Lead in large transactions</b>	<ul style="list-style-type: none"><li>▪ Be the logical first call when it comes to large transactions due to integrated, tailored services offering</li></ul>
<b>Further diversify loan portfolio</b>	<ul style="list-style-type: none"><li>▪ Keep client retention rates high (currently over 80%<sup>1</sup>) and be selective when sourcing deals and managing loan book growth</li></ul>
<b>Optimise margins and increase commission income</b>	<ul style="list-style-type: none"><li>▪ Target profitable growth and increase commission income</li></ul>
<b>Bring customer service to the highest level</b>	<ul style="list-style-type: none"><li>▪ Seize key business opportunities in new/ growing sectors (energy and industry and food production)</li></ul>
<b>Provide services outside local market cautiously</b>	<ul style="list-style-type: none"><li>▪ Understand current client needs to grow beyond Iceland</li><li>▪ Build key international relationships</li></ul>

## Key take-aways

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✓ Proven ability to deliver large and complex deals

✓ Loyal customer base

✓ Strategy for profitable growth

✓ Successful cross-selling

✓ Dedicated and experienced team

✓ Leadership positioning across sectors

# Investment bank

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# Leading full service investment banking franchise

Service large corporates, institutions and individuals

## Description

- Offers full spectrum of investment banking services and is a leading Icelandic broker, IPO and M&A advisor and securities trading house
- Managed the only IPO listed on the Main Market Nasdaq Iceland stock exchange in 2016

## Key Highlights and Strengths

- Solid track record and reputation
- Strong balance sheet to engage in transactions and support clients
- Forward contracts in capital markets
- Significant cross-divisional cooperation allowing to leverage customer relationships across Arion Bank
- Capable staff with low turnover
- Good and trusted relations with the Icelandic investors
- Key ingredient for Arion Bank's placement power along with dealflow

# 1

Equity brokerage (trading volumes)

100%

Managed all Icelandic IPOs on the Main Market in 2015 & 2016

8/13

Managed majority of Icelandic IPOs since 2011

ISK 1.8 Bn

Fee and commission income generated in 2016

#1

Best investment bank in Iceland 2016 according to Euromoney

# Investment banking business subdivisions

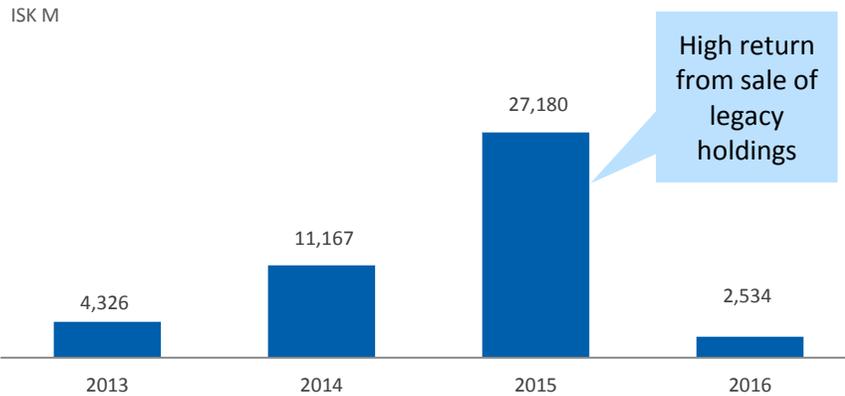
Full Service offering with strong team of banking professionals

Capital markets	Corporate finance	Research
<ul style="list-style-type: none"><li>▪ Securities brokerage: equity, fixed income, swaps and forwards as well as related derivatives</li><li>▪ Foreign exchange: spot, forwards, money market, options, swaps, advisory in relation to CBI FX auctions</li></ul>	<ul style="list-style-type: none"><li>▪ M&amp;A advisory: acquisitions, takeovers, divestitures, mergers, corporate restructurings, spin-offs and LBOs</li><li>▪ Capital markets advisory: IPOs and listing, follow on offerings, private placements, block trades, share buy backs, delistings, bond issues</li></ul>	<ul style="list-style-type: none"><li>▪ Macro and equity research</li><li>▪ Publish forecasts and updates regularly on key economic issues as well as cover companies listed on the Nasdaq Iceland stock exchange</li><li>▪ Icebreaker in meetings for other divisions</li><li>▪ Supports the fee generating units</li></ul>
30	Banking professionals	
13 years	Average relevant experience	
13	Average number of projects in corporate finance per year 2013-2016	
60%	Of IB employees have completed post graduate studies	

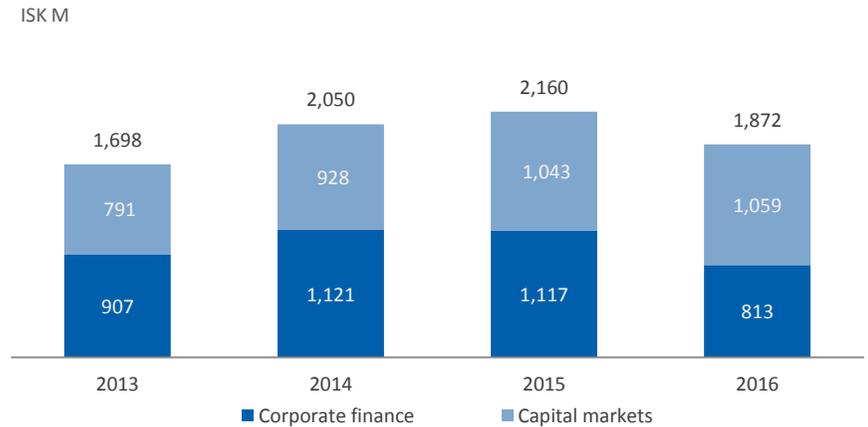
# Key financials<sup>1</sup>

Balanced income stream with consistent growth

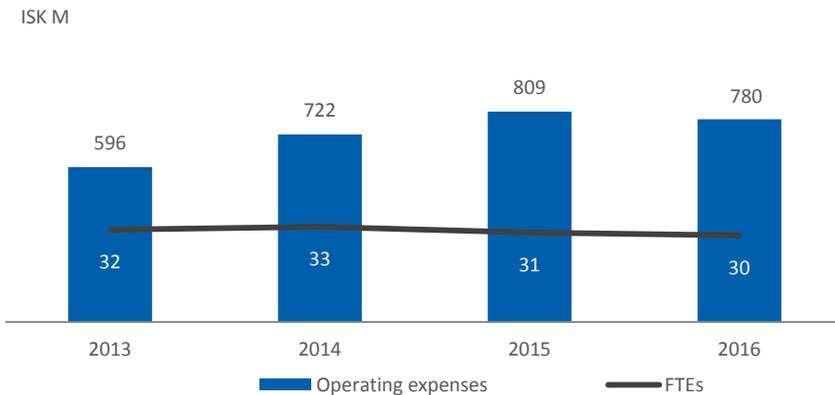
## Operating income



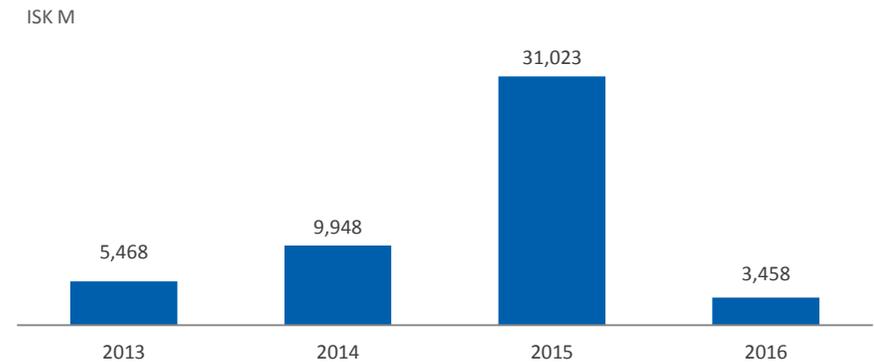
## Net fee and commission income



## Operating expenses



## Earnings before tax



# Leveraging universal relationship banking services

Arion Bank's Investment Bank leverages bank infrastructure, service offerings and balance sheet to enable projects

Company	Products sold						
 <p><b>Skeljungur</b></p>	Advisory buy side	Participation in acquisition through SF IV	Securing credit	Sales advisory	IPO and listing		
Skeljungur: One of Iceland's key petroleum retailer							
 <p><b>REITIR</b></p>	Refinancing and restructuring	Rights issue advisory	Bond issue and listing	IPO and listing	M&A advisory	Bond program issue and listing	
Reitir: Iceland's largest real-estate company							
 <p><b>EDITION</b> THE BEYKJAVIK</p>	Funding of initial plot purchase	Securing lead developer of hotel	Securing Marriott for hotel operations	Securing hotel credit facility	Securing residential credit facility	Hotel equity raising	Residential equity raising
Project Plaza/Project East: luxury hotel & high-end apartments adjacent to Harpa Conference Center							

# Capture market opportunities based on leading franchise

Strong customer focus and diverse product offerings

## Objectives

**Leverage the universal relationship banking model**

- Utilise entire Arion Bank's customer network to market Arion Bank's product offerings unavailable to smaller boutiques
- Offer unique product offerings by leveraging Arion Bank's balance sheet

**Leading research with strong reputation**

- Maintain leading status of independent research team that plays a vital role in the generation of business ideas

**Continuous strong volume growth in key capital markets**

- Maintain leading position in equity brokerage
- Strengthen Arion Bank's position in secondary bond market
- Maintain a strong position in FX brokerage and bond issuances

**M&A activity foreseen to increase with lower interest rates and debt levels**

- Focus on large fee paying clients and products
- Consistent increase in M&A market share with +30% as a target

**Diverse and increased capital markets advisory based on economic growth and investment needs**

- Maintain Arion Bank's leading position in IPOs and listing activities
- Be first choice for secondary market offerings

**Attract foreign investors**

- Increase foreign ownership of listed equities
- Capture opportunities arising from easing of capital controls in M&A and capital markets activities

## Key take-aways

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- ✓ Experienced employees with a good track record
- ✓ Increased opportunities in M&A and capital markets are expected from easing of the capital controls
- ✓ Leading player in IPOs and equity brokerage with a strong position in FX brokerage and fixed income
- ✓ Diverse product range and able to utilise Arion Bank's financial strength and infrastructure
- ✓ Well-known and respected research unit that supports the investment banking business
- ✓ Large and reliable customer base with strong relationships

# Asset management & Stefnir

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# Introduction

## 2 pillar Asset management

### Combined Group



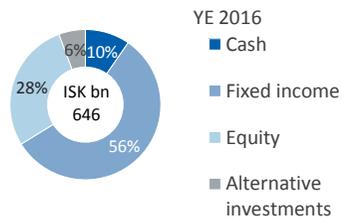
- Established in 1980s with ISK 1,055 billion in AuM in 2016
- Composed of 2 distinct legal entities, Arion Bank Asset Management Division and Stefnir, a fund management company
- Leading asset management franchise in Iceland<sup>1</sup>
- Core focus on pension funds, institutional investors and High Net Worth Individuals / Investors (“HNWI”)
- Strong team, good reputation and strong track record make Arion Bank well-positioned to take part in the local dealflow
- Operational strength to meet increasing risk management, transparency and regulatory requirements
- Well-positioned for easing of the capital controls with strong expertise and product range in global funds

### 100% Independent Subsidiary

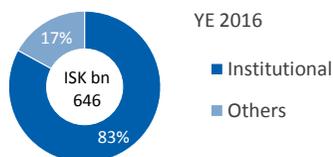
#### Asset Management Division

- ISK 646 billion in AuM in 2016
- 82% growth in AuM from 2011 to 2016
- Asset management for institutional investors
- Full services for pension funds from 1994
- Private Banking for HNWI, family offices and legal entities
- Strong relationships with other divisions
- Main distributor of Stefnir funds
- Partnership with three major global asset and fund managers
- More than 100,000 customers<sup>3</sup>
- 33 employees

#### Asset class (AuM)



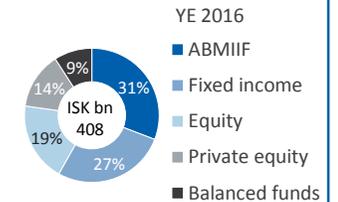
#### Client split (AuM)



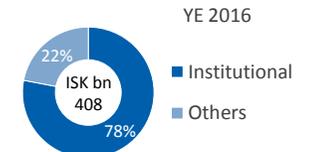
#### Stefnir

- ISK 408 billion in AuM in 2016
- Sourced from Arion Bank AM as well as from external investors
- Emphasis on independence and corporate governance
- More than 40 funds
- High penetration covering 5 out of 5 major domestic, universal insurance companies and 20 out of 20 largest domestic pension funds
- Provides fund management services to Arion Bank AM as well as external parties
- Wide range of products offered: fixed income, equities, private equity, balanced funds, ABMIIF<sup>2</sup>
- Approximately 11,500 owners in mutual funds
- 21 employees
- 2015 ROE of 51.2%

#### Product offering (AuM)



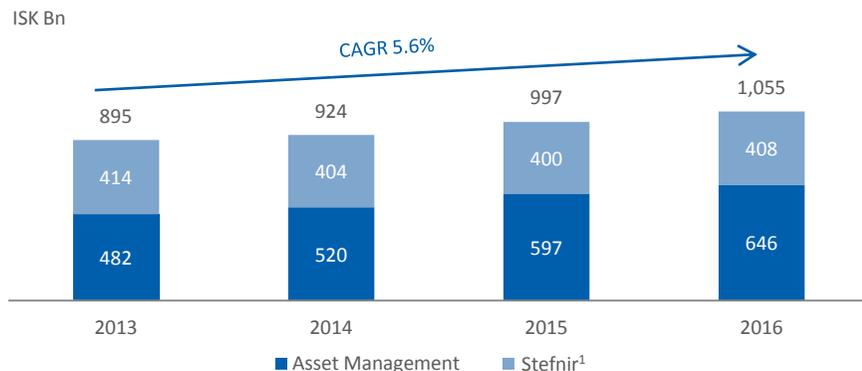
#### Client split (AuM)



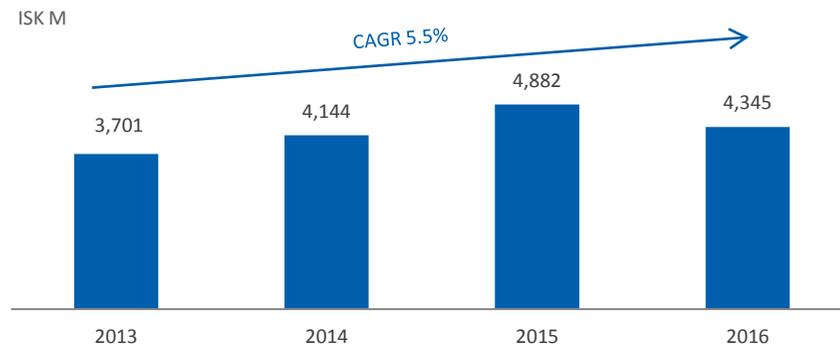
# Key financials (incl. Stefnir)

Increasing assets under management and profitability

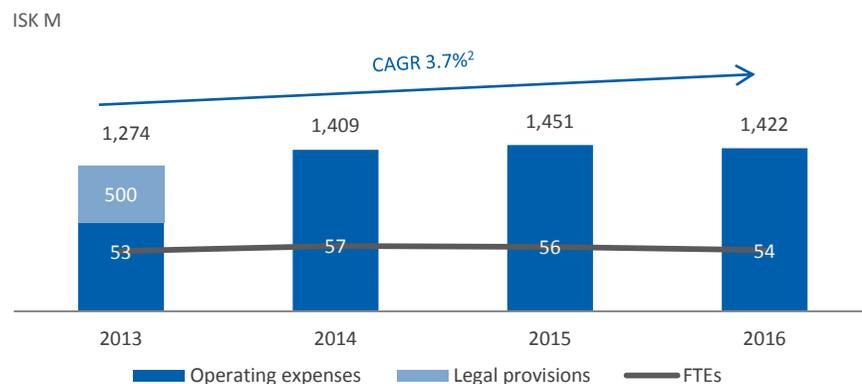
## Assets under Management



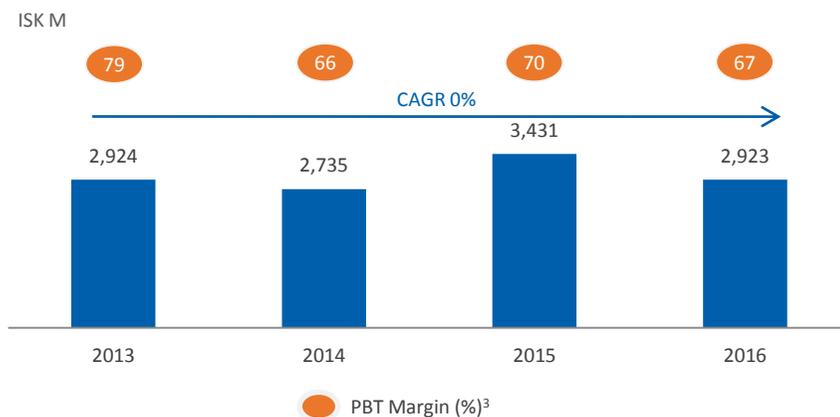
## Operating income



## Operating expenses



## Earnings before tax



Source: Company information

1. Outflow from Arion Bank Mortgages Institutional Investors Fund (ABMIIF): ISK 20 Bn in 2014 and ISK 25 Bn in 2015
2. Computed with legal provisions taken into account, see note 36 in Arion Bank 2013 annual report
3. PBT Margin computed as PBT over Operating Income

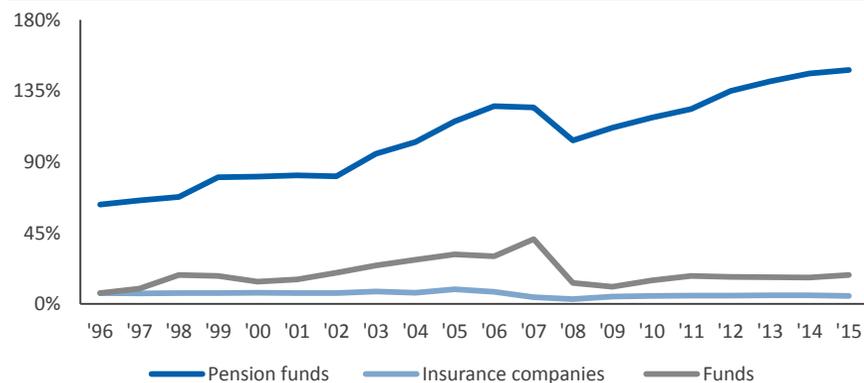
# Icelandic asset management market

National savings largely within the pension system

## Market characteristics

- Savings in Iceland dominated and driven by pension funds
- Expected continued inflow into pension schemes
- Main trends and key drivers:
  - Continued growth since financial crisis
  - Broadening of product offering
  - International investing
- Pension funds assets now thirty times larger than financial assets managed by insurance companies
- Capital controls easing expected to shift focus to more international investing
- Total AuM in the domestic market estimated to be approx. ISK 2,400 billion<sup>1</sup> at year end 2015 (including fund management companies)

## Institutional investors – investable assets as % of GDP

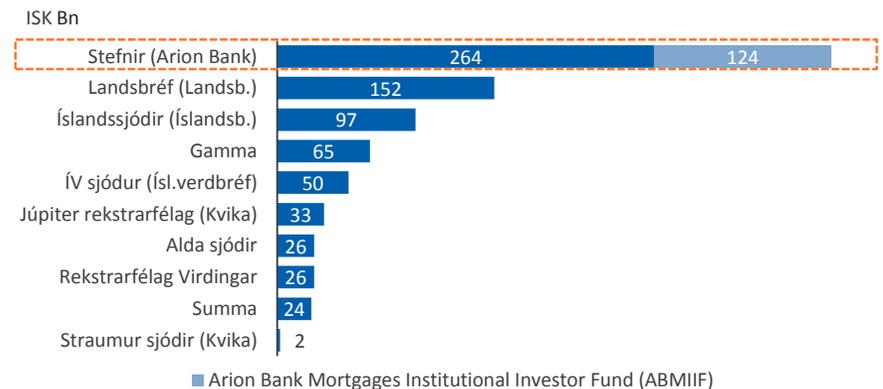


Source: Central Bank of Iceland.

## Competitive landscape

- Stefnir is the largest fund management company in Iceland<sup>2</sup> with ISK 408 billion in AuM at year end 2016
- Arion Bank's Asset Management division is the leader in the market
  - Well-positioned to benefit from changes in regulations and capital control easing to maintain leading position in the pension market
- Significant number of competitors with pressure on fees
  - Increasing cost pressure and regulations on funds have driven consolidations in the pension market – expected to continue in the future

## Fund management companies by AuM at H1 2016



Source: Semi-annual Financial Statements.

