Interim Financial Statements

1 January - 30 June 2012

Arion Bank
Borgartún 19
105 Reykjavík
Iceland

Reg. no. 581008 - 0150

Contents

Endorsement and Statement by the Board of Directors and the CEO

The Interim Financial Statements of Arion Bank for the period ended 30 June 2012 include the Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Arion Bank is a group of financial undertakings which provide comprehensive financial services to companies, institutions and private customers. These services include corporate banking, retail banking, investment banking and asset management and comprehensive wealth management for private banking clients.

Kaupskil ehf., a company owned by Kaupthing hf. (formerly Kaupthing Bank hf.), holds 87% of the shares in Arion Bank. The remaining shareholding of 13% is held by the Icelandic State Financial Investments on behalf of the Icelandic government.

Operations during the period

Net earnings amounted to ISK 11,249 million for the period ended 30 June 2012. Total equity amounted to ISK 125,143 million at the end of the period, including share capital amounting to ISK 2,000 million. The capital adequacy ratio of the Group, calculated according to the Act on Financial Undertakings, was 22.3%. By law this ratio is required to be no lower than 8.0%, but the Icelandic Financial Supervisory Authority ("FME") requires it to be no less than 16%. The Group's liquidity position was strong with the liquidity ratio and cash ratio being 32% and 14% respectively at the end of the period. This compares favourably with the regulatory minimum of 20% and 6% respectively.

Arion Bank generally performed well during the period and core banking activities continued to yield strong results. The same applied to core subsidiaries.

Arion Bank continues to strenghten and diversify its funding base. To that effect, the Bank, on 17 February, issued it's first covered bonds under it's EUR 1 billion Covered Bond Programme. The issue was ISK 2.5 billion index linked, with a final maturity in 2034, targeted towards Icelandic institutional investors. The issue was close to four times oversubscribed. Arion was also the first Icelandic bank to issue fixed rate (non index linked) covered bonds. The Bank issued a total of ISK 2.5 billion 6.5% fixed rate covered bonds maturing in 2015. Furthermore, the Bank in the first half of the year actively begun it's investor relation work with two non deal roadshows, in London and Frankfurt.

The Bank has put effort in selling its shareholding in legal entities which were acquired as a result of a foreclosure. During the first half of the year the Bank sold a large part of its shareholding in Hagar hf. or 15.1% of issued shares of Hagar hf. The Icelandic Competition Authority granted the Bank a permission to hold on to the remaining shareholding in Hagar hf. At the end of the period the Bank's effective shareholding in Hagar is 6.4% and is classified as a trading asset. At the beginning of June the Bank finalized the sale of 38.9% share in N1 hf. The agreement was signed in October 2011 but Icelandic Competition Authortity gave approval in May 2012 and final agreements were signed early June. The profit from the sale of those shares was ISK 868 million and