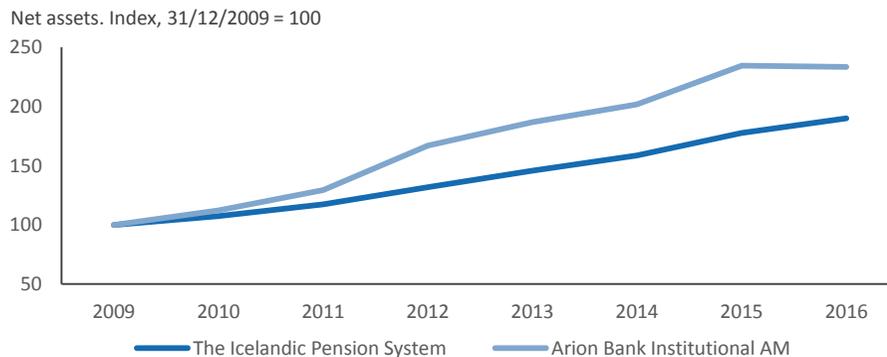
1. The estimation is based on Arion Bank's assumptions on fund management companies and asset management services from annual reports, news, etc.  
 2. FME

# A unique service offered to pension funds

Long track record of managing funds

Services	<ul style="list-style-type: none"> <li>Extensive services in branches and service centres</li> <li>Own website</li> <li>Marketing and sales</li> </ul>
Investing	<ul style="list-style-type: none"> <li>Team-based approach</li> <li>Supporting board of directors in setting IPS</li> <li>Extensive processes and access to dealflow</li> </ul>
Administration and risk management	<ul style="list-style-type: none"> <li>Effective operational team</li> <li>Experienced back office</li> <li>Risk management reports</li> </ul>
Regulatory	<ul style="list-style-type: none"> <li>Extensive resources to meet regulatory requirements</li> <li>Strong compliance and legal advisory teams</li> </ul>

## Arion Bank institutional AM compared to the Icelandic pension system

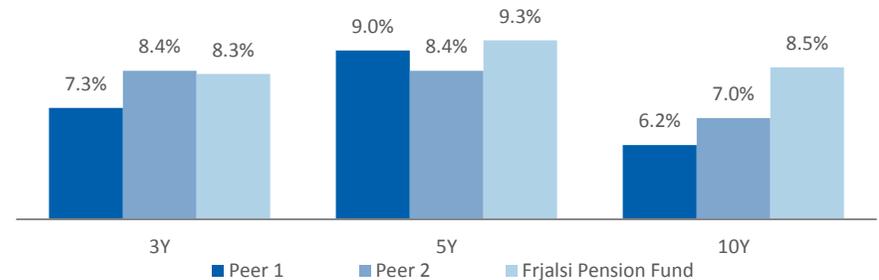


Source: Central Bank of Iceland, Arion Bank Asset Management

- The sixth largest pension fund in Iceland (source: FME) with assets of ISK 174 Bn at year end 2015. In full operations at Arion Bank
- Composite returns computed by asset-weighting individual sub-funds/portfolios
- No specific award category for Iceland from 2012 and onwards

## Comparison of Frjalsi<sup>1</sup> pension fund with peers

Geometric average returns<sup>2</sup> (annualised) as of YE 2015



Source: Peers' and Frjalsi Pension Fund annual reports

## Awards won by Frjalsi<sup>1</sup> pension fund

### Investment & Pensions Europe (IPE) Awards for Pension Funds

- 2014–2015 – Best Small Pension Fund in Europe
- 2013–2014 – Best Pension Fund in Small Countries
- 2014 – Best Institutional Real Estate Investor
- 2009–2010–2011 – Best Pension Fund in Iceland<sup>3</sup>
- 2005 – Best European Pension Fund in the category DB/DC Strategy



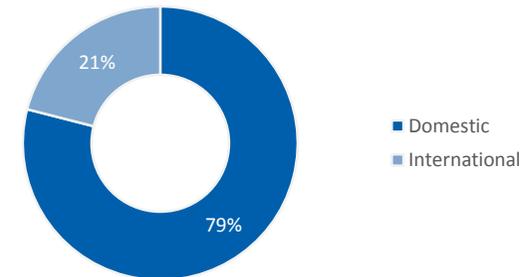
# International cooperation

## Capital controls easing creates new opportunities

- Asset management and Stefmir are well-positioned to capture opportunities resulting from the easing of capital controls
- Institutional investors and retail clients alike will likely increase their exposure to foreign assets. Currently, pension funds have only 22% of their assets outside Iceland.<sup>1</sup> Arion Bank Asset Management and Stefmir expect this ratio to gradually increase to around 40% over the next 15-20 years
- Stefmir has a long history of managing international equity funds, both funds of funds and actively managed stock picking funds. Most of the funds are domiciled in Luxembourg
- Stefmir has the largest team of investment professionals dedicated to international markets
- Through its 3rd party fund business, Arion Bank has a reselling agreement with three of the top 10 largest asset management companies in the world<sup>2</sup>

## AuM allocated to international investments

As of 31/12/2016



Source: Company information.

## Icelandic pension funds – share of foreign assets



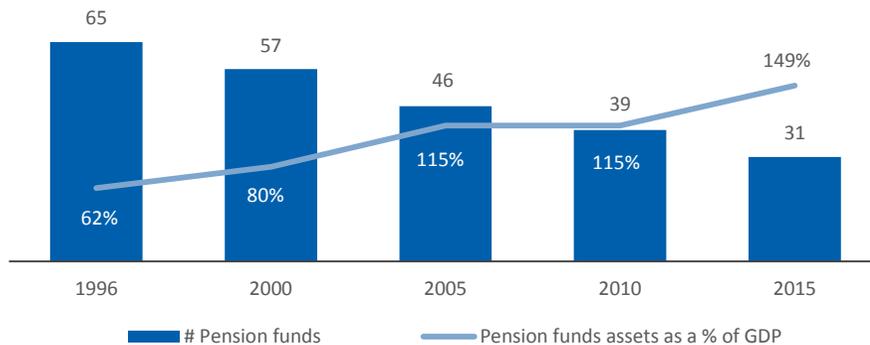
Source: Central Bank of Iceland.

# Icelandic Pension System

## Robust growth expected to continue

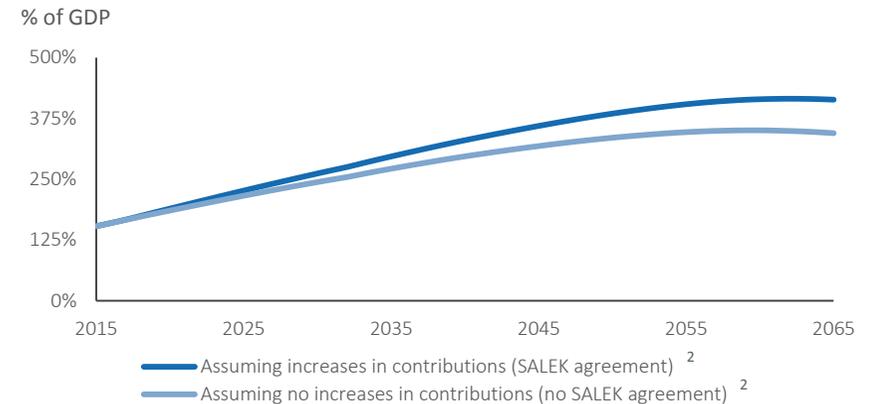
- Strong organic growth in pension funds due to favourable demographics
- New legislation could further increase inflow and postpone outflow
- Second largest pension funds system in the world in relative GDP terms (149% of GDP)
- Number of pension funds in Iceland has decreased in recent years due to consolidations
- Consolidation likely to continue due to regulatory changes

### Pension fund consolidation in Iceland

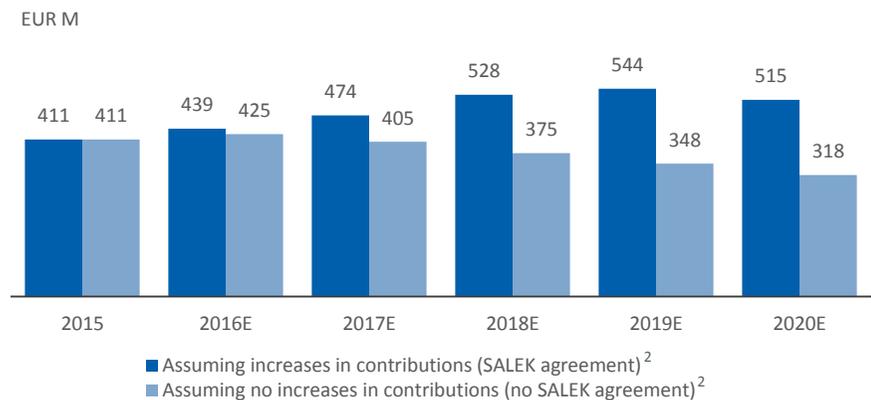


Source: Icelandic FSA, Statistics Iceland, Central Bank of Iceland

### Development of the pension system's size<sup>1</sup>



### Net inflow to the pension system<sup>1</sup>



1. Based on Arion Bank AM in-house study

2. The cooperation agreement between the employers' and employees' associations relating to the salary information and economic forecasts for wage increases

# Clear strategy and focus areas

Main drivers of future results

## Objectives

**Retain close  
client relationship**

- Maintain market position and prudent growth in AuM

**Maintain employee motivation**

- Highly skilled people in each position continuously motivated

**Capture investments  
opportunities**

- Prudent investment results according to risk levels

**Strong focus on digitalisation  
opportunities**

- Improved efficiency and increased sales

**Strong capabilities to benefit  
from increasing regulatory  
complexities**

- Seize opportunities through changes in regulations

## Key take-aways

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- ✓ Experienced employees with team approach to investment decisions
- ✓ Long-term relationships with our clients
- ✓ Long-term track record in generating returns and in products and services offering
- ✓ Largest player in the Icelandic asset management industry
- ✓ Increased inflow from existing clients, particularly from pension funds
- ✓ Well-positioned in local dealflow
- ✓ Well-positioned to benefit from easing of the capital controls

# Financial Performance

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# Summary of financial performance

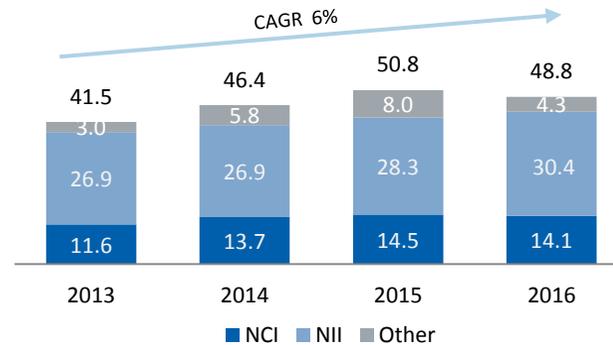
## Diversified income streams and healthy margins

- Diversified business model across a wide spectrum of comprehensive financial product and services offering
- Stable and diversified income streams, comprising high and growing portion of fee and commission income
- Competitive cost-to-income ratio temporarily increased by mainly lower other revenues, salary increases under wage agreements and growth initiatives at Valitor and at the Keflavik international airport
- Cost efficiency measures driving improvements in the cost-to-income ratio going forward
- Adjustments relate to one-off items, primarily impacts from non-core assets and legacy equity holdings

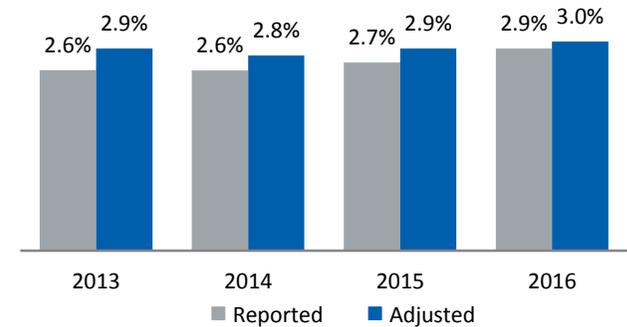
### Total operating income (adjusted)

#### Total operating income (adjusted)

ISK Bn

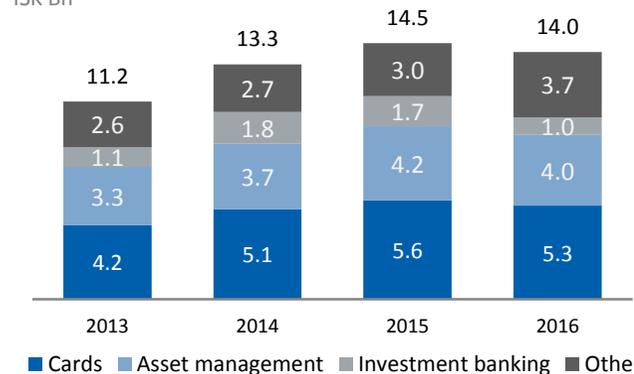


### Net interest margin<sup>1</sup>

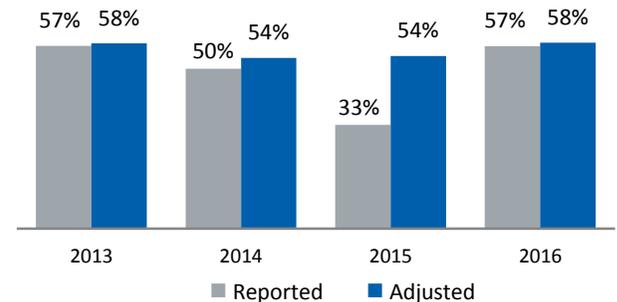


### Net fee and commission income (reported)

ISK Bn



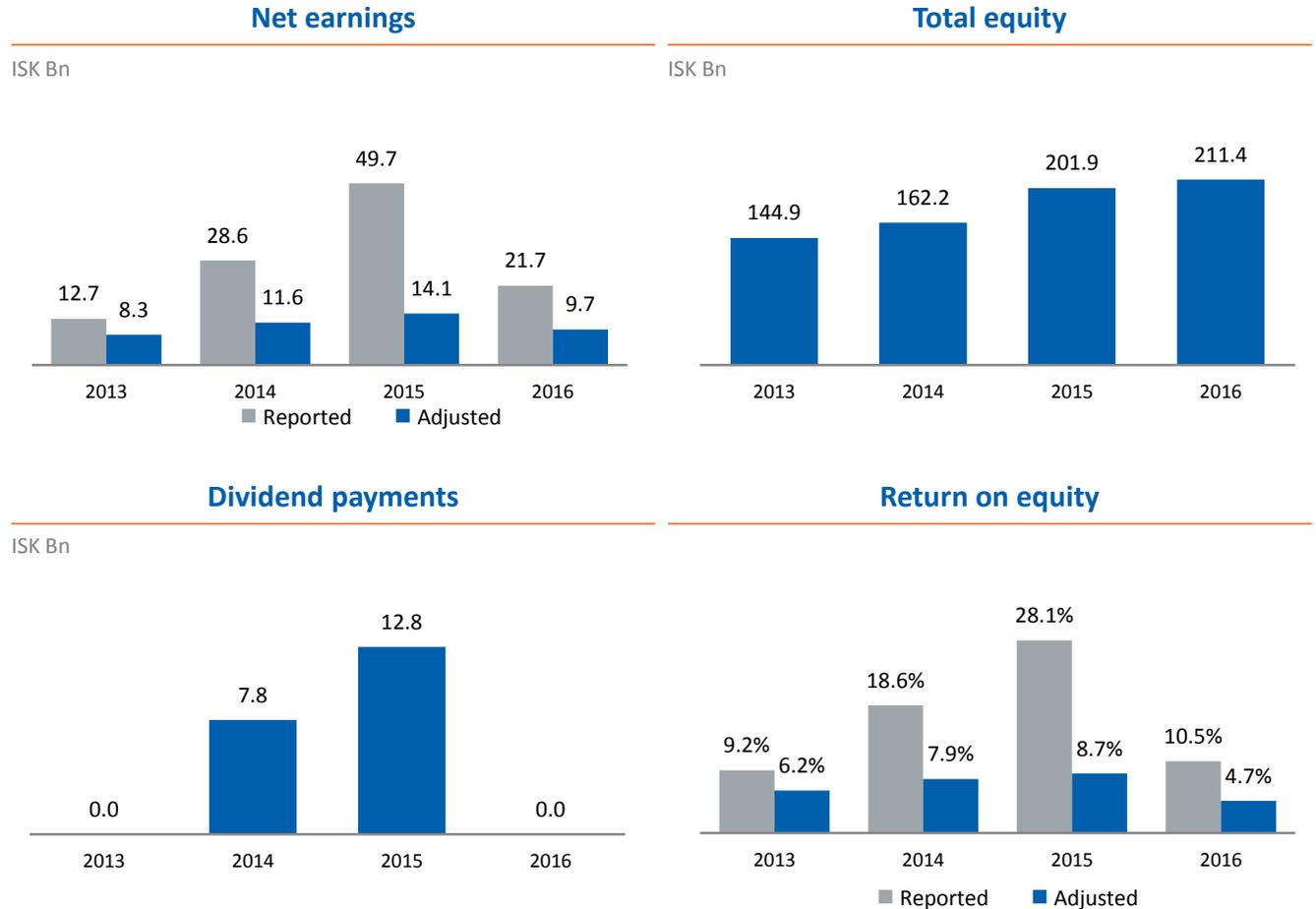
### Cost-to-income ratio



# Summary of financial performance

Good profitability underpinned by strong fundamentals

- Substantial growth of equity due to profit generation as well as one off income items
- Dividend payments have been modest as the majority owner has not had an economic benefit from receiving dividends
- Return on equity has been relatively stable since 2013 despite higher earnings due to higher CET1



# Summary of financial performance

Good profitability underpinned by strong fundamentals

- Total operating income growth driven by strong growth in fee and commission income coupled with stability in net interest income
- Volatility in financial income relating to MTM of listed equity holdings acquired as legacy loans and some FX volatility at subsidiary level
- Substantial increase in staff expenses due to Valitor international expansion, the new branch at Keflavik airport and a national wage round in 2016
- Unusually high bank levy affects pre-provision profit levels
- Loan loss impairments relatively stable, but offer possibilities for improvement

## Income statement (adjusted)<sup>1</sup>

ISK Bn	2013	2014	2015	2016
Net interest income	27.0	26.9	28.3	30.4
Net fee and commission income	11.6	13.7	14.5	14.1
Financial income	0.5	1.7	5.3	0.9
Other operating income	2.4	4.1	2.7	3.4
<b>Total operating income</b>	<b>41.5</b>	<b>46.4</b>	<b>50.8</b>	<b>48.8</b>
Staff expenses	(13.4)	(13.9)	(14.9)	(16.3)
Operating expenses	(10.6)	(10.9)	(12.6)	(12.4)
Bank levy	(2.9)	(2.6)	(2.8)	(2.9)
<b>Pre-provision profits</b>	<b>14.5</b>	<b>18.9</b>	<b>20.5</b>	<b>17.2</b>
Net impairment	(3.5)	(3.7)	(3.9)	(4.0)
<b>Earnings before taxes</b>	<b>11.0</b>	<b>15.2</b>	<b>16.7</b>	<b>13.1</b>
Income tax	(3.1)	(4.1)	(2.9)	(4.3)
Net gain from disc. op.	0.4	0.5	0.4	0.9
<b>Net earnings</b>	<b>8.3</b>	<b>11.6</b>	<b>14.1</b>	<b>9.7</b>

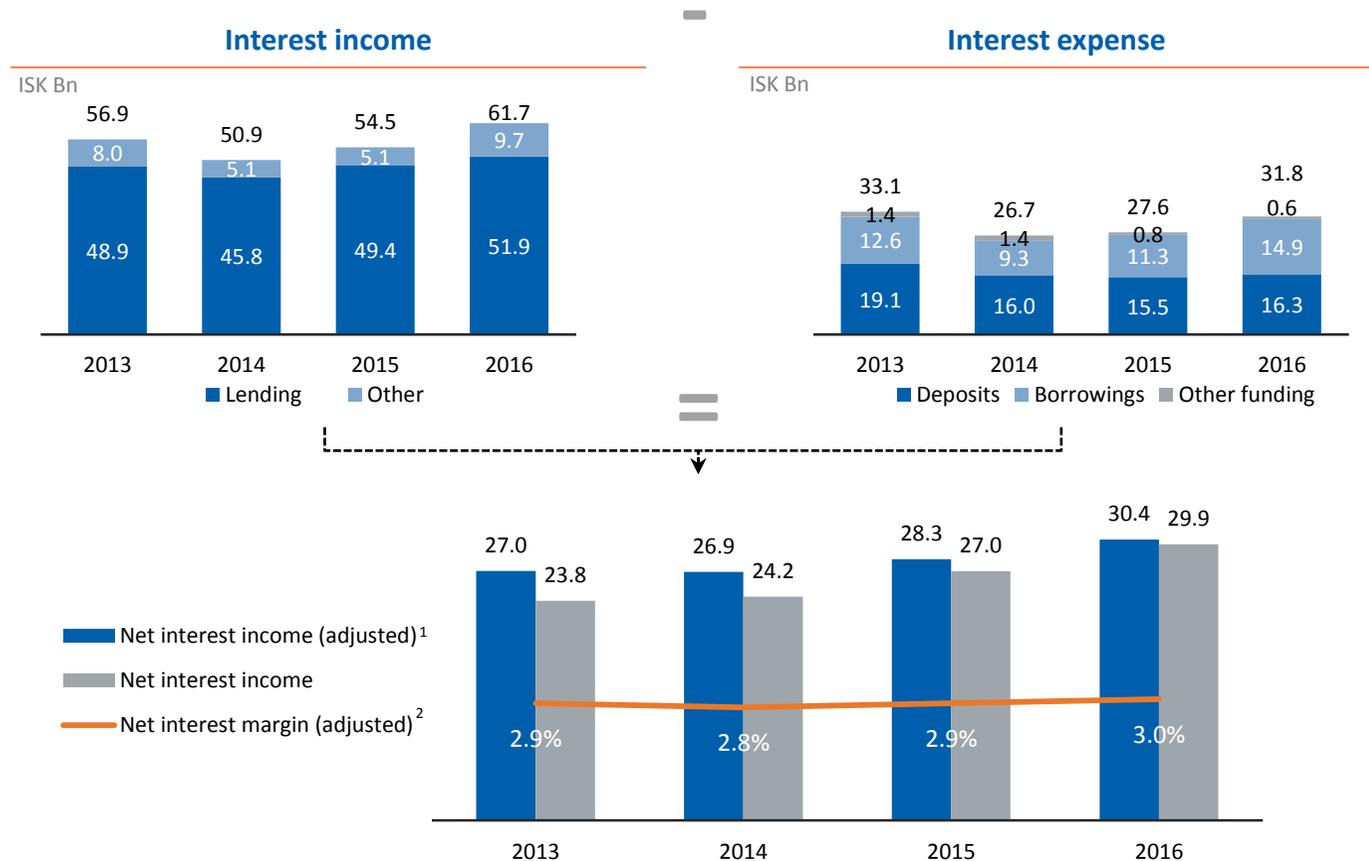
Source: Company information

1. Adjustments relate to one-off items, primarily impacts from non-core assets, operating expenses and legacy equity holdings

# P&L details: net interest income

Stable margins driven by disciplined lending as well as funding and liquidity management

- Emphasis on margins rather than volumes in lending activities
- Increased focus on funding and liquidity management has supported the development of the net interest margin
- New funding during 2016 mostly issued covered and senior bonds while deposits remain stable
- Inflation, which has been low in Iceland since 2013, generally has a positive effect on margins
  - Positive CPI imbalance of ISK 116 billion at year end



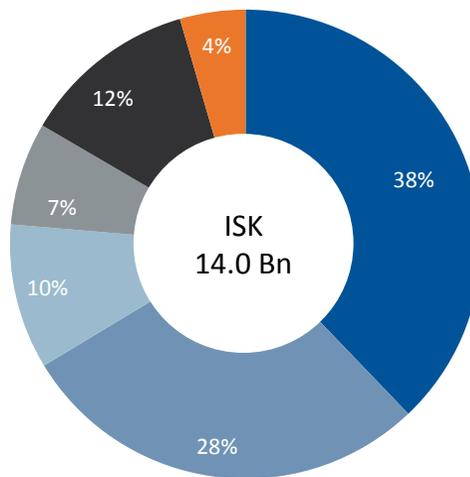
# P&L details: net fee and commission income

Emphasis on commission income growth in all lines of business

- High growth in net fee and commission income from cards since 2013 relating to expansion of Valitor in the Nordics and the UK
- Strong performance in asset management, partially linked to market performance
- Good progress in investment banking for the past few years which has led the re-establishment of the Icelandic equity capital markets
  - Investment Banking managed three IPOs in 2015 and one IPO in 2016 (all IPO's in Iceland in both years)
  - Good progress in capital markets in equities, bonds and FX trading
- No adjustments are impacting net fee and commission income

Net commission income breakdown

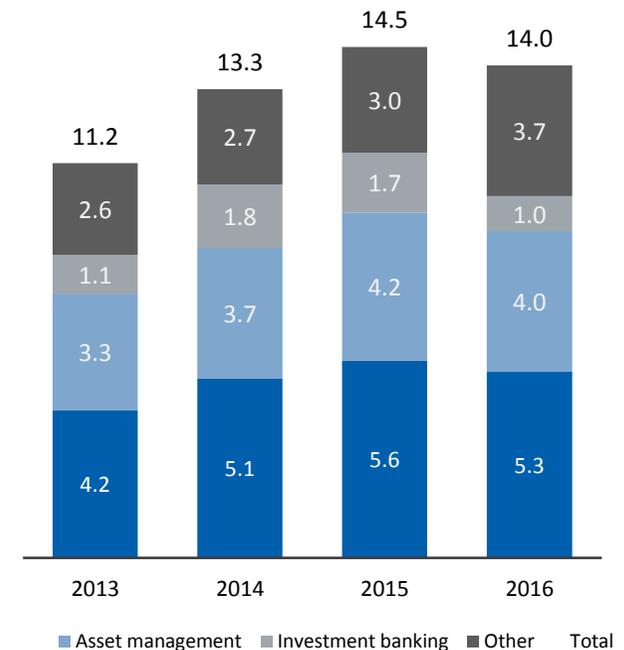
2016



- Cards and payment solutions
- Asset management
- Collection & payment services
- Investment banking
- Lending & guarantees
- Other

Net fee and commission income

ISK Bn



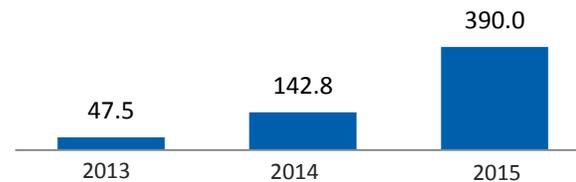
# P&L details: Valitor financials<sup>1</sup>

Offering diversification and international growth opportunities

- 30 years of payments tech competence in a highly competitive market
- Tech platform strength
- International operations focusing on e-commerce and online payment solutions
- Substantial recent growth in Denmark and the UK
- Star customers include Stripe and Klarna
- Substantial pipeline of growth initiatives
- Recent infrastructure and scalability investments with significant outlook for revenue growth and increased profitability

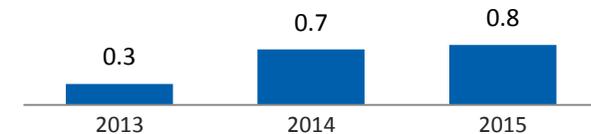
## International acquiring volume

ISK Bn, 2015



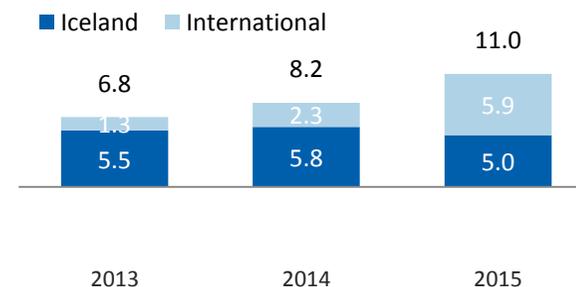
## Operating profit (EBITDA + net interest)

ISK Bn, 2015



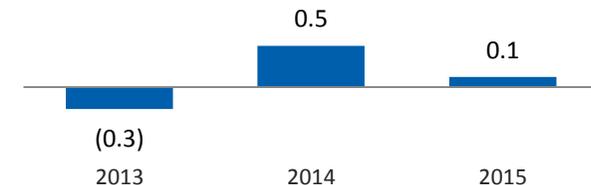
## Revenues

ISK Bn, 2015



## Valitor group profit before tax

ISK Bn, 2015



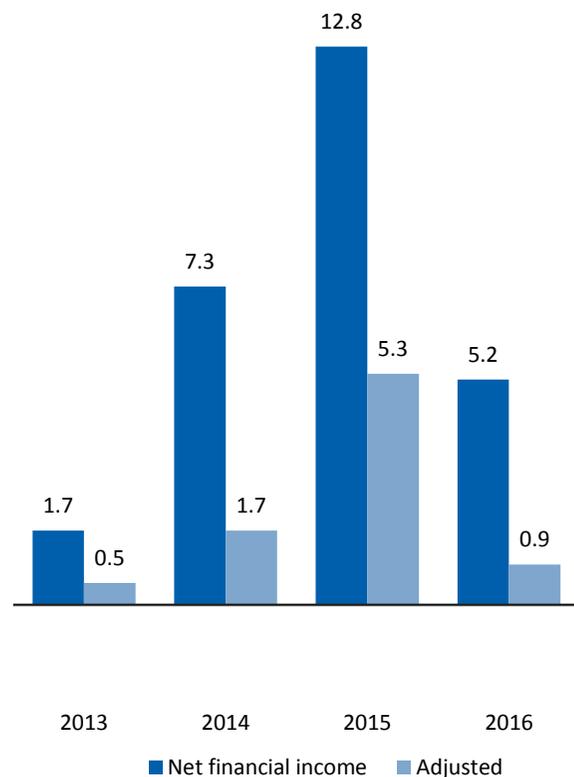
# P&L details: Net financial income

Net financial income largely relates to divestitures of holdings

- Security strong investment return on positions following listing of several companies
- Equity holdings decreased during the year, mainly due to sale of equity holding in Visa Europe and sale of listed and unlisted holdings
- Financial instruments increased with the acquisition of Vördur at the end of Q3, ISK 4.5 billion in bond holdings and ISK 4.2 billion in equity holdings
- The Icelandic stock market underperformed during 2016 with OMXI8 dropping 9.0% during the year
- The ISK continued to strengthen during the year resulting in a FX loss at subsidiary level

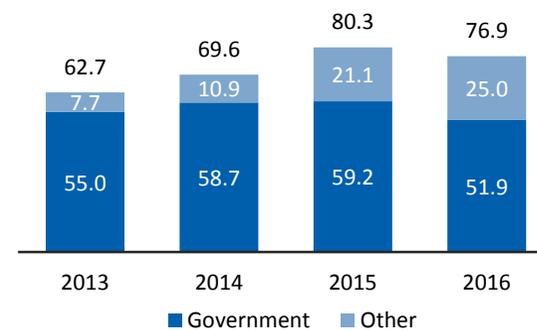
### Net financial income

ISK Bn



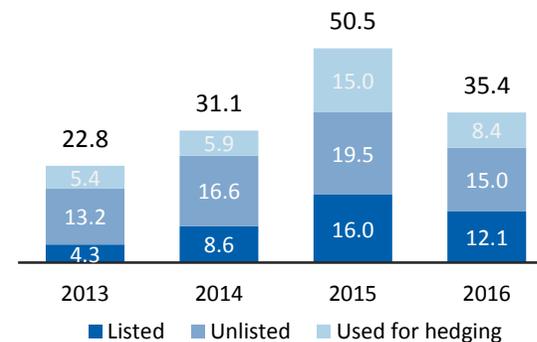
### Bond holdings

ISK Bn



### Equity holdings

ISK Bn



Source: Company information

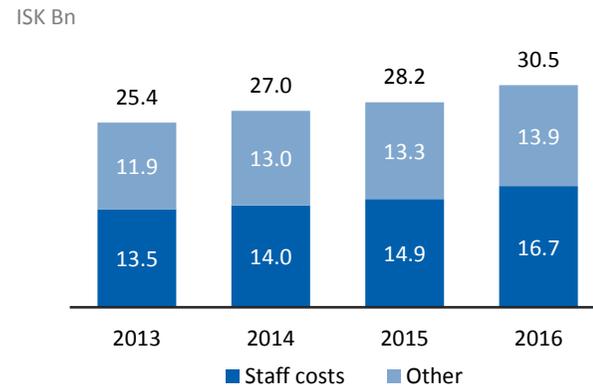
# P&L details: Total operating expenses

Increase in expenses relating to increased salaries and activities

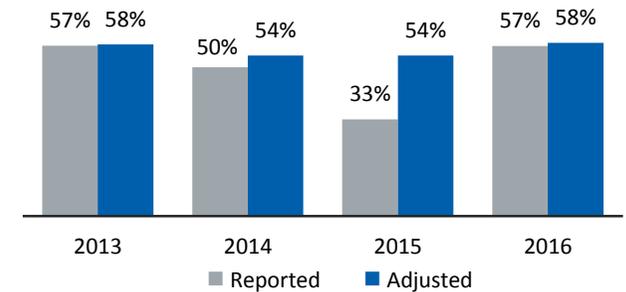
- Increase in salaries and related expenses due to expansion of Bank's operations, by opening a major new branch at Keflavík International Airport, increased activities at Valitor and the incorporation of the insurance company into the Group in Q4. New collective wage agreements and the cost associated with the reduction of FTEs at the end of September also had a major impact
- Increase in professional services, marketing expenses and IT expenditures compared with prior years
- Cost-to-income ratio volatile mainly due to large one-off income items
- There will be cost increase, although not fully quantified yet, relating to the implementation of upcoming regulation including MiFID II, EMIR, Short selling, MAR, BRRD, PSD II and GDPR.

Source: Company information

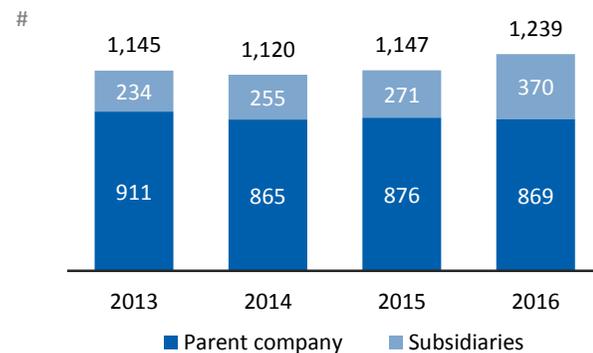
### Total operating expense



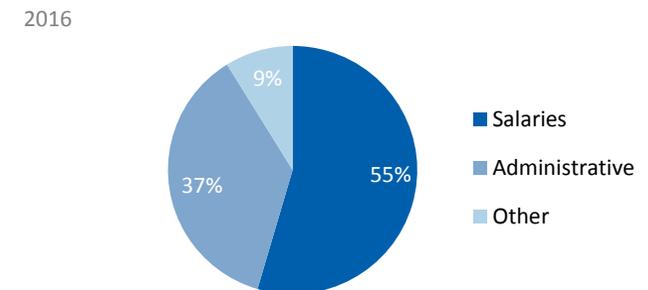
### Cost-to-income ratio



### Number of employees



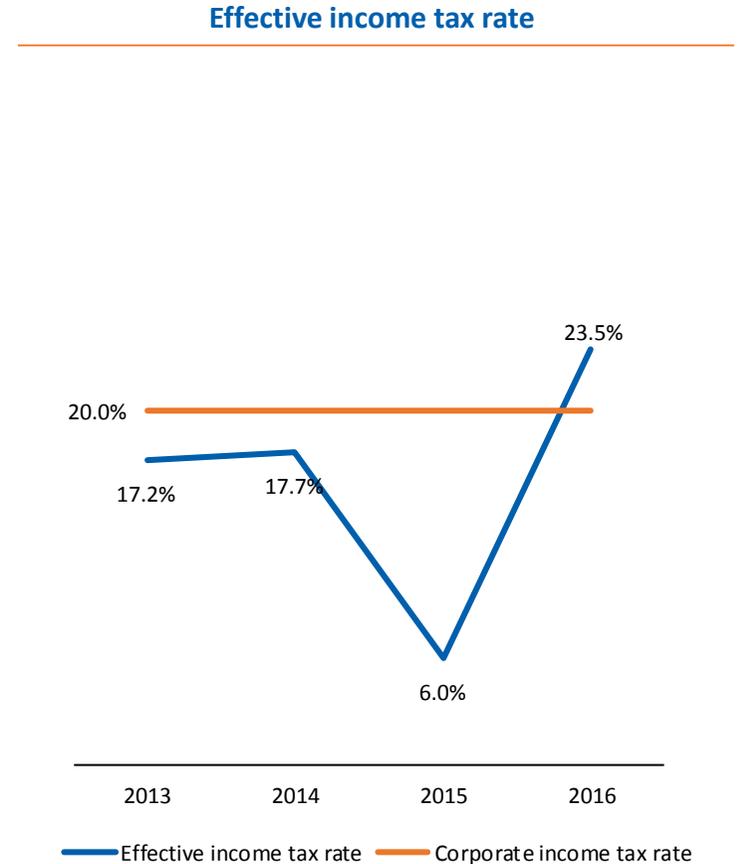
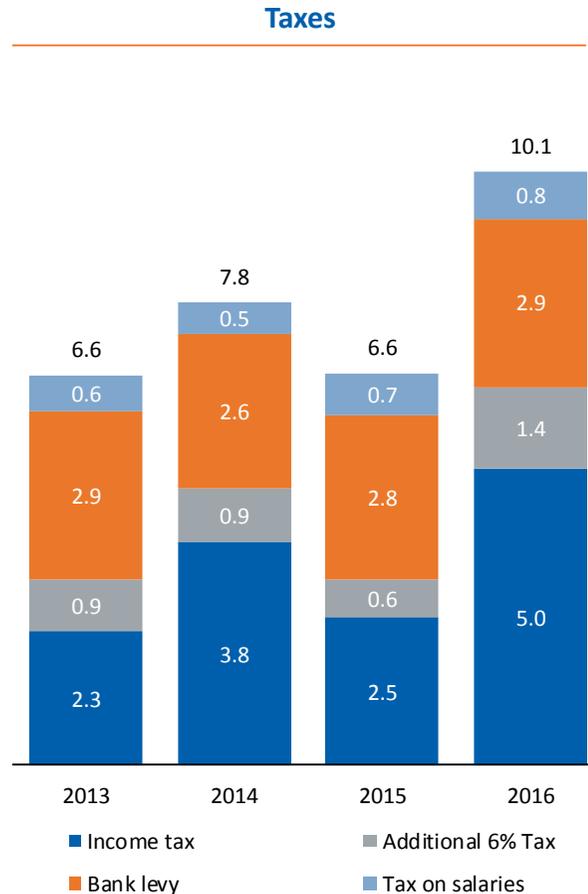
### Operating expenses breakdown



# Tax expense

## Financial institutions in Iceland face a stringent tax burden

- Icelandic corporate income tax rate is 20%
- Financial institutions pay additional taxes:
  - 6% additional income tax on taxable income above ISK 1 Bn
  - Bank levy of 0.376% on total debt above ISK 50 Bn
  - 5.5% tax on employee salaries (6.75% in 2013)
- The bank levy was introduced in 2010 at 0.041% and subsequently increased in 2013. It was expected that bank levy would be lowered in 2017 but the long-term budget of the Icelandic Ministry of Finance indicates it is not the case
- The historically lower effective income tax rate primarily driven by tax exempt income relating to equity positions

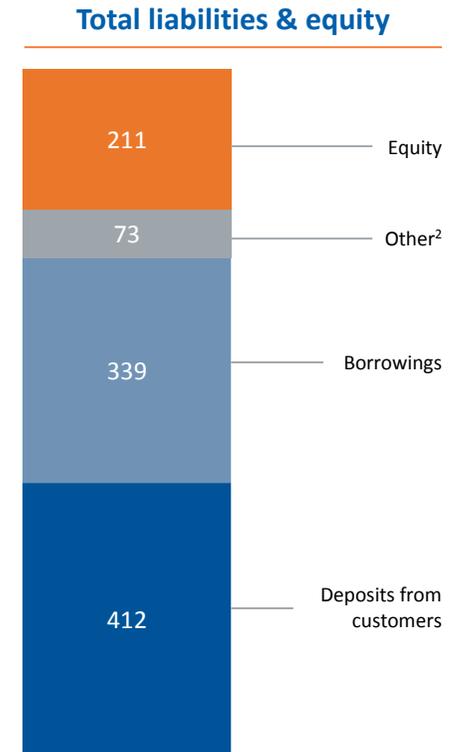
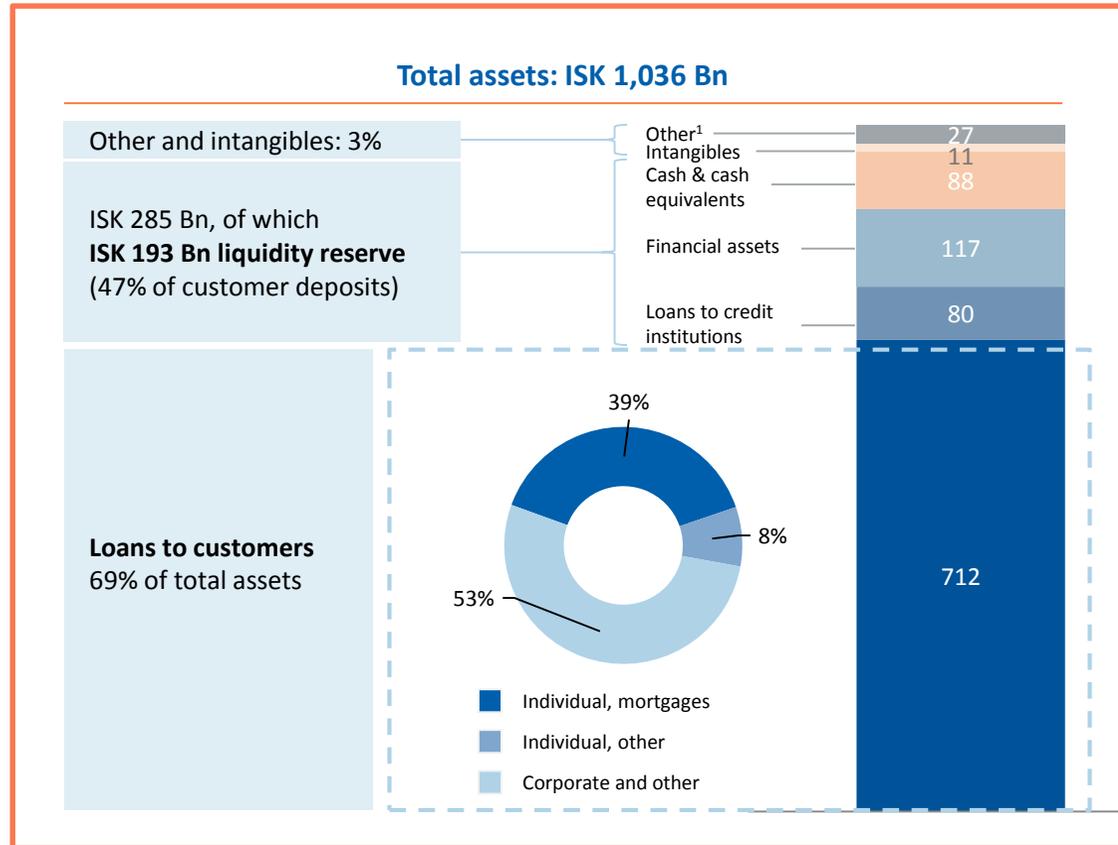


Source: Company information

# Strong balance sheet

Strong, simple and high quality balance sheet

ISK Bn, 2016



# Balance sheet development

Strong, simple and high quality balance sheet

- Good liquidity position
- Positive increase in loans to customers
- Investments in associates decreased due to sale of Bakkavor Group Ltd.
- Decrease in deposits mainly due to funding agreement with Kaupthing
- Continued increase in borrowings to fund loan growth and prepayments of debt facilities
- Strong equity position

ISK Bn

<b>Assets</b>	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
Cash & balances with CB	88	48	21	38	30
Loans to credit institutions	80	87	109	102	101
Loans to customers	712	680	648	636	567
Financial assets	117	133	102	87	138
Investment property	5	8	7	29	29
Investments in associates	1	27	22	18	7
Other assets	32	27	26	30	30
<b>Total Assets</b>	<b>1.036</b>	<b>1.011</b>	<b>934</b>	<b>939</b>	<b>901</b>
<b>Liabilities and Equity</b>					
Due to credit institutions & CB	8	11	23	28	33
Deposits from customers	412	469	455	472	449
Other liabilities	65	62	61	58	59
Borrowings	339	256	201	205	195
Subordinated loans	-	10	32	32	34
Shareholders Equity	211	193	161	140	127
Non-controlling interest	0	9	2	5	4
<b>Total Liabilities and Equity</b>	<b>1.036</b>	<b>1.011</b>	<b>934</b>	<b>939</b>	<b>901</b>

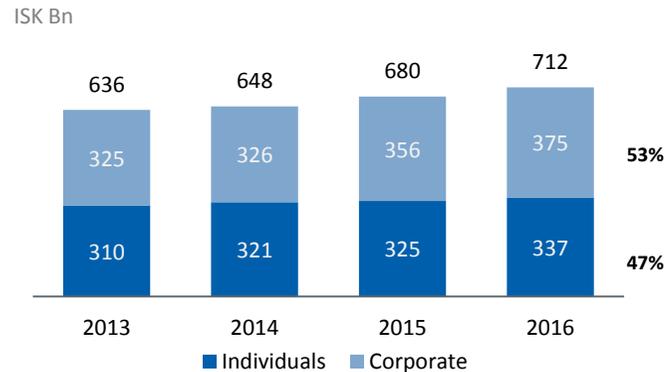
Source: Company information

# Loan portfolio overview

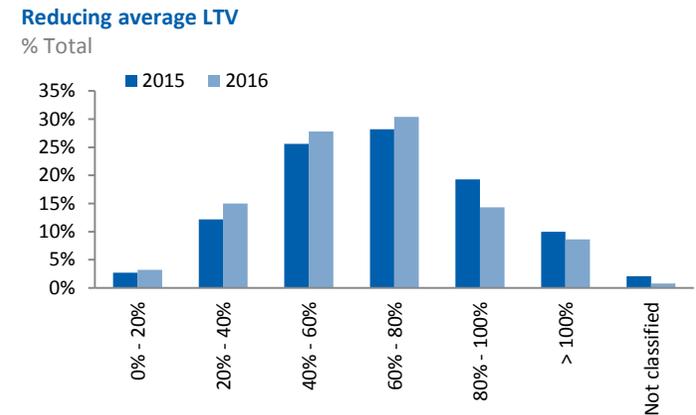
Well balanced between loans to individuals and corporates

- Loans to individuals represent 47% of total loans to customers
- Corporate loans are diversified across a broad set of industries and types
  - Small international corporate portfolio in the seafood sector
- Diversification of the corporate loan book of Arion Bank mirrors the activities in the Icelandic economy
- Loan demand looks favourable, especially on the corporate side of the business
- Demand for mortgage loans is also high but pension funds, who operate in a different regulatory environment, are currently competing through direct lending

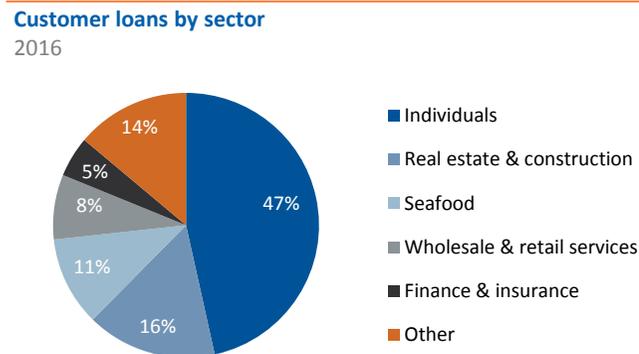
## Continued growth in customer loans



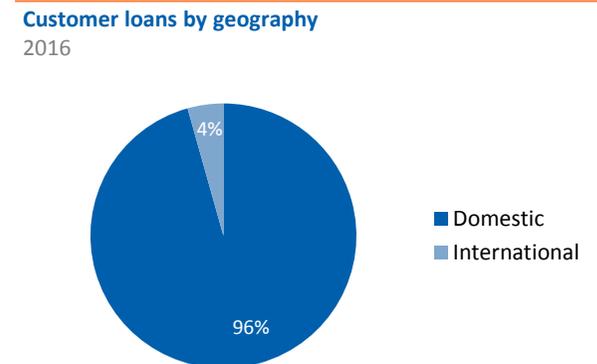
## Mortgage loan-to-value ratio



## Diversified across sectors



## Domestically focused loan book

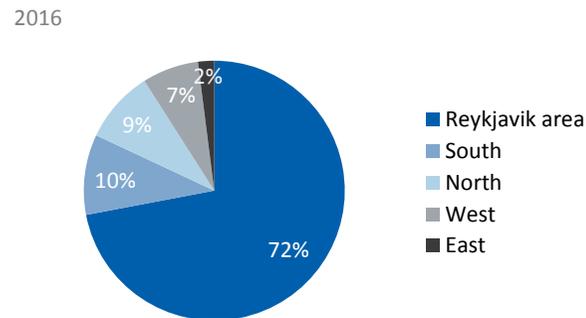


# High quality mortgage portfolio

Full range of mortgage products with strong position in the market

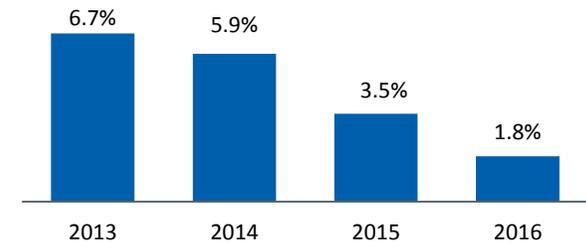
- Offers full range of mortgage products and maintains a strong position in the market
- The quality of the mortgage portfolio is good and continues to improve through amortisations as well as increasing housing prices
- Leading innovator in the mortgage market, being the first to introduce new products such as fixed rate non-CPI linked mortgages
- Successful acquisitions of mortgage portfolios at the end of 2011 and 2013
- Arion Bank was the first of the three banks to return to the mortgage market after the crisis

### Mortgage loans by region

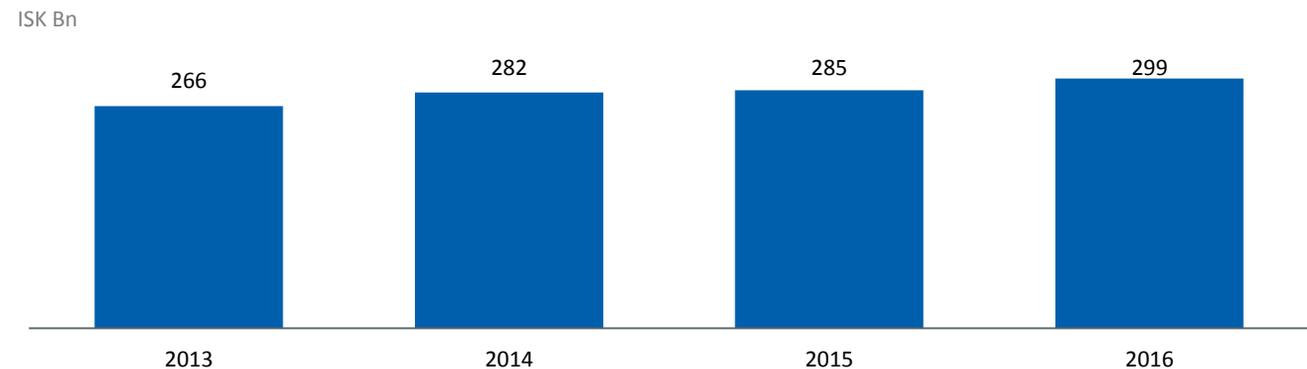


### Improving credit quality

#### Mortgage loans in +90 days default (%)



### Mortgage loans

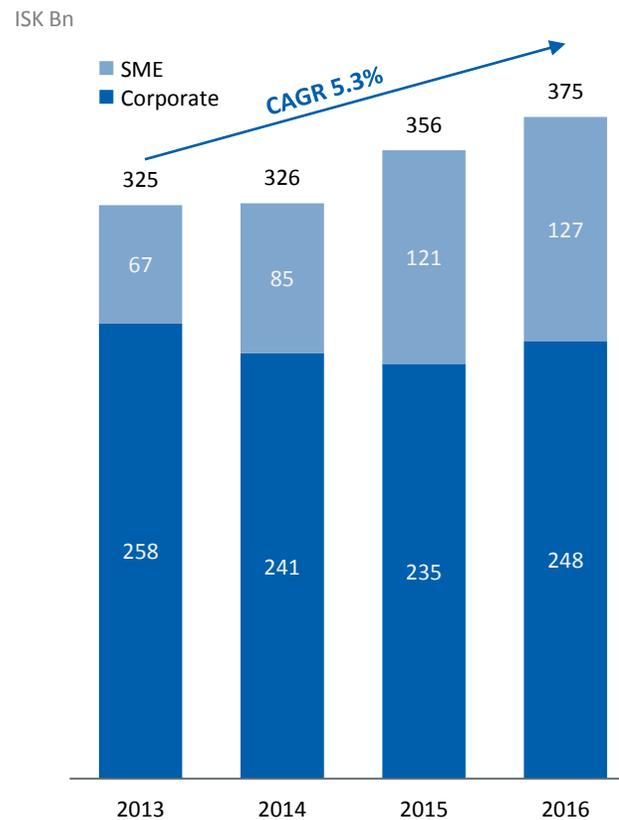


# Overview of the corporate & SME loan book

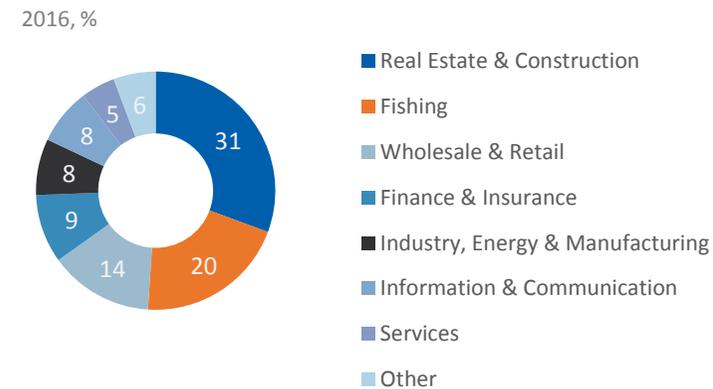
Good diversification in the corporate & SME loan book

- Good pipeline for corporate loans
- Strong demand from export industries that generally favour loans in FX
- New lending for corporate and SME's in the year 2016 amounted to ISK 166 Bn according to definition from the Central Bank and repayment of total ISK 99 Bn

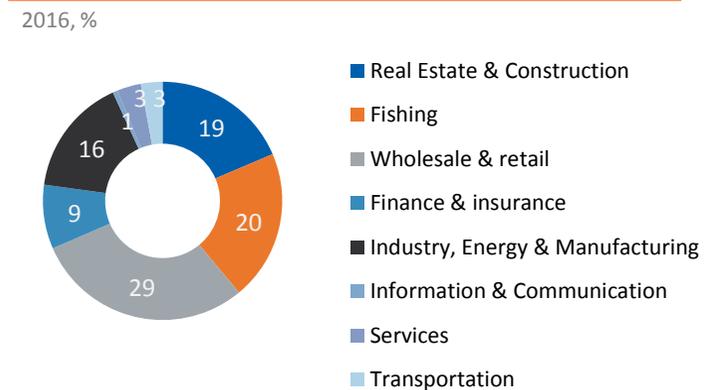
## Strong growth in corporate lending



## Loans to corporate by sector



## Loan commitments – ISK 82 Bn



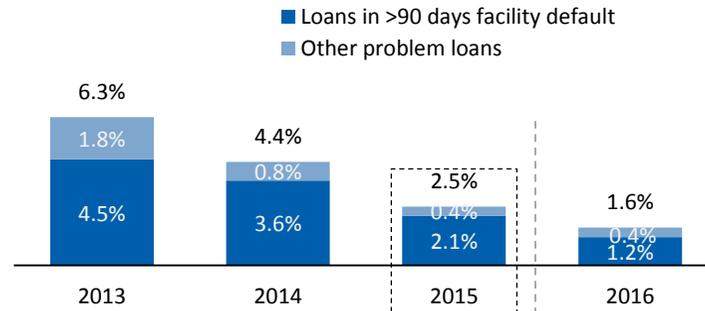
# Asset quality improvements

High quality credit profile and problem loan ratios now narrowing in on the Nordic banks

- Much effort has been made since 2010 to improve asset quality resulting in continued improvements in problem loans
- Ongoing improvements and work proactively to further enhance the credit quality profile
- Strong coverage ratio
- Cost of risk is high compared with Nordic banks. The objective is to further narrow in on the Nordic banks acknowledging that special Icelandic issues, such as loan indexation, will probably result in higher default ratios in Iceland than in the Nordics
  - Collateral
  - Improved lending
  - Early intervention

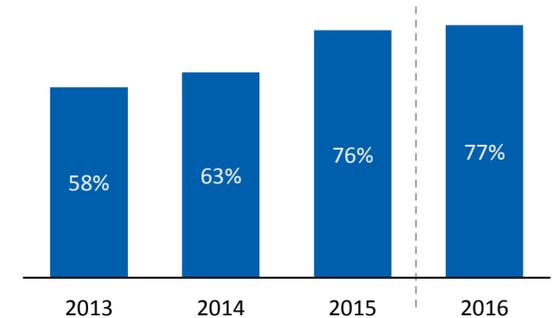
## Continuously improving credit quality...

Problem loans %

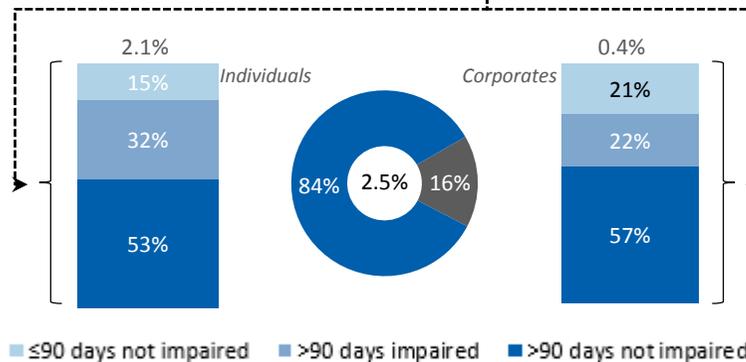


## ...and strong coverage

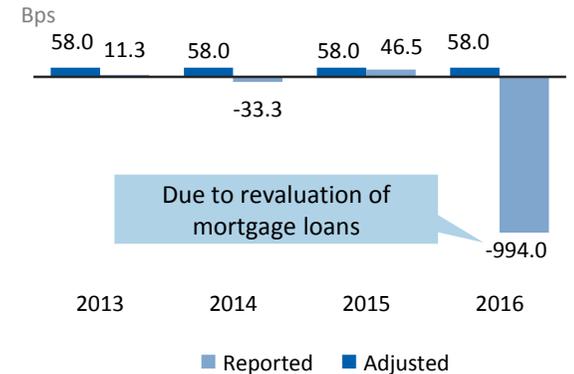
Coverage ratio (%)



Breakdown of problem loans by status



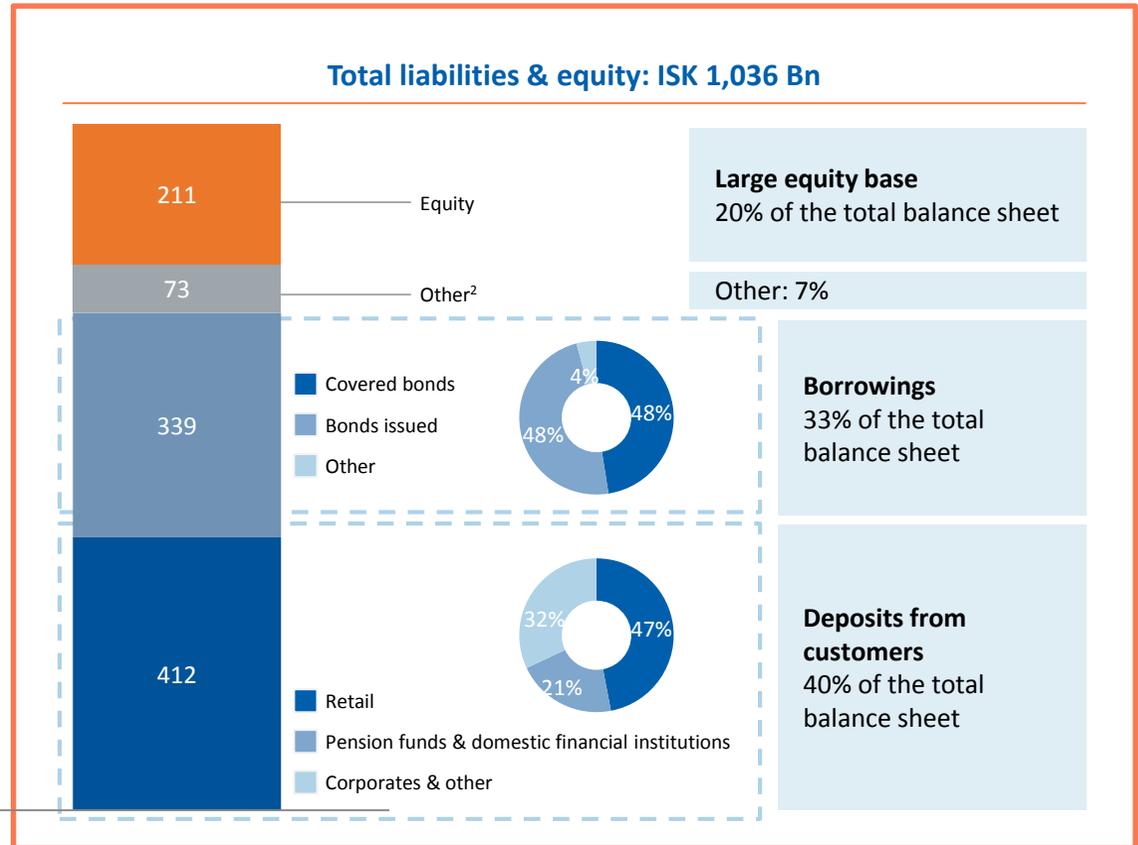
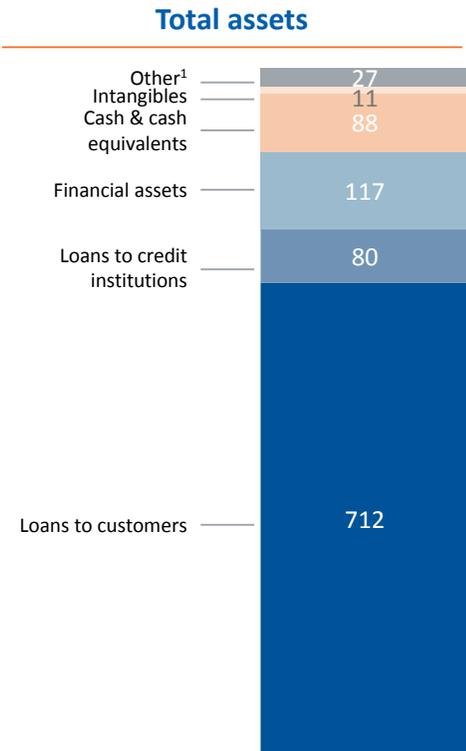
## Cost of risk



# Simple and solid balance sheet

Diversified funding platform with high degree of equity

ISK Bn, 2016



# Conservative maturity schedule

Focus on introducing Arion Bank to new investors

- Arion Bank concluded a EUR 300 M EMTN benchmarks in April and November 2016
- EMTN private placements in US Dollars, Romanian Leu, Norwegian krone and Swedish krona
- It is Arion Bank's policy to promote transparency and equality towards investors
- Arion Bank endeavors to make public, in accordance with the principle of equal treatment, as soon as possible, any information necessary for investors to evaluate the Bank's financial standing, earnings and outlook, and to evaluate financial instruments issued by the Bank and admitted to trading on a regulated market, and related financial instruments.

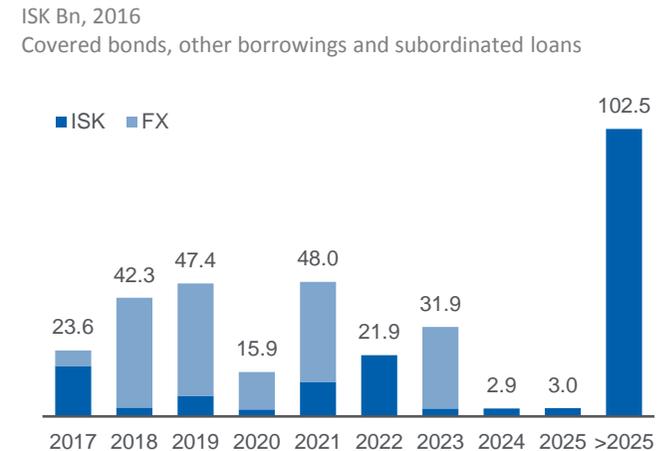
## International funding

- Two new Euro benchmarks (EUR 300M each) in April and November
- EMTN private placements (EUR 5-25 M offered to EMTN dealers)
  - Diversification of funding – competitive funding spreads
  - Increased awareness of Arion Bank as issuer
- Increased emphasis on debt investor relations
  - Investor base concentrated in the Nordics and UK
  - Non deal roadshows

## Domestic funding

- Monthly issuance of covered bonds – target of ISK 20 Bn per year
- Continued issuance of short term bills
  - Capitalise on demand for covered bonds

## Limited near-term re-financing needs



## Ratings - S&P

		
Senior unsecured	BBB	A-
Short term debt	A-2	A-2
Outlook	Positive	Stable

Source: Company information

# Recent issue in the Eurobond market

## Successful EUR benchmark transactions

- On 3 March 2015, Arion Bank launched its inaugural euro senior unsecured benchmark transaction, the first from an Icelandic bank since 2008
- In April 2016 Arion Bank issued a second 300mn EUR transaction
- In December 2016 Arion Bank returned to the international capital market for the 2<sup>nd</sup> time in 2016. Arion issued EUR 300 million, 5-year at MS+165bps. This deal represents the 1<sup>st</sup> 5yr EUR senior transaction from Icelandic Bank since 2008. In January 2017 Arion Bank did a 200 million tap at MS+155bps.

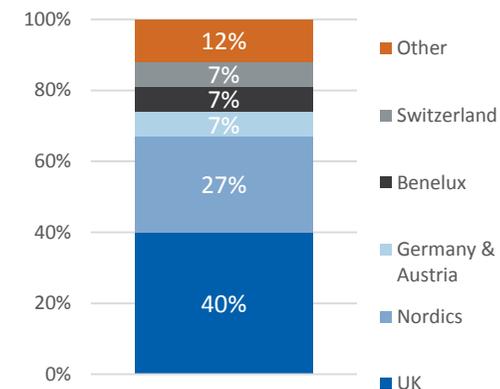
### Senior unsecured bonds



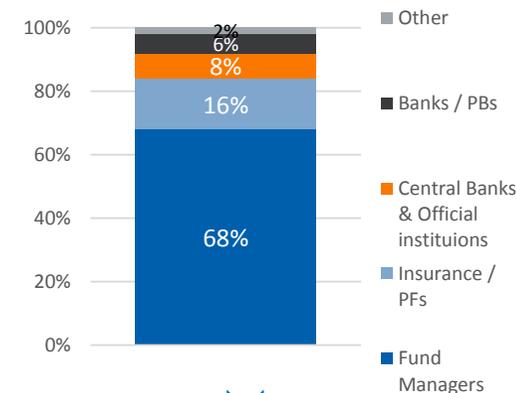
#### Issue Details

	2016	2017 Tap
Issue rating (S&P):	BBB (positive)	BBB (Positive)
Format:	Senior Unsecured	Senior Unsecured
Pricing date:	24 November 2016	5 January 2017
Settlement date:	1 December 2016	10 January 2017
Maturity date:	1 December 2021	1 December 2021
Size:	EUR 300 M	EUR 200 M
Coupon:	1.625%	1.625%
Issue price:	99.534	99.831
Initial spread guidance:	MS + 165 bps area	MS + 155 bps area
Launch spread	MS + 165 bps	MS + 270 bps
Lead managers:	DB, MS, Citi, Barclays	Barclays, JPM, Nomura

### Distribution by geography



### Distribution by investor type

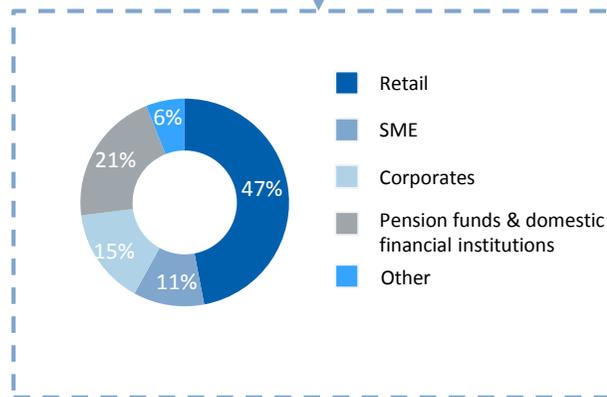
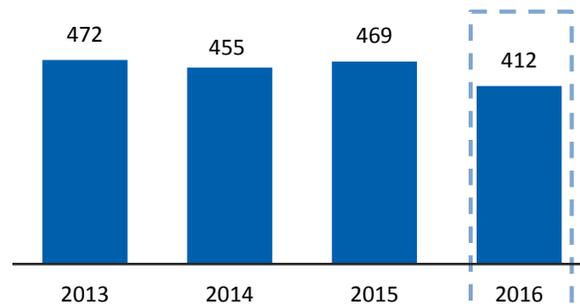


# Overview of deposits

- Stable deposit base as Arion Bank continues to diversify its funding base
- Reduced concentration of demand deposits
- Kaupthing moved ISK 41 Bn equivalent of FX deposits into long-term EMTNs in January 2016 explaining the reduction year-on-year
  - As per agreement between Kaupthing and the Icelandic government
  - Affected the average deposit yields in 2016
- An element of pension fund related deposits flowing into money market funds

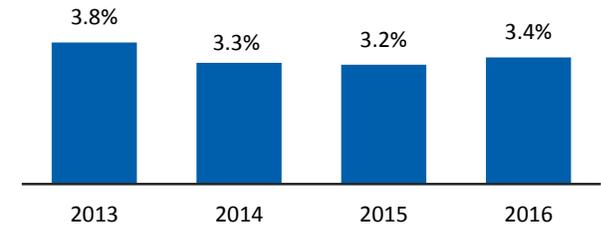
## Deposits development

ISK Bn



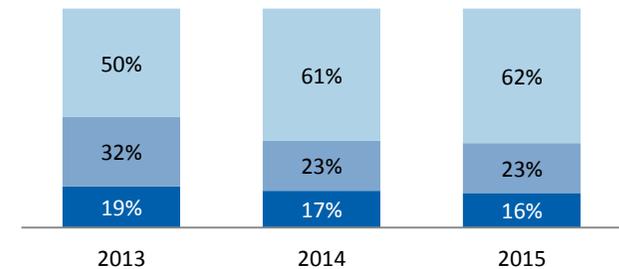
## Average deposit yields

Deposit interest expense % avg. deposits



## Concentration of demand deposits

Demand deposits within 30 days

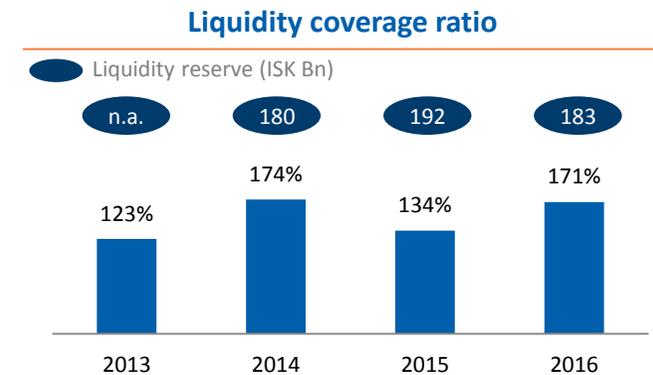
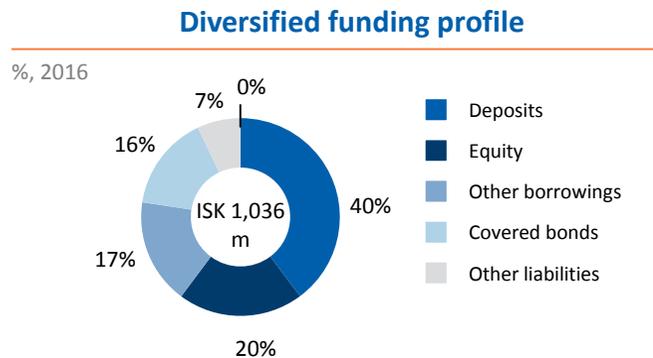
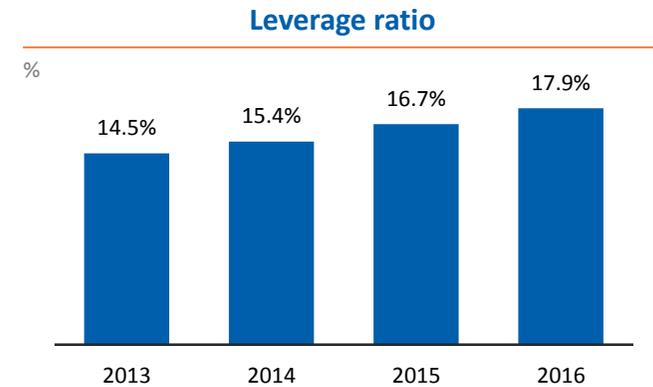
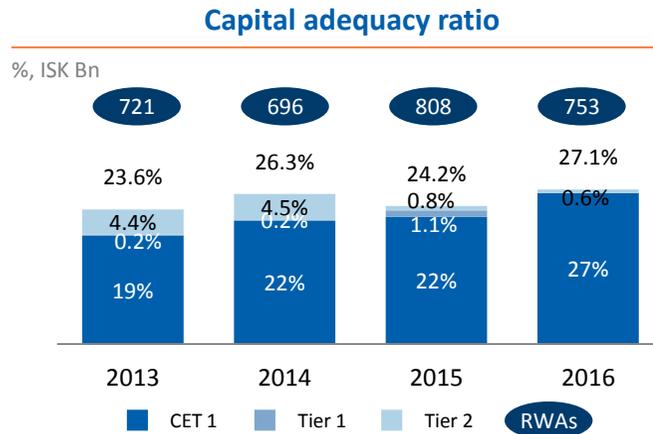


- Largest depositors (1-10)
- Largest depositors (11-100)
- Remaining

Source: Company information

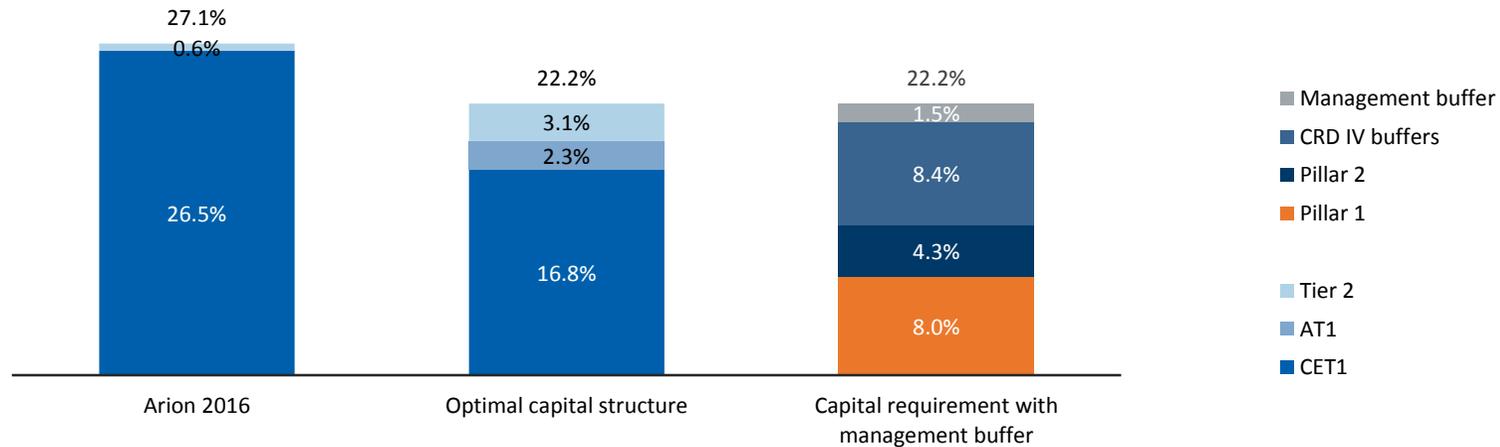
# Solid capital adequacy and strong liquidity position

- Strong capital position and leverage ratios
- Diversified funding platform with high degree of equity
  - First mover in re-entry into international debt markets
- Operates with a robust liquidity position with limited near-term refinancing needs
  - Strong liquidity reserve and ratio
  - High degree of stickiness in deposit base
- Significant dividend capacity
  - Solid profit generation
  - Target reduction of excess capital
  - Further capital optimisation



# Capital structure and requirements

- The Bank's total capital ratio was **27.1%** at year end 2016. Final CRD IV adoption in the fall of 2016 had limited effects
- At Q4 of 2017, the combined capital buffer requirement will reach 8.4%, with a recent add-on from the Financial Stability Board to the countercyclical buffer, which increases from 1.0% to 1.25%
- With FME's SREP result, the regulatory capital requirement is **20.7%**, including fully-implemented buffers (CET1 requirement without management buffer is 15.3%)
- Including a management buffer of 1.5%, the Bank had a surplus capital of ISK 37 billion at year end 2016



# Capital management strategy and dividend policy

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## ARION BANK'S DIVIDEND POLICY

- Based on the Arion Bank's expected financial performance over the medium term, Arion Bank aims to pay an annual dividend before special distributions, in line with a payout ratio around 50% of net earnings attributable to shareholders

## ARION BANK'S CAPITAL MANAGEMENT

- Arion Bank's objective is to maintain a capital adequacy ratio that is 1.5% above total FME requirements, including Pillar 1, 2 and combined capital buffers
- Irrespective of the objective, the capital adequacy ratio should not be lower than 20%
- Current capital adequacy ratios are in excess of the targets, and Arion Bank aims to distribute surplus capital to shareholders
- However, the speed and quantum would depend on a number of factors, including (but not exclusively) FX imbalances management, capital optimisation strategy and regulatory consent, and is likely to take place over a number of years

## Medium term targets

---

<b>CET 1 Ratio</b> (Subject to regulatory requirements)	Decrease to circa 17%
<b>Loan Growth</b>	Prudent lending to outpace economic growth in the next few years
<b>RoE</b>	Reach double digit returns
<b>Dividend Policy</b>	Payout ratio of circa 50% of net earnings attributable to shareholders
<b>Cost to Income Ratio</b>	Decrease to circa 50%

# Arion Bank strategic path

The path to double digit return on equity in the medium term

 <b>Loan growth</b>	<ul style="list-style-type: none"><li>Further grow loan portfolio on the back of the underlying growth in the Icelandic economy</li></ul>	<b>VALITOR</b> <b>Card payments</b>	<ul style="list-style-type: none"><li>Commission income growth through Valitor's international expansion</li></ul>
 <b>Digitalisation</b>	<ul style="list-style-type: none"><li>Continued implementation of digitalisation across both client-facing offerings and automation to further increase efficiency</li></ul>	 <b>Capital release</b>	<ul style="list-style-type: none"><li>Dividend payments and the release of surplus capital to shareholders</li></ul>
 <b>Efficiency</b>	<ul style="list-style-type: none"><li>Further implementation of efficiency measures through lean banking, operational improvements and outsourcing</li></ul>	 <b>Reduce cost of risk</b>	<ul style="list-style-type: none"><li>Move in the direction of Nordic levels</li></ul>
 <b>Universal insurance offering</b>	<ul style="list-style-type: none"><li>Realisation of synergies from integration of the non life insurance company</li></ul>		

# Arion Bank in a nutshell



# Appendix

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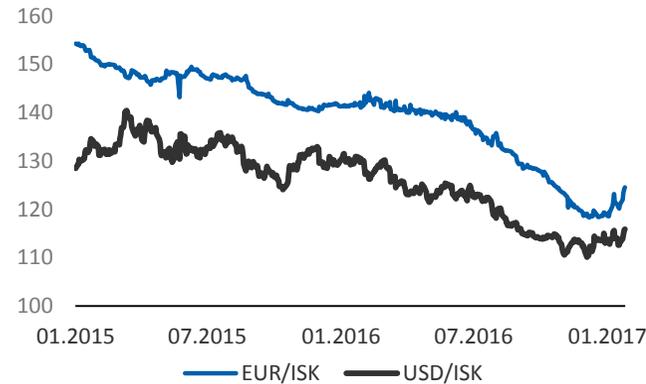


# Appreciation of the ISK caused by underlying macro-economic factors

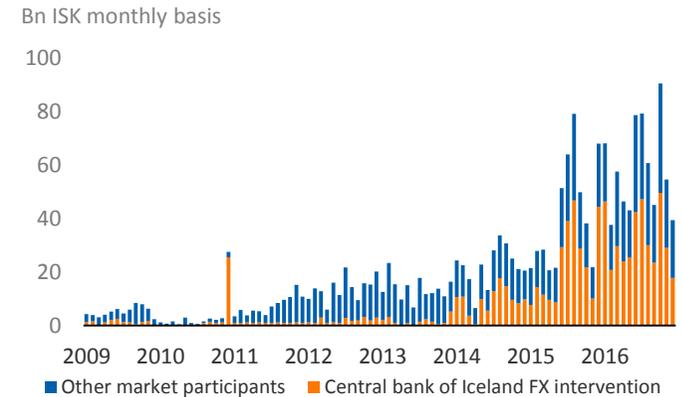
Growth in tourism, increased FX inflow, current account surplus and positive IIP drives the appreciation

- The Icelandic krona strengthened considerably last year
  - Increased export especially driven by tourism
  - Macro-economic factors driving the appreciation of the ISK:
    - Increased FX inflow
    - Current account surplus
    - Positive international investment position
- The Central Bank of Iceland has responded with added intervention on the FX market (ISK 386 bn. in 2016)
- FX reserves of the Central Bank of Iceland 37% of GDP at year end 2016
- The real exchange rate of the Icelandic krona is now slightly above historical averages

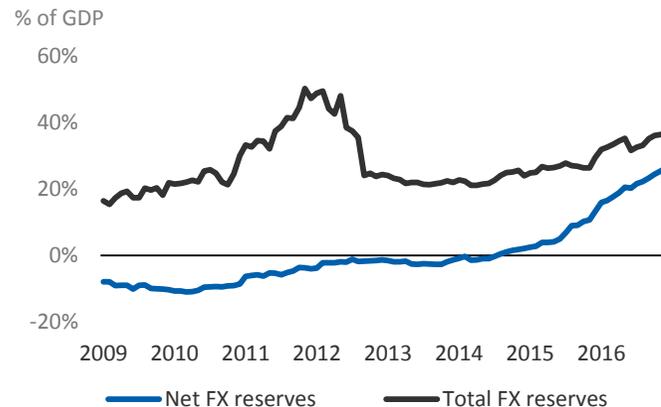
EUR/ISK vs USD/ISK



FX market turnover



FX reserves of the Central Bank of Iceland



The real exchange rate of the Icelandic krona



# RETAIL BANKING



# Introduction to Icelandic retail banking market

## Characteristics of the mortgage loans market

### Description

#### The Icelandic mortgage loans market

- Iceland is and is expected to remain a homeowner's market. Rent prices have been on the rise, pushing more people into buying, thus increasing investment demand in the market
- Housing prices are going up (expected until 2018). Real estate index currently above the CPI
- Historically, CPI linked mortgage loans have been the most popular and keep growing in popularity in 2016
- Government supported initiatives in recent years
  - Tax benefits to home buyers on allocation of private saving
  - First time home purchases after the financial crisis

#### Competition

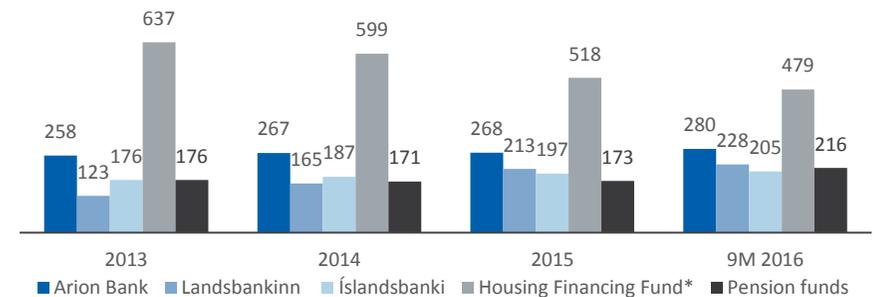
- Historically, large government participation through the Housing Financing Fund, however limited activity today
- Main competition comes from Landsbankinn and Íslandsbanki
- In 2016, pension funds have been aggressive in lending rates and gained market share

#### Quality portfolios

- Strict government rules in credit rating and payment plans for mortgage loans
- Maximum loan-to-value ratio up to 80% (up to 85% for first-time home buyers)
- Low default rates in mortgage loans

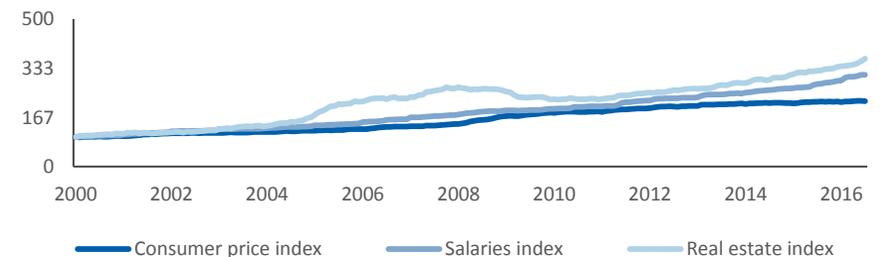
### Mortgage loans market

ISK Bn



### Icelandic market

Index=100, 2000



# Mortgage loans to individuals

Maintaining market share in an increasingly competitive market

## Arion Bank initiatives

- Arion Bank has a full range of mortgage products and strong position in the market
- Arion Bank was the first to offer ISK – CPI linked mortgage loans at competitive rates in 2004. Gained large market share with that offer
- Since 2011, further strengthened first mover advantage by offering mixed CPI linked /non-CPI linked mortgage loans
- Arion Bank was the first to introduce fixed 5 year interest rates on non-CPI linked mortgage loans in 2011
- Digitalisation in mortgage loan process underway
- Further opportunities with acquisition of Vörður, insurance company

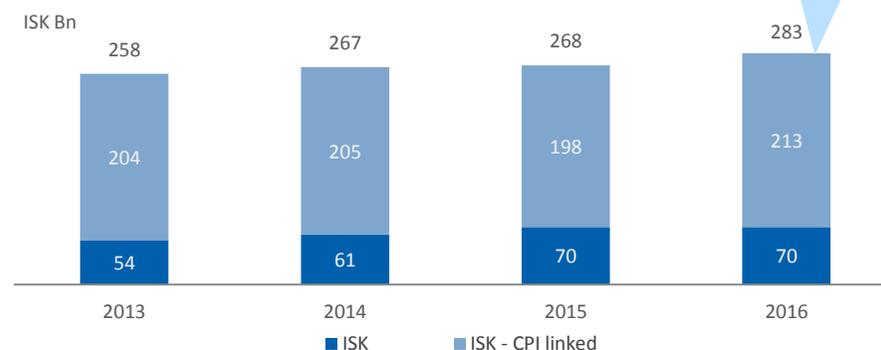
## Healthy portfolio

- Weighted average LTV for the retail mortgage portfolio of 61,6% as of 2016
- Low default rate as Arion Bank is conservative regarding LTV
- ISK – CPI linked loans have an early prepayment fee attached to them (0-2%)
- Circa 90% of properties owner occupied<sup>1</sup>
- Strong positioning in the mortgage loans market leading to high cross-selling potential (for example, deposit products)

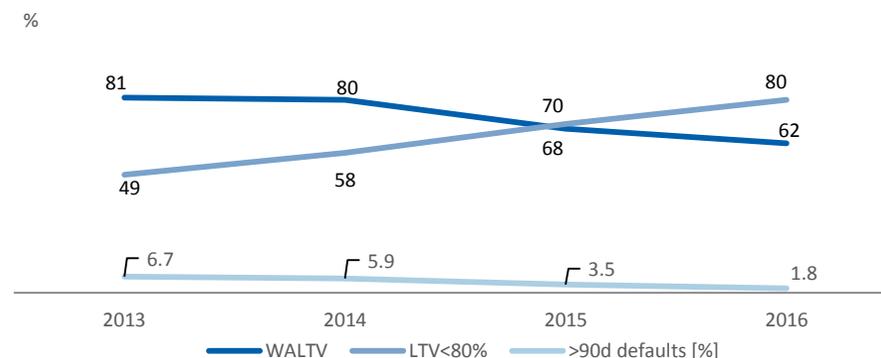
Source: Company information

- Company Information
- After Q3 2016 LTV bucket allocation is calculated using the face value of loans and the property assessment value (FMR) or market value within two years old of the collateral. Prior to that, the book value of loans and property assessment value (FMR) of the collateral were used

## Arion Bank mortgage loans volume – individuals



## Development of key ratios in Arion Bank mortgage loans portfolio<sup>1,2</sup>



# Focus on SMEs

## Significant growth profile driving portfolio diversification

### Key highlights

- Significant rise in SME loan volumes from ISK 67 Bn in 2013 to ISK 127 Bn in 2016
- SME loan book in Arion Bank traditionally relatively small in comparison with competitors
- Appetite to grow in the SME space for further diversification and deliver growth in the loan book
- Three sectors drive growth in the SME loan market
  - The real estate and construction sector has increased from ISK 18 Bn in 2013 to ISK 31 Bn in 2016
  - The wholesale and retail trades industry has increased from ISK 12 Bn in 2013 to ISK 22 Bn in 2016
  - The seafood industry has increased from ISK 5 Bn in 2013 to ISK 22 Bn in 2016

### Arion Bank initiatives

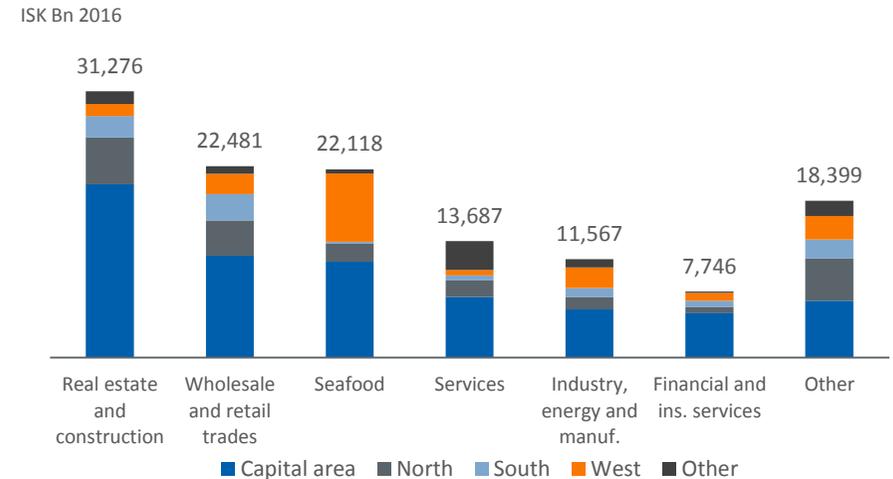
- Decentralisation strategy creating SME units in branches has driven growth in SME loans by moving credit authority closer to customer
- Initiatives in new products in the last 5 years
  - Factoring
  - Vehicle and equipment financing
  - Cooperation with the European Investment Fund in SME lending at lower rates with focus on start-ups and development projects

Source: Company information

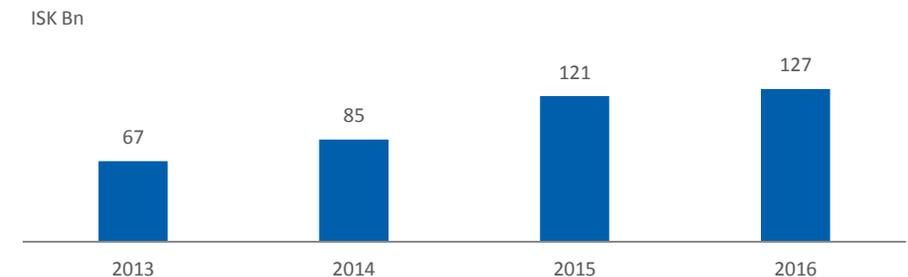
1. SME loan book

2. Loan volume development. In 2014 / 2015 SME loans were moved from Corporate Bank to Retail Bank ~22 Bn

### SME loans by geographic area and industry sector<sup>1</sup>



### Loan volume development<sup>2</sup>



# Deposits from customers

Opportunity to grow through leveraging strong mortgage loans customer base

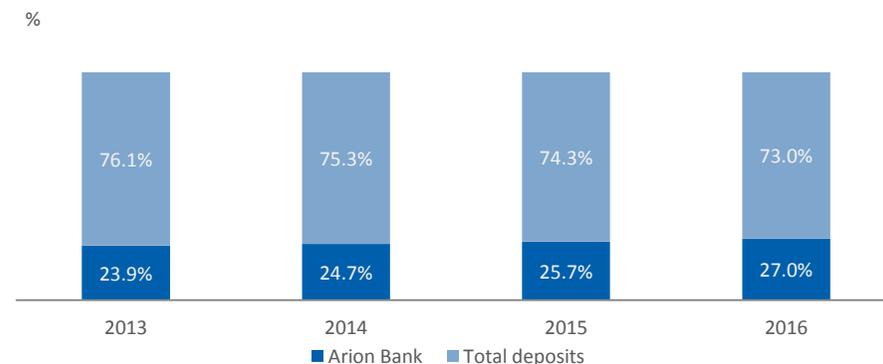
## Key highlights

- Bank customers in Iceland are accustomed to keeping deposits with their main bank
  - Opportunity to attract deposits from customers who have their mortgage loans with Arion Bank but deposits with another bank
- The new online onboarding platform is a key catalyst for attracting new customers, along with the comprehensive digital offering
- Relatively stable market for individual deposits. SMEs' deposits are more price sensitive
- Government recently cancelled the state guarantee on deposits. No effect expected
- Good cooperation with Asset Management division of Arion Bank enables many opportunities
  - Retail offering combined with insurance and pension products
  - The growing SME activity also provides cross-selling opportunities
  - Increase the retail deposits market share
- Smaller market share in deposits, as compared to the other large banks
- CPI linked deposits sticky due to regulations

## Total deposits volume in Retail Bank



## Arion Bank's share of the total deposits market – individuals



# Loan portfolio management

## A conservative loan portfolio management

### Limited exposure to holding companies

- Retail Banking provides, and has in its loan book, loans to holding companies.
- Holding companies are categorized under "Financial Sector" with other loans. Loans classed under "Financial Sector" represent 4.9% of loans to customers

### A very small percentage of Retail Banking's loan book has collateral in listed or unlisted securities

- The Bank's credit rules specify benchmarks for collateral coverage in listed and unlisted securities and Retail Banking adheres to them
- Recognized valuation methods are used when collateral is taken in securities, such as discounted cash flow, comparisons of valuations of comparable companies or the liquidation value in valuations of private equity

### Limited concentration risk and well secured portfolio

- 10 largest loan a fraction of the loans to customers
- Majority of loans secured by real estate or directly by underlying operations and assets

### Prudent lending in foreign currencies

- The majority of companies with loans in foreign currencies are seafood companies
- Loans in foreign currencies are restricted by the conditions on such loans stipulated in the Icelandic Foreign Exchange Act. The Bank also operates in accordance with credit rules and internal benchmarks which are not public

### Unsecured overdrafts are insignificant part of the Retail Banking loan portfolio

- Unused overdraft (including unused credit card limits) total ISK 46 billion at YE 2016 and is almost entirely related to customers of Retail Banking. Loan commitments for the bank in total amounted to ISK 82 billion, retail banking share in this is a minority



# CORPORATE BANKING



# Corporate banking market and competition

## Proactive and successful Approach to market developments

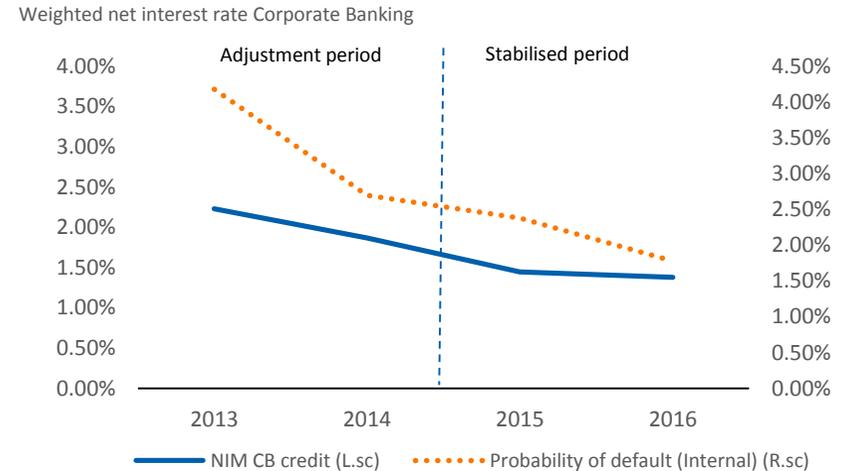
### Key highlights

Post crisis material margin pressure in high quality credits unfolded due to increased competition from pension funds as yields on government bonds decreased and credit quality of companies improved

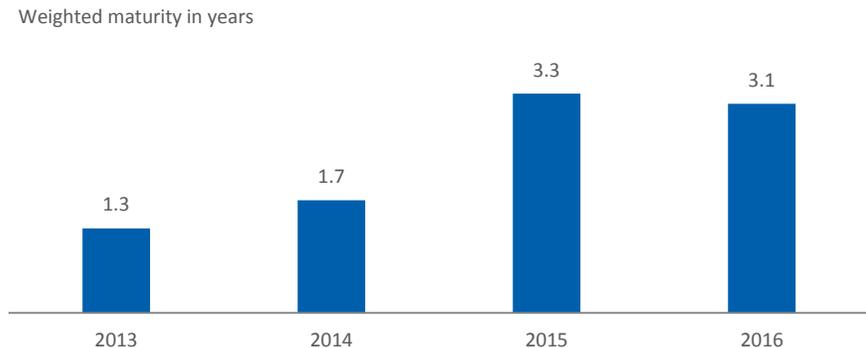
- Deleveraging and steep repayment profiles imposed by banks post financial crisis
- Shortening maturity profiles across the corporate banking industry were a response to increased competition as long-term financing of the banks was still expensive
- Corporate banking has managed to stabilise its margins and to extend maturity profiles in 2015 and 2016 after realigning operations in 2013 and returning to a proactive approach in 2014:
  - Corporate Banking balanced decreasing margins with large, less price sensitive infrastructure and energy projects as well as international seafood
  - Teamed up with foreign players in syndicated deals where Arion Bank took the second lien due to better market knowledge, thereby maintaining margins (while foreign players took lower yielding first lien)
  - Customer base defence through focus on longer dated credits and by employing full product range (thereby cross-selling) which kept revenues up
  - Increased focus on customer retention and relationship development by organising and increasing focus on the relationship management role in Corporate Banking
- Successful increase in average loan book maturity, thereby materially reducing prepayment risk and risk of client losses on small price differentials benefitting from better access to long-term funding (especially FX)

Source: Company Information

### Credit risk analysis



### Increasing loan book maturity



# Product offering overview

## Diversified book

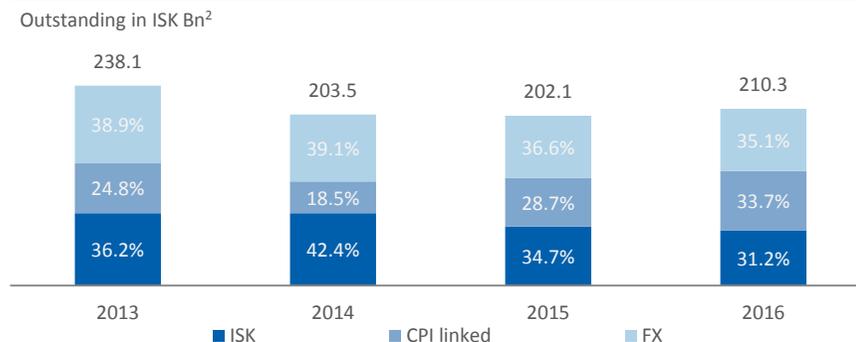
### Key highlights – term loans

- Term loans are the highest volume product in all client sectors and drives both income and NIM
- Competitive and price sensitive market
- New investment in the economy expected to drive current demand in general, as do expected consolidation trends in commercial real estate, tourism and seafood
- Increasing dealflow in large scale project finance deals (energy intensive, real estate, etc.) as economy recovers
- Customer segment redefinition in 2014 (handover to retail bank in 2014 and 2015<sup>1</sup>) and NIM preservation
- New large scale project finance deals sourced in 2015, expected to be realised in 2017-2020

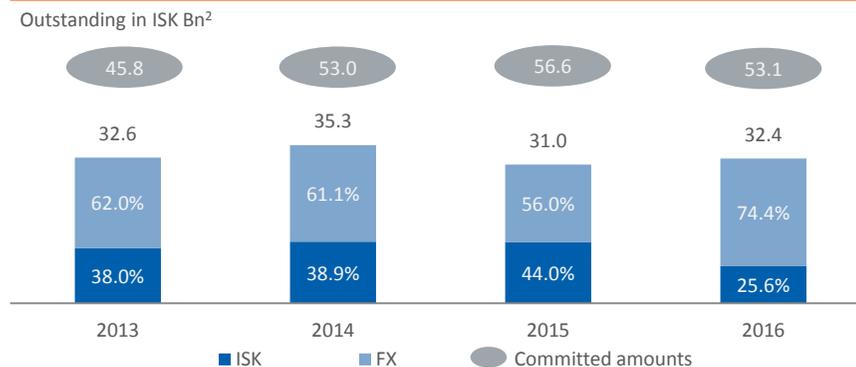
### Key highlights – revolving credit facilities

- A lower volume core product business
- Characterised by seasonality and high price sensitivity
- Seafood is key industry for RCF demand
- Current accounts, overdrafts and trade finance activity covered
- Lower margin business

### Term loans outstanding



### Revolving credit facilities



Source: Company information

1. Corporate Bank redefined its customer segment from Iceland 300 largest to Iceland 100 largest companies resulting in a successful SME customer handover to the Retail Bank
2. Including lending to Arion Bank's independent subsidiaries

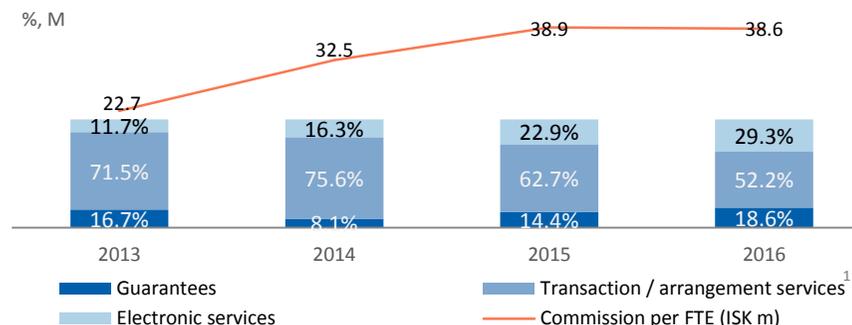
# Product offering overview

## Services growing and complementing credit risk

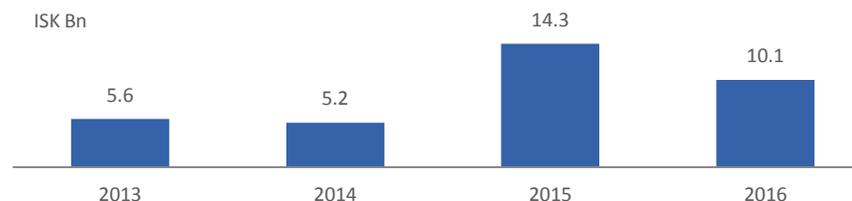
### Key highlights

- Focus on commission income has resulted in a clear positive trend of increasing commission income per FTE as well as its relative contribution
- Clear responsibilities with relationship managers spending their whole time serving clients better with a profound understanding of client needs and requirements
- Better digital solutions are expected to increase customer stickiness
- Digital services are scalable and allow for income growth per FTE
- Corporate Banking has the ability to capitalise on strong large corporate relations to bid for digital services in conjunction with regular lending activity
- Guarantee business as a growing product, both in terms of volume and income contribution
  - Traditionally confined to import/export and trade finance
  - Growing imports support demand as well as large project finance deals where Arion Banks is lead and “house bank”
- Further investments in a corporate digital platform on the horizon to improve service and gain increased share in digital services

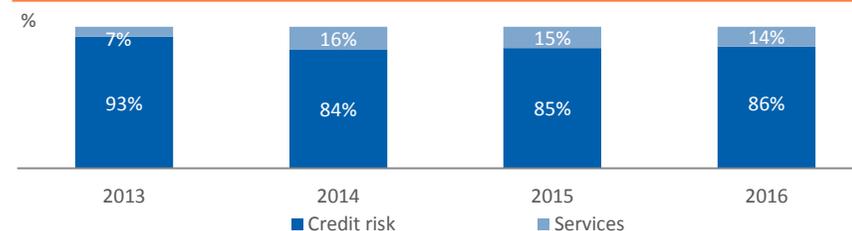
### Commissions income breakdown



### Guarantees outstanding



### Product income split



Source: Company information

1. Transaction / arrangement services include prepayment fees which were a substantial part of fee and commission income in 2014, amounting to 44.1% of total fee and commission income. Prepayment fees are not a sustainable income source and are mainly relevant during time of rapid prepayments and short loan book

# Corporate Banking and risk management

## Low risk profile

### Loans secured with listed or unlisted securities

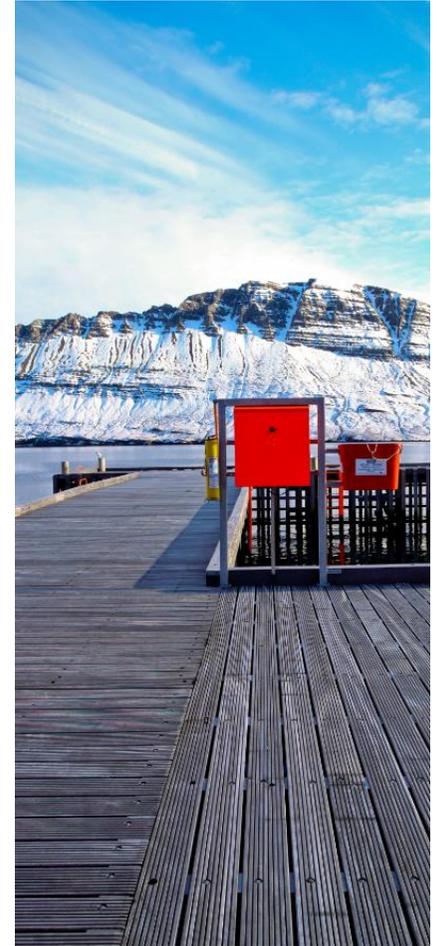
- Loans secured by listed securities
  - Collateral value of the cash and securities securing loans to customers amounts to approximately ISK 20 billion
  - Majority of loans are to corporates and only a minor proportion to individuals
  - In the cases where collateral is taken in securities, it involves almost exclusively listed securities
  - The Bank's credit rules, specify benchmarks for collateral coverage in listed and unlisted securities
  - Loans to holding companies with collateral in listed securities are categorized under Financial and insurance activities with other loans
  - The average collateral coverage of the underlying securities is deemed sufficient by the Bank
- Loans with their main collateral in unlisted securities are virtually unknown in the Corporate banking unit
  - Unlisted securities are in some instances taken as collateral to facilitate collection
- The Bank's credit rules, specify benchmarks for collateral coverage in listed and unlisted securities and Corporate Banking adheres to them
- Recognized valuation methods are used when performing valuations of unlisted companies, such as discounted cash flow, comparisons of valuations of comparable companies or the liquidation value in valuations of private equity

### Loans in foreign currencies

- Loans in foreign currencies are restricted by the conditions on such loans stipulated in the Icelandic Foreign Exchange Act
- The Bank also operates in accordance with credit rules and internal benchmarks which are not public

### Large exposures

- Largest risk exposure represents less than 10% of the risk base
- In the 2015 risk report, figure 4.2 on page 40, it states that risk exposures which make up more than 2.5% of the capital base totaled 99% of the capital base – 2016 risk report will be published in March



# INVESTMENT BANKING



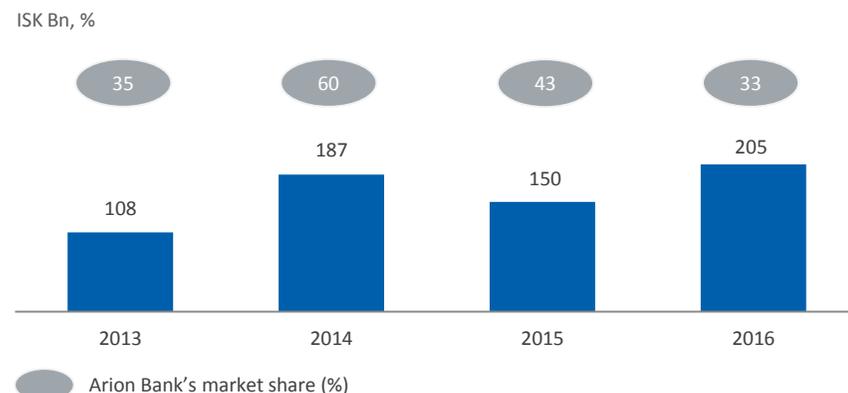
# Introduction to Icelandic Investment banking market

Recent strong IPO market driving trading volume

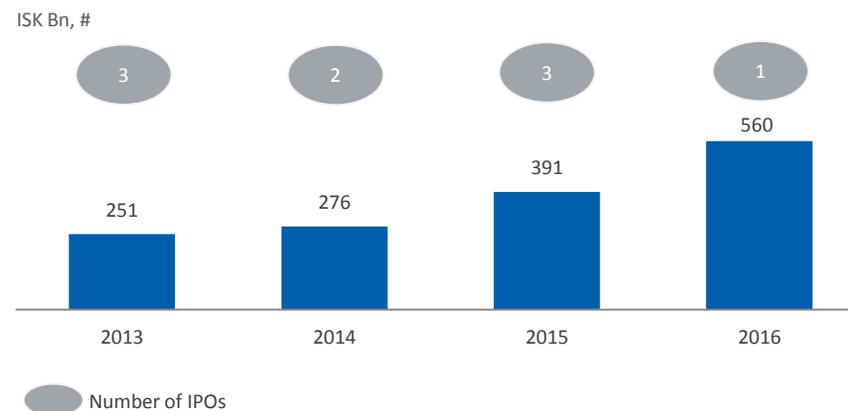
## Highlights

- Small and geographically isolated with few local competitors
- Iceland's investment banking market is comprised of the three largest banks in Iceland (Arion Bank, Islandsbanki and Landsbankinn) with a few smaller boutiques
- Arion Bank has managed 8 of the last 13 IPOs since 2011 with the intention to facilitate further trading volumes in the Icelandic stock market whereby the investor base is a combination of institutional investors, such as pension funds, and HNWI
- Activity in new bond issues has increased in recent years whereby the real estate companies along with the Bank's covered bond issues have been the key drivers with institutional investors driving the demand
- Traditional companies have relied to a greater extent on credit facilities from banks, but developments in corporate bond market are expected to fuel growth

## Bonds new issues and market share<sup>1</sup>



## Total trading volume in equities and number of IPOs on Nasdaq Iceland stock exchange



# Corporate Finance

Leading advisory track record

## Highlights

### Description

- Focus on large fee paying clients
- Leading player in building up the equity market
- Strategic initiatives in terms of focus on product and sector mix in accordance with regular analysis of micro- and macroeconomic trends

### Key Strengths

- Being a part of universal relationship bank ensures:
  - Dealflow
  - Distribution capabilities
- Highly capable and experienced staff
- Strong balance sheet
  - Underwriting capabilities
- Strong infrastructure and lean management help focus on customer relations, pipeline and dealflow

## Involved in 8 out of 13 IPOs since 2011



## M&A Track Record



# Capital markets

Leading market position in equity and strong market position in FX and bonds

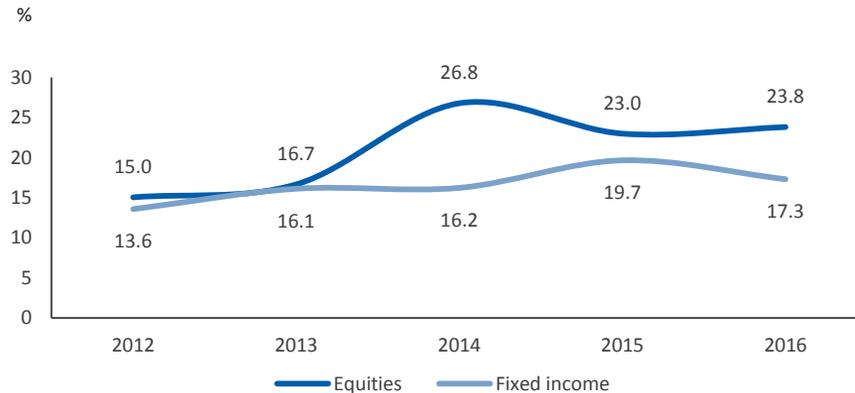
## Description

- Leading in equity brokerage and strong position in FX brokerage and bond issuances market
- Equity and bond desks servicing pension funds, AM companies and professional investors
- FX desk providing services to corporates in spot, forward, swap and option products. Only Icelandic bank that provides oil hedging products

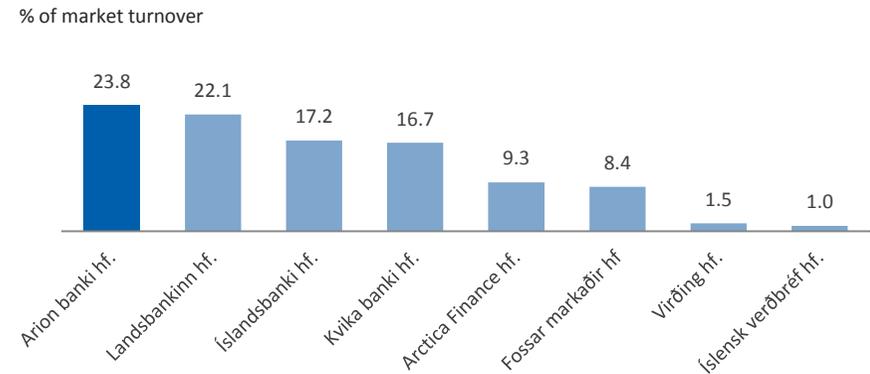
## Key Strengths

- Leading in equity brokerage in Iceland
- Leading player in restoring the equity market in Iceland
- Strong position in FX brokerage and bond issuances
- Strong relationship with all major investors in capital markets

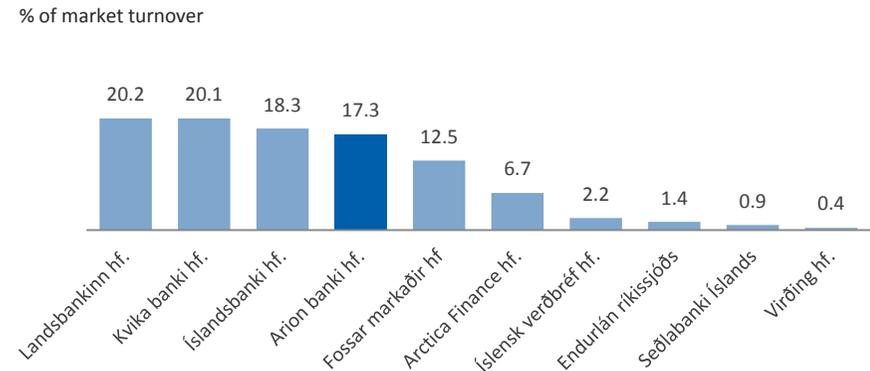
## Market share in brokerage on Nasdaq Iceland



## Nasdaq Iceland: Equities 2016



## Nasdaq Iceland: Fixed income 2016



# Research team

## Leading research capabilities

### Team

6	Independent research team of six strong analysts covering the Icelandic economy and securities markets
2	Meetings per week with clients
7	Industries covered

### Publications



### Products & services

#### External publications

- **Morning Briefings**  
Daily notes covering the most prominent news and research issues
- **Market Briefings**  
Brief reports highlighting current domestic economic issues. Over 2,000 subscribers. MBs are followed by Icelandic media and are regularly cited in media articles
- **Equity Reports**  
Regular reporting on 12 listed companies in Iceland
- **Special Market Reports**  
Tailored for key clients of Arion Bank's Investment Banking
- **Economic Outlook**  
Monthly publications on Iceland's economic issues and outlook

#### Conferences & presentations

- **Open Conferences at Arion Bank HQ**  
Regular presentation sessions & conferences on key economic topics such as housing market, tourism industry and equity markets. Annual conferences when leading research reports are published
- **Private Meetings**  
Tailored for specific clients of Asset Management, Retail Banking, Investment Banking or Corporate Banking
- **Internal Morning Briefings**  
Morning briefings held for internal staff to brief on current market issues

#### Internal support

- Arion Bank's divisions increasingly seek short reports, presentations, opinions, memos or data analysis regarding specific economic issues or client pitches

# Swap agreements and equity holdings

## Forwards and swaps<sup>1</sup>

<i>Derivatives</i>	Notional value	Fair value	
		Assets	Liabilities
2016			
Forward exchange rate agreements, unlisted .....	31,921	266	247
Interest rate and exchange rate agreements, unlisted .....	210,143	4,288	1,104
Bond swap agreements, unlisted .....	2,995	1	8
Share swap agreements, unlisted .....	8,138	597	457
Options - purchased agreements, unlisted .....	1,218	7	26
<b>Derivatives .....</b>	<b>254,415</b>	<b>5,159</b>	<b>1,842</b>

## Shareholdings and equity instruments with variable income

<i>Shares and equity instruments with variable income</i>	Amortised cost	Trading	Designated at fair value	Total
Listed .....	-	2,949	9,125	12,074
Unlisted .....	-	1,348	10,579	11,927
Bond funds with variable income, unlisted .....	-	1,027	2,007	3,034
<b>Shares and equity instruments with variable income .....</b>	<b>-</b>	<b>5,324</b>	<b>21,711</b>	<b>27,035</b>

- The Bank's total assets in listed shares which are not in the trading book amounts to ISK 9.1 billion and private equity is ISK 10.6 billion at the end of 2016. In addition the Bank owns units in bond funds amounting to ISK 2 billion.
- The largest unlisted asset is a 16.3% shareholding in Stoðir hf. and the holding of EAB subsidiary EAB1 ehf. in Ferskur holding. Both of these companies own underlying holdings in Refresco Gerber BV, which is a listed company on Euronext in Amsterdam. In other respects the Bank refers to its website for information on assets and holdings for sale: <https://www.arionbanki.is/bankinn/almennar-upplýsingar/eignir-til-solu/>
- Proprietary trading at Arion Bank, which is responsible for market making and is on the active market, is not included in these shareholdings. Those shares are in the first column in the table above and are active on the market while those shares in the orange box are considered more as a long-term investment although the Bank does not plan to hold them for an extended period.

Source: Company information

1. Overview from the consolidated financial statements. For bonds the collateral coverage is 2.5% to 15% and depends on the duration of the bond and issuer, for shares the collateral coverage is around 25 to 50%. Bond and share swap agreements are relatively small compared to Arion's shareholder's equity and/or total assets

# Equity holdings contd.

## Listed equities

- Four of the largest listed shareholdings are administered by the CEO's office and are the responsibility of the Bank's investment board, see table below.

Company	Shares	Book value as of YE2016
Reitir fasteignafélag hf.	42,864,221	4,007,804,664
HB Grandi hf.	91,789,601	2,386,529,626
Síminn hf.	160,444,804	502,192,237
Skeljungur hf.	119,033,542	805,857,079
<b>Total</b>		<b>7,702,383,606</b>

## Unlisted securities

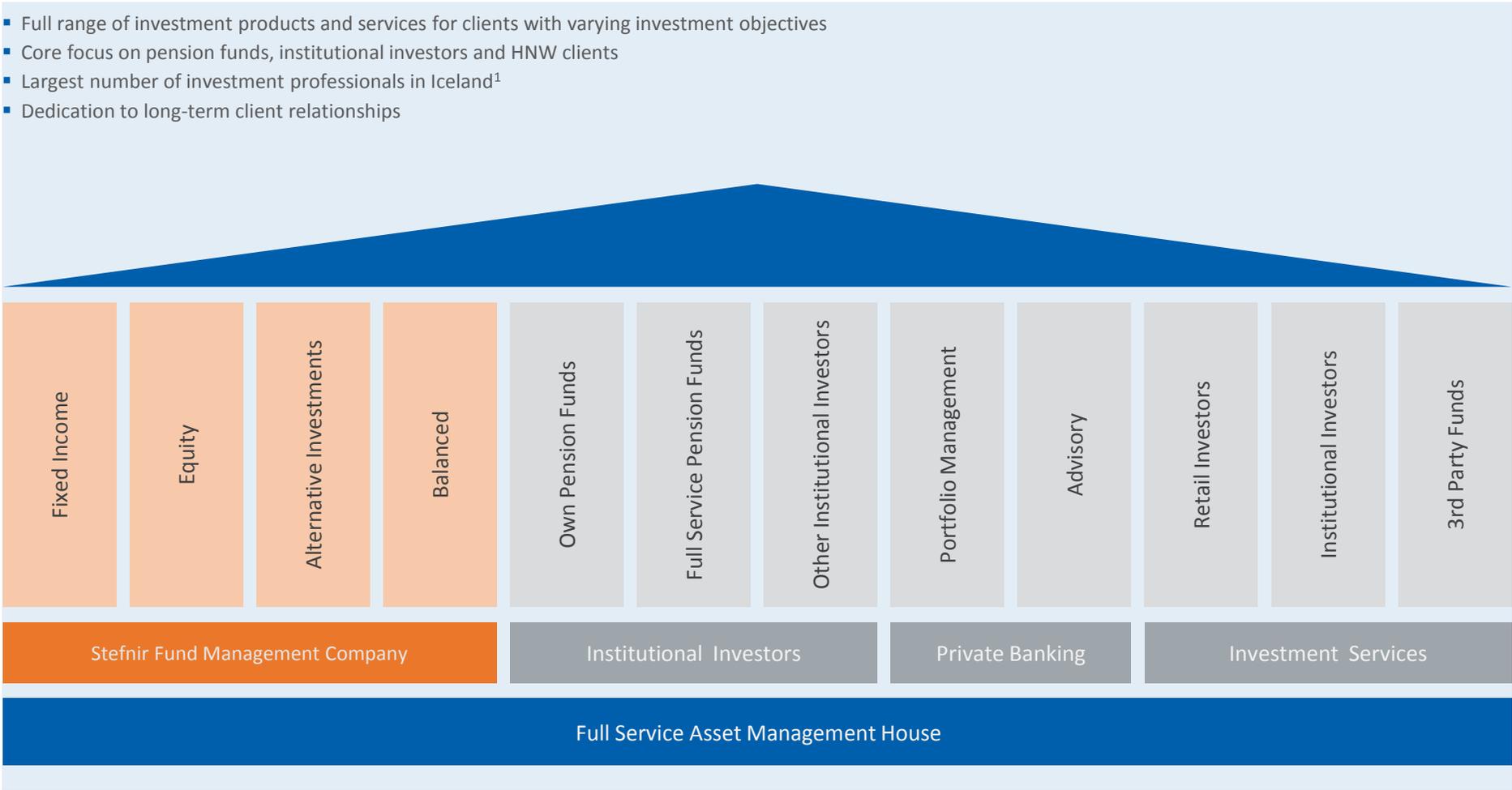
- With regard to the valuation of unlisted securities held by the Bank, please also refer to note 23 in the annual financial statement – this contains a description of the methods used, which are generally recognized methods of valuation and have been checked by the Bank's auditors.



# ASSET MANAGEMENT AND STEFNIR



# A comprehensive Product and Services offering



# Stefnir

## Fund overview and performance

### UCITS, non-UCITS and instit. investor funds (AuM ISK 352 Bn)<sup>1</sup>

<b>Fixed income</b>	<ul style="list-style-type: none"> <li>Funds: 6</li> <li>AuM (ISK Bn): 83</li> <li>Wide fund range</li> <li>Oldest incorporated UCITS fund in Iceland (inception in 1986)</li> </ul>
<b>Equities</b>	<ul style="list-style-type: none"> <li>Funds: 2 domestic; 4 intl.; 3 intl. domiciled in Lux.</li> <li>AuM (ISK Bn): 78</li> <li>Domestic and international equities</li> <li>Consistent growth in AuM since 2008</li> </ul>
<b>Balanced funds</b>	<ul style="list-style-type: none"> <li>Funds: 6</li> <li>AuM (ISK Bn): 37</li> <li>Oldest incorporated non-UCITS fund in Iceland (inception in 1996), highly distributed retail and PB ownership</li> </ul>
<b>Institutional investor funds/ other</b>	<ul style="list-style-type: none"> <li>Funds: 9</li> <li>AuM (ISK Bn): 154 (ABMIIF; 126 ISK Bn)</li> <li>Market leading product development</li> </ul>

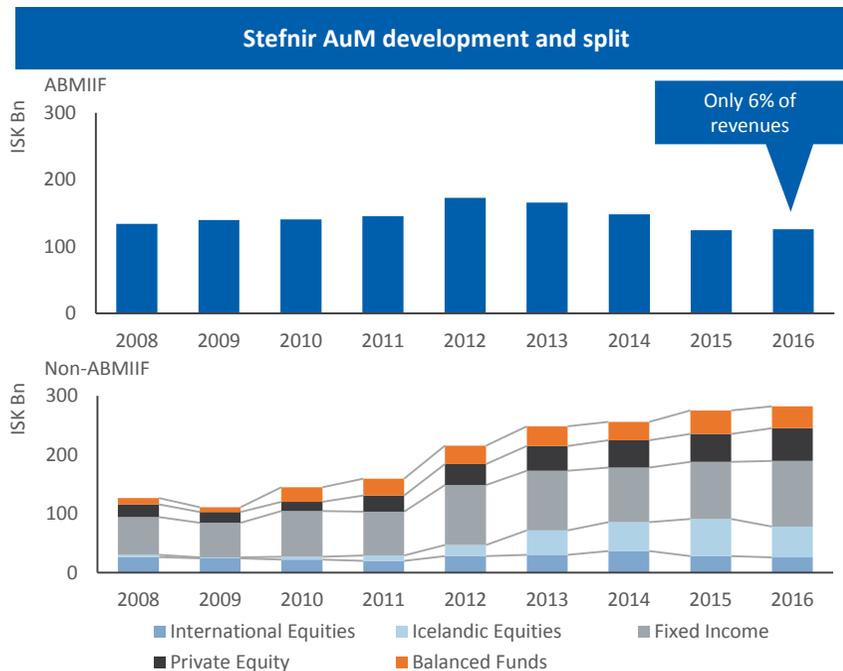
### Private equity and real estate funds (AuM ISK 56 Bn)<sup>1</sup>

<b>SIA I (PE)</b>	<ul style="list-style-type: none"> <li>Fund size at inception (ISK Bn): 3.4</li> <li>Exits: 3 (2 IPOs and one trade sale)</li> <li>Co- investments: 2, adding ISK 6.8 Bn in AuM</li> </ul>
<b>SIA II (PE)</b>	<ul style="list-style-type: none"> <li>Fund size at inception (ISK Bn): 7.5</li> <li>Exits: 1 IPO</li> <li>Co- investments: 3, adding ISK 15.8 Bn in AuM</li> </ul>
<b>SIA III (PE)</b>	<ul style="list-style-type: none"> <li>Fund size at inception (ISK Bn): 12.8 / raised spring 2016</li> <li>Largest PE fund raised in Iceland by any investment manager</li> </ul>
<b>SRE I and SRE II (real estate)</b>	<ul style="list-style-type: none"> <li>SRE I at inception (ISK Bn): 1.6</li> <li>SREI II at inception (ISK Bn): 4.9</li> <li>All investments sold in autumn 2015 and summer 2016 to a listed REIT</li> </ul>

# Stefnir

## Strategic growth and customer satisfaction

- Stefnir has achieved financial and market share growth through long-term strategic planning by its board of directors implemented since 2009 with emphasis on a healthy revenue mix
- Product development and AuM diversification have led to new income sources as well as higher income yielding products



Source: Company information

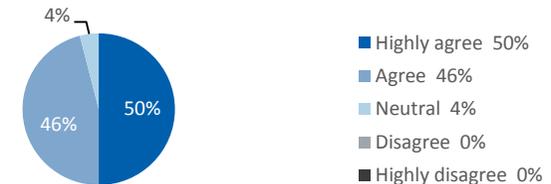
### Preferred partner of institutional clients

#### 2016 Client Survey Results <sup>1</sup>

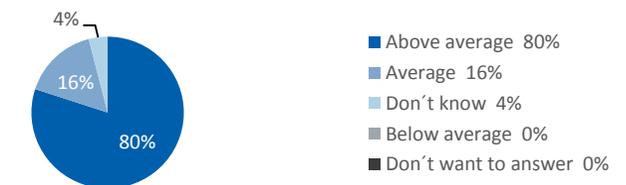
Would you recommend Stef'nir to other institutional investors?



Stef'nir offers a comprehensive product range that meets needs of institutional investors



How is professional knowledge of Stef'nir employees in your opinion?



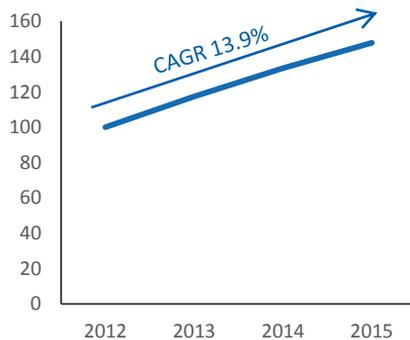
# Private banking

## Tailor made personal service to clients

- Special focus on Ultra High Net Worth (UHNW) clients in Iceland
- Healthy growth in PB AuM
- Tailor made and highly personal service
- Discretionary and non-discretionary asset management
- Experienced account managers – average 18 years in the financial market
- Team-based approach to investments and services, working closely with other divisions of the Bank
- Good access to local dealflow due to the size of Arion Bank's AM
- Specialised balanced portfolios

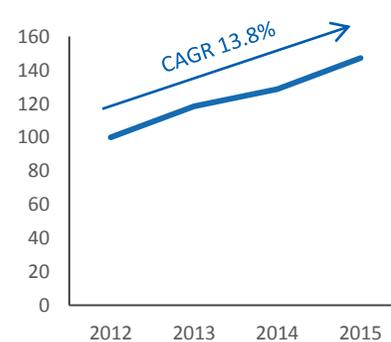
### Growth in PB AuM

Index, 2012 = 100



### Portfolio<sup>2</sup> development

Index, 2012 = 100

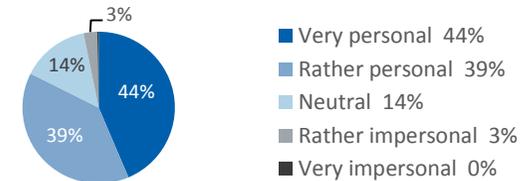


### 2016 client survey results <sup>1</sup>

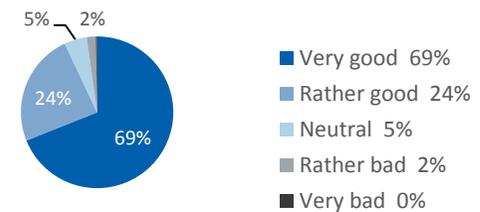
All things considered, how satisfied or unsatisfied are you with Arion Bank Private Banking services?



Do you feel the employees of Arion Bank Private Banking give you a personal or impersonal services?



How good or bad is the access to your Account Manager?



Source: Company information

1. 583 of Arion Bank Private Banking clients were invited to take part, 71% response ratio  
 2. YoY change in number of customer accounts in excess of ISK 100 M

# FINANCIAL PERFORMANCE



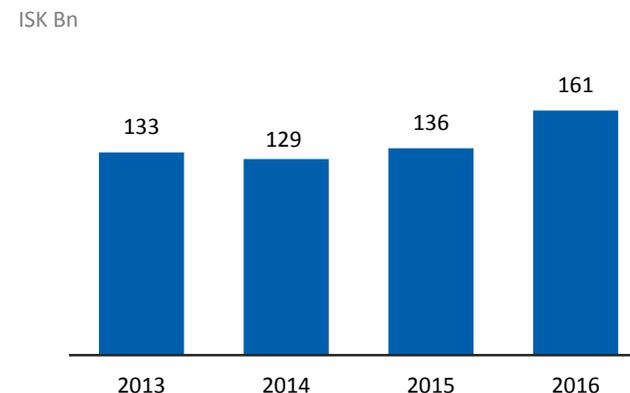
# Overview of covered bonds

## Arion Bank's covered bonds programme

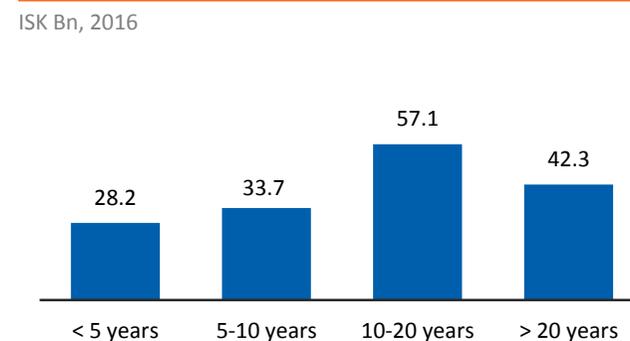
- Arion Bank has set up a EUR 1 Bn programme for the issuance of covered bonds
- In 2011, Arion Bank was licensed by the Icelandic Financial Supervisory Authority to issue covered bonds
  - Icelandic covered bond regulation is very similar to Swedish covered bond regulation
- Investors include pension funds, mutual funds and insurance companies

	Legislative covered bonds	Contractual covered bonds
Currency	Multi currency	Icelandic krona
Description	Covered bonds issued according to Icelandic legislation	Covered bonds issued prior to 2008. Contractual
Rating	Not rated	Not rated
Outstanding	ISK 64.1Bn	ISK 101.4 Bn
<b>Cover Pool Information</b>		
Asset balance	ISK 70.6 Bn	ISK 126.0 Bn
Number of loans	5,786	7,188
Pool LTV	55.5%	60.6%
Over-collateralisation	13.8%	24.3%

## Covered bonds development



## Maturity profile of covered bonds



Source: Company information

# Overview of senior unsecured bonds

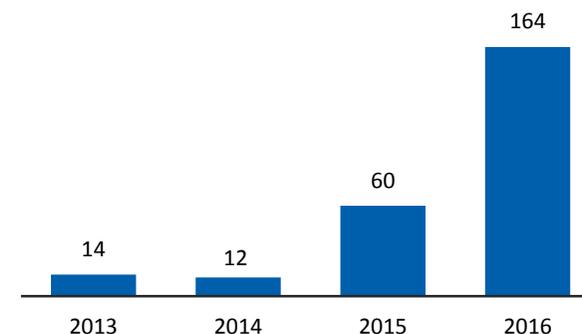
## Arion Bank's senior unsecured bonds

2016

Currency	Year Issued	Maturity	Maturity Type	Terms of interest	Size (ISK Bn)
USD	2016	2017	At maturity	Floating, 3 month LIBOR +1.93%	3,406
EUR	2009	2018	Amortising	Floating, EURIBOR +1.00%	662
ISK	2010	2018	Amortising	Floating, REIBOR +1.00%	1,063
EUR	2015	2018	At maturity	Fixed, 3.125% (MS + 3.10%)	36,610
SEK	2016	2018	At maturity	Floating, 3 month STIBOR + 1.09%	3,113
EUR	2016	2019	At maturity	Fixed, 2.5% (MS + 2.70%)	36,307
RON	2016	2019	At maturity	Fixed, 3.80%	951
SEK	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	3,422
NOK	2015	2020	At maturity	Floating, NIBOR + 2.95%	10,617
NOK	2016	2020	At maturity	Floating, NIBOR + 1.95%	2,902
EUR	2016	2021	At maturity	Fixed, 1.625%	35,639
USD	2016	2023	At maturity	Floating, 3 month LIBOR + 2.60%	29,317
<b>Senior unsecured bonds issued</b>					<b>164,009</b>

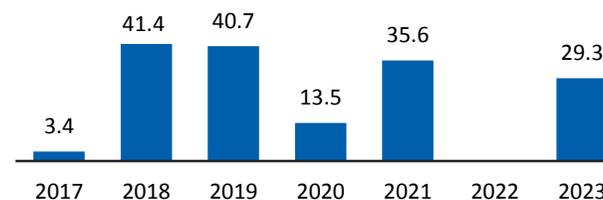
## Senior unsecured bonds development

ISK Bn



## Maturity profile of senior unsecured bonds

ISK Bn, 2016



Source: Company information

# Details on P&L adjustments

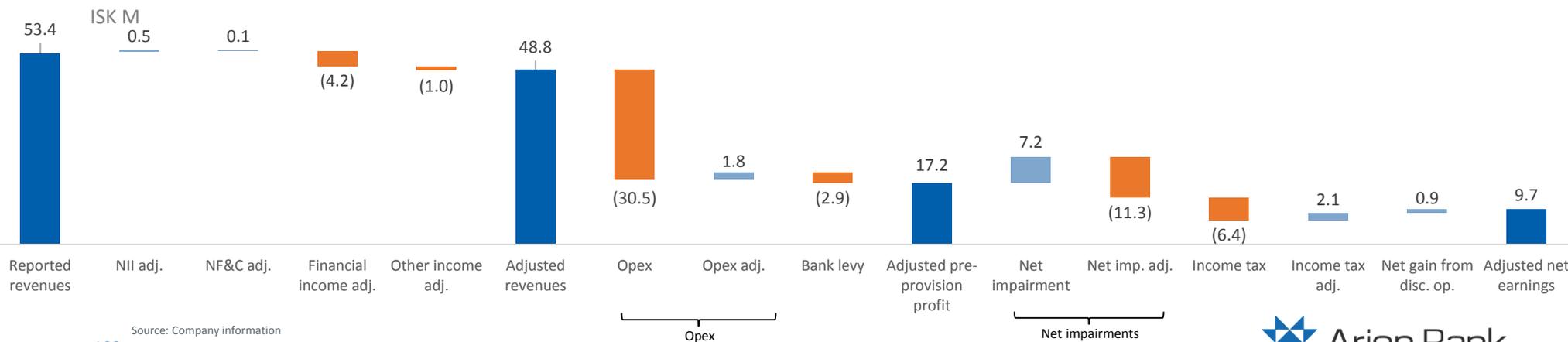
## Details on revenue adjustments

- **Net interest income:** Adjustments mainly refer to calculated net interest income earned in Treasury, had Arion not held non-core assets at the time and interest income and expenses at non-core subsidiaries
- **Net fee and commission income:** Adjustments refer to net fee and commission income at non-core subsidiaries
- **Financial income:** Adjustments mainly relate to value changes / gain on sale of legacy equity holdings Arion Bank and subsidiaries held ownership stakes in, following a restructuring of the loan book
- **Other operating income:** Adjustments relate to value changes / gain on sale of a number of equity holdings held by Arion Bank and subsidiaries. Furthermore, a significant part of the adjustments to other operating income relates to share of profit or loss of associates

## Adjusted operating expenses and net earnings

- **Total operating expenses:** Adjustments relate to fines from competition authorities, branch restructure, the expense of non-core subsidiaries and estimated expense of 30 FTEs during the historical period, which is the management estimate of effort related to one-off projects
- **Net impairments:** Adjustments relate to all change on loans over the historical period. The total changes are removed and 0.58% yearly estimated impairment is calculated on the total loan book
- **Income tax:** Tax effect of total adjustments assuming a 26% tax rate
- **Net gain from discontinued operations:** Adjustments refer to profit from sale of legacy equity holdings, prior to listing

## 2016 adjusted earnings



Source: Company information

## Details on P&L adjusted (cont'd)

### Adjusted revenues

<i>In ISK million</i>	2013	2014	2015	2016
Net interest income	23,800	24,220	26,992	29,900
Changes	3,157	2,642	1,347	530
<b>Net interest income adjusted</b>	<b>26,957</b>	<b>26,862</b>	<b>28,339</b>	<b>30,430</b>
Net fee and commission inc.	11,223	13,309	14,484	13,978
Changes	337	366	7	81
<b>Net fee and commission inc. adj.</b>	<b>11,560</b>	<b>13,675</b>	<b>14,491</b>	<b>14,059</b>
Net financial income	1,675	7,290	12,844	5,162
Changes	(1,158)	(5,597)	(7,513)	(4,240)
<b>Net financial income adjusted</b>	<b>517</b>	<b>1,693</b>	<b>5,331</b>	<b>922</b>
Other income	7,650	9,171	32,235	4,399
Changes	(5,217)	(5,031)	(29,579)	(1,022)
<b>Other income adjusted</b>	<b>2,433</b>	<b>4,141</b>	<b>2,656</b>	<b>3,377</b>
Total operating income	44,348	53,990	86,555	53,439
Changes	(2,881)	(7,619)	(35,738)	(4,651)
<b>Total operating income adjusted</b>	<b>41,467</b>	<b>46,371</b>	<b>50,817</b>	<b>48,788</b>

### Adjusted operating expenses and net earnings

<i>In ISK million</i>	2013	2014	2015	2016
Operating expenses	(25,395)	(27,042)	(28,196)	(30,540)
Changes	1,322	2,213	698	1,794
<b>Operating expenses adjusted</b>	<b>(24,073)</b>	<b>(24,829)</b>	<b>(27,498)</b>	<b>(28,746)</b>
Bank levy	(2,872)	(2,643)	(2,818)	(2,872)
Changes	0	0	0	0
<b>Bank levy adjusted</b>	<b>(2,872)</b>	<b>(2,643)</b>	<b>(2,818)</b>	<b>(2,872)</b>
Net impairment	(680)	2,135	(3,087)	7,236
Changes	(2,806)	(5,853)	(764)	(11,275)
<b>Net impairment adjusted</b>	<b>(3,486)</b>	<b>(3,719)</b>	<b>(3,851)</b>	<b>(4,039)</b>
Income tax	(3,143)	(4,679)	(3,135)	(6,410)
Changes	28	566	221	2,130
<b>Income tax adjusted</b>	<b>(3,115)</b>	<b>(4,113)</b>	<b>(2,914)</b>	<b>(4,280)</b>
Net gain from disc. operation	399	6,833	360	886
Changes	5	(6,290)	0	0
<b>Net gain from disc. op. adjusted</b>	<b>404</b>	<b>543</b>	<b>360</b>	<b>886</b>
Net earnings	12,657	28,594	49,679	21,739
Changes	(4,333)	(16,984)	(35,582)	(12,002)
<b>Net earnings adjusted</b>	<b>8,324</b>	<b>11,610</b>	<b>14,097</b>	<b>9,737</b>



# INFORMATION TECHNOLOGY



# Core banking systems overview

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- **Current situation**

- Currently Arion Bank uses RB system (along with other banks) as its core banking system for deposits, and all payment instructions are settled through the RB system
- RB is a centralised cash settlement system in Iceland (IT service centre for the Icelandic financial market, clearing house)
- RB's system has been in operation for 40 years
- To satisfy operational excellence, RB intends to replace its current deposit and payment systems with Sopra Banking system expected to go live mid 2017
- This requires Arion Bank to replace deposit and payment systems
- Replacement of other core banking systems is not essential in the near term

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- **Next steps**

- RB and SAP still being explored as future partners for deposits and payments
- The solutions will be evaluated on cost optimisation, product offerings and simplification in the system architecture
- Preparing to make a decision on future solution for deposits and payments 2017

# Information technology overview

Focus on reliable operations, digitalisation and customer satisfaction

## Reliable and efficient operations

IT reliability and efficiency – key management focal points

- Ongoing maintenance and development of systems currently in operation
- Ongoing focus to improve resilience and security
- Maintaining high uptime
- Continuously improving time to market

53%<sup>1</sup>

Reduction of impacting incidents from year 2010

99.95%<sup>1</sup>

arionbanki.is uptime

>99.999%<sup>1</sup>

Network core uptime last year greater than 99.999%

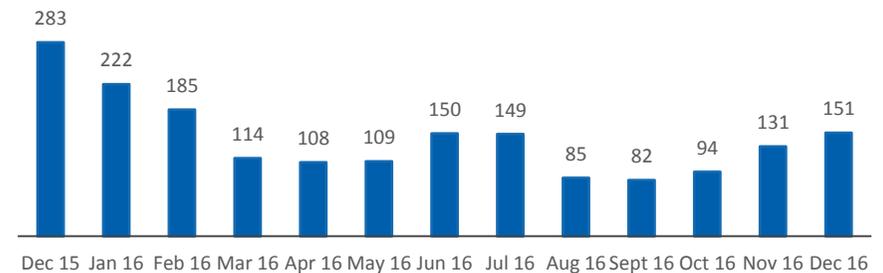
## Digitalisation and innovation

Arion Bank at the forefront of technology and innovation

- Strong focus on digital banking, ring-fenced cross-functional teams working on digital projects
- Defined plan for digital projects for the next three years
- Increase customer access to products and services digitally
- Extensive ATM network and forerunning ATM capabilities
- Internal and external innovative ideas presented (hackathons)
- Enclosed market allows for quick adaptation

## Customer satisfaction at the heart of Arion Bank's business<sup>2</sup>

- Working to continue to put customers' needs at the heart of the business
- Number of customer inquiries regarding netbank:

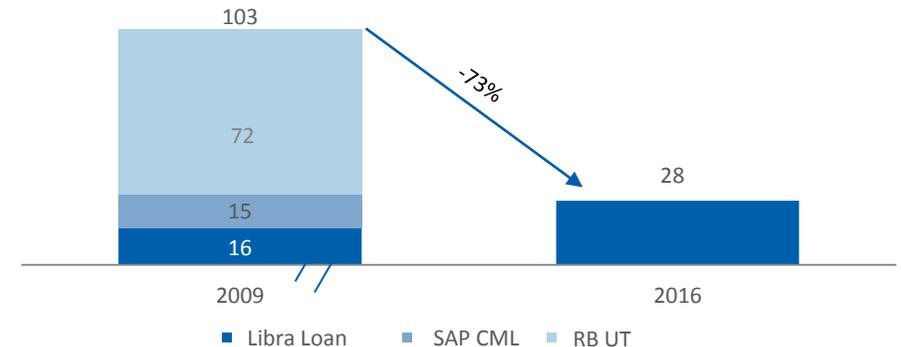


# Focus on automation

## Results in simplification

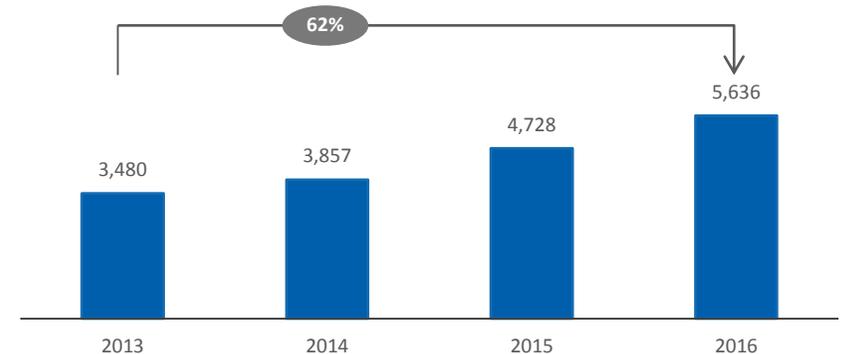
- Three-to-one loan system migration scheme
  - In 2009, Arion Bank had three loan systems in operation: RB UT, SAP CML and Libra Loan, each servicing a different portfolio of loans
  - Expensive and inefficient to maintain three systems. All changes executed in all three systems, integration to all three systems, reporting across all three systems, three service agreements
  - The goal with the simplification was to increase system operations efficiency, improve reporting efficiency and quality and decrease operational risk
  - Maintenance fee decreased from ISK 103 million in 2009 to ISK 28 million in 2016, i.e., 73% reduction in maintenance cost

**Achieving operational efficiency**  
Migration to Libra Loan. Reduction in maintenance cost (ISK M)<sup>1</sup>.



- Increased automation in mortgage processes resulted in less manual input and repetitive work
- Implementation of document management system resulted in fewer manual searches for documents at the document centre. 95% of documents have been migrated to the system
- Financial statements and notifications sent via online bank rather than snail mail resulting in lower costs
  - Number of annual portfolio statements 50,000 reduces cost by ISK 4 million
  - Number of annual interest rate change notifications 10,000 reduces costs by ISK 15 million (project still ongoing)

**Achieving operational efficiency**  
Average number of transactions processed per employee<sup>2</sup>

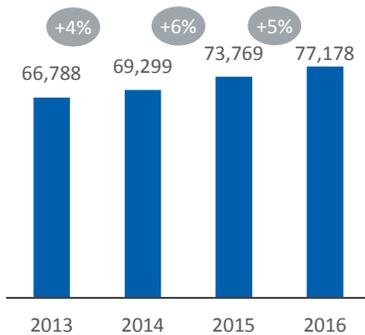


# Digitalised banking Framework

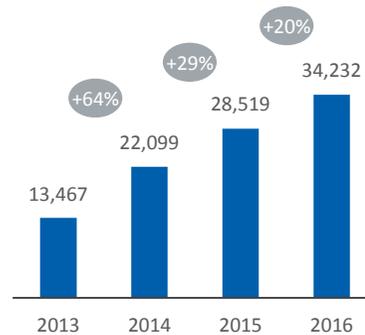
With strong customer focus

## Increasing digital impact

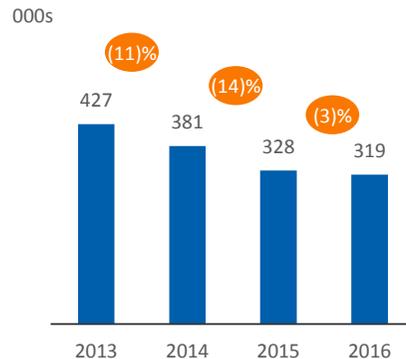
Active online bank users<sup>1</sup>



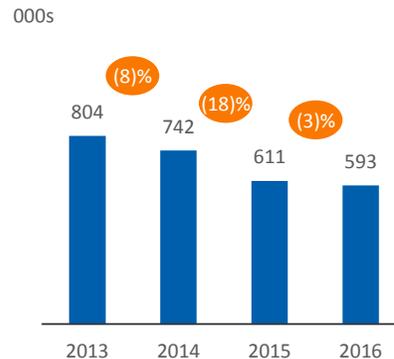
Active Arion Bank app users<sup>1</sup>



Number of calls to the call centre<sup>2</sup>



Number of visits to branches<sup>2</sup>



## Initiatives

<b>Arion Bank app</b>	<ul style="list-style-type: none"> <li>▪ Gives customers quick access to their daily banking</li> <li>▪ Further functionality continuously being added. High customer satisfaction. Developed in-house</li> <li>▪ Driven by customer demand for mobile banking applications</li> </ul>
<b>eID login</b>	<ul style="list-style-type: none"> <li>▪ Makes digital banking more accessible</li> <li>▪ National authentication and signature</li> <li>▪ Authentication by utilising mobile phones and via internet</li> </ul>
<b>Scalable online banking</b>	<ul style="list-style-type: none"> <li>▪ Online banking scalable for different channels, i.e., mobile, computers</li> </ul>
<b>CRM system</b>	<ul style="list-style-type: none"> <li>▪ Implemented in all customer facing units and most supporting units</li> <li>▪ Tracking customer communication, case handling and account planning (Microsoft CRM)</li> </ul>

Source: Company information

108  
2. Retail bank

90 day active online users and 30 day active app users, counted on June 30<sup>th</sup> each year. Definition by Finalta

# RISK MANAGEMENT



# Risk management for Arion Bank

Risk Management integrated across the entire Bank



- **Board of Directors** is ultimately responsible for:
  - Setting the Bank’s risk and governance policies
  - Articulating its risk appetite
  - Ensuring effective internal control and management of risk
- **Internal Audit** is responsible for the independent review of risk management and the control environment
- The **Chief Executive Officer (“CEO”)** is responsible for the enforcement of the Board of Directors’ policies
- The CEO delegates risk management to the **Chief Risk Officer (“CRO”)** and regulatory compliance to the Compliance Officer
- The **Compliance Division** is responsible for reducing the Bank’s legal and regulatory risks
- **Risk Management Division** focuses on the identification, monitoring and control of risk as well as monitoring compliance with internal and external limits, standards and regulations
- Strong emphasis is placed on reporting risk to the relevant stakeholders in a clear and meaningful manner
- Risk Management division is headed by the **Chief Risk Officer**
- The division is divided into four units: credit analysis, credit control, balance sheet risk and operational risk
- The Bank’s Security Officer is a member of Risk Management
- Risk Management had 30 FTEs at the end of 2016

# Risk appetite

Clearly articulated risk appetite cascaded down to risk limits

- The objective of the **risk appetite framework** is to provide a common framework to the board of directors and the management to communicate, understand, and assess the types and level of **risk that the board of directors is willing to accept**
- The framework furnishes an appropriate understanding of the Bank's **risk profile relative to its risk appetite**
- The Bank's risk appetite is clearly articulated through a risk appetite statement and **cascaded down to risk limits**

Example risk appetite metrics	31.12.2016	Legal limit	Within risk appetite?
<b>Credit risk</b>			
Largest exposure – group level	8.6%	25.0%	✓
Sum of 3 largest sectors	65.0%	n/a	✓
Largest sector	30.6%	n/a	✓
Expected loan loss rate	0.60%	n/a	✓
<b>Market risk</b>			
Total equity exposure	13.8%	n/a	✓
Unlisted equity exposure	6.9%	n/a	✓
Indirect equity exposure	0.35%	n/a	✓
<b>Funding &amp; liquidity risk</b>			
Liquidity coverage ratio	166%	90% <sup>1</sup>	✓
Loan-to-deposit ratio	173%	n/a	✓
Encumbered asset ratio	20.5%	n/a	✓
<b>Capital management</b>			
Capital ratios (e.g., CAD)	27.1%	18.8%	✓
Leverage ratio	17.9%	3.0%	✓
<b>Assets &amp; liability management</b>			
Currency imbalance – group level	2.4%	15.0%	✓
Interest rate risk	3.4%	n/a	✓

Source: Company information  
Note: 1. From 1 January 2017 rises to 100%.

# Stress testing overview

Stress test results are incorporated into the review of risk appetite and limits

## Stress tests framework

- The Bank's stress testing framework is aligned with FME guidelines, which are based on EBA's Guidelines on Stress Testing
- Stress testing at the Bank is based on sensitivity analysis and scenario analysis
- Stress testing results are incorporated into the review of the risk appetite and the Bank's limit framework

## Stress tests performed

<b>Central Bank &amp; FME Stress Tests</b>	<b>Annually</b>	<ul style="list-style-type: none"> <li>▪ Stressed scenarios provided by the CBI in collaboration with the FME</li> </ul>
<b>Internal Stress Tests on Business Plan</b>	<b>Annually</b>	<ul style="list-style-type: none"> <li>▪ Risks and stress provided by each business unit</li> <li>▪ Economic case by Research</li> </ul>
<b>ICAAP / ILAAP</b>	<b>Annually</b>	<ul style="list-style-type: none"> <li>▪ Interest rate risk, value-at-risk on trading book, credit risk stress tests</li> </ul>
<b>Focused Stress Tests</b>	<b>Daily / Monthly</b>	<ul style="list-style-type: none"> <li>▪ For example: liquidity and market risk, risk appetite for indirect equity positions</li> </ul>

Source: Company information

# Stress testing

Stress tests results are incorporated into the review of risk appetite and limits

## Capital controls liquidity stress testing

- Arion Bank has performed a number of stress tests in relation to capital controls
- Scenarios have assumed full outflow of deposits from entities in winding-up and foreign parties, including the re-termining of Kaupthing FX deposits into EMTN funding
- Such stress test was delivered to the Central Bank of Iceland in the fall of 2015:

Scenario	Stress Test Results						Realization (31.12.2016)			
	Amount Out		LCR		NSFR		Amount Out			
	FX	Total	FX	Total	FX	Total	FX	% of test	Total	% of test
<b>15.9.2015</b>			184%	117%	200%	102%				
Kaupthing FX re-termining	38.519	38.519	194%	120%	227%	105%	38.519	100%	38.519	100%
Winding-up entities: 100% outflow	7.788	50.299	229%	102%	227%	105%	7.788	100%	50.299	66%
Foreign banks: 100% outflow	468	4.608	232%	102%	227%	105%	241	51%	2.557	55%
Other foreign parties: 50% outflow	638	4.105	234%	100%	226%	105%	43	7%	- 1.731	-42%
Total deposits out	47.412	97.531					46.591	98%	89.644	92%

↓ Accumulative effect

- The stress tests revealed that the lifting of capital controls posed limited threat to liquidity and in fact this risk has been largely eliminated as is evident when stressing the same scenarios today:

Scenario	Amount Out		LCR		NSFR	
	FX	Total	FX	Total	FX	Total
<b>31.12.2016</b>			255%	166%	190%	121%
Winding-up entities: 100% outflow	0	0	255%	166%	190%	121%
Foreign banks: 100% outflow	259	2.125	258%	168%	190%	121%
Other foreign parties: 50% outflow	641	4.950	262%	166%	189%	120%
Total deposits out	900	7.076				

↓ Accumulative effect

Source: Company information

# Risk management

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## Problem loans & other

### Early Warning System for potential problem loans

- For Problem loans that are not categorized in 90 days default then the the main monitoring measures other than checking the list of defaulters (which contains loans to borrowers more than 30 days in default) are quarterly meetings with account managers and 6-monthly valuation reports on major borrowers which are classed as Orange/Red under the Bank's early warning system (EWS). EWS is intended to identify the greater credit risk of borrowers based on the financial strength of the borrower, e.g. leveraging. The entire process and EWS are described in more detail in chapter 4.7 in the risk report

### Recalculation of currency linked loans completed

- Currently no impairments in respect of illegal currency linked loans
- Recent Supreme court rulings regarding currency linked loans are not estimated to affect the bank's position



# Risk management systems

Arion Bank utilises a number of effective and sophisticated systems to manage risk

	<b>Return on Allocated Capital (ROAC)</b>	<ul style="list-style-type: none"> <li>Risk-adjusted performance metric</li> </ul>		<b>Internal Rating System</b>	<ul style="list-style-type: none"> <li>Credit rating model to monitor developments of credit risk</li> <li>Estimate customer's probability of default and expected loss</li> </ul>
	<b>Related Parties and Large Exposure</b>	<ul style="list-style-type: none"> <li>Connection of related parties according to internal rules</li> <li>Control and economic dependencies</li> </ul>	<b>VaR</b>	<b>Value-at-Risk Engine</b>	<ul style="list-style-type: none"> <li>VaR calculations for trading book, basis for Pillar 2 capital requirement</li> </ul>
	<b>Early Warning System</b>	<ul style="list-style-type: none"> <li>Forward looking classification system for loans and borrowers</li> </ul>		<b>Trading Book Monitoring Systems</b>	<ul style="list-style-type: none"> <li>Proprietary trading and non-strategic derivatives book</li> <li>Position limits</li> <li>Collateral needs, margin calls</li> <li>Monitoring of exposures</li> </ul>
	<b>Collateral Management System</b>	<ul style="list-style-type: none"> <li>Collateral maintenance, valuation and central storage of collateral information</li> </ul>		<b>Investment Limits</b>	<ul style="list-style-type: none"> <li>Monitoring of investment limits/benchmarks for Asset Management and Stefmir</li> </ul>

# IFRS 9 Readiness

<b>Implementation Status</b>	<ul style="list-style-type: none"><li>▪ Steering committee overseeing the implementation process</li><li>▪ Currently analysing change from IAS 39 to IFRS 9 on current processes and being reviewed and updated accordingly</li><li>▪ Quantitative Impact Study (“QIS”) to measure potential effects of the change in impairment models (from incurred to expected) on assets</li><li>▪ Designing a new and improved impairment models based on the requirement of IFRS 9</li></ul>
<b>Effects</b>	<ul style="list-style-type: none"><li>▪ All chapters are likely to affect the Bank</li></ul>
<b>QIS</b>	<ul style="list-style-type: none"><li>▪ Carried out by KPMG, based on loan book at the end of June 2015</li><li>▪ Key results<sup>1</sup>:<ul style="list-style-type: none"><li>– If the current credit ratings on assets would be used as under IAS 39 calculations, the effect of modification from incurred loss to expected loss on net book value of loans would be immaterial</li><li>– The calculated expected credit loss amounts might change depending on the assessment of what is a significant change in credit quality, and would therefore call on a reclassification from 12 month expected credit loss to lifetime expected credit loss</li></ul></li></ul>
<b>Next Steps</b>	<ul style="list-style-type: none"><li>▪ Process comparison, validation and updates will continue</li><li>▪ Definition and documentation on various estimates and inputs within IFRS 9 will continue</li><li>▪ Completion and validation of the impairment models to be used going forward</li><li>▪ Design and validation of new IFRS 9 compliant notes</li><li>▪ Test- and parallel run on new processes, notes and models – expected in Q3 and Q4 2017</li></ul>
<b>Expectations</b>	<ul style="list-style-type: none"><li>▪ The Bank is currently on track and should be ready for a test run in Q3 and parallel run in Q4 2017 and to be fully compliant from 1 January 2018</li></ul>

Source: Company information

116 Note: 1. The calculations are based on the classification of assets as of June 2015 based on IAS 39. Reclassification of some assets could affect the model calculations

# VALITOR APPENDIX



# Full and well diversified product range

## Valitor card acquiring services

- Offers both card-present and e-commerce acquiring services to merchants, ISOs (independent sales organisations), payment facilitators and PSPs (payment service providers)
- Domestically, Valitor services merchants directly with its end-to-end e-commerce and card present solutions
- Internationally, Valitor does business in many European countries through its partners, and also services merchants directly in selected markets, currently the UK, Ireland and the Nordic countries
- Revenue is based on percentage of processed volume, terminal rentals and other payment related services
  - Domestic business c. 83% card present
  - International business c. 90% e-commerce

Share of Revenue

77%



## Valitor card issuing services

- Valitor issues both physical and virtual cards on behalf of banks and programme managers
- Offers BIN (bank identification number) sponsorship and processing services with operations in over 50 European prepaid programmes
- State-of-the-art card issuing platform is integrated with Visa and MasterCard and, in addition to issuing via banking partners, is designed to accommodate the specific needs of the prepaid market
- Partners with Icelandic banks and international issuing programme managers
- Revenue is based on processed volume, loads and number of issued cards

Share of Revenue

23%



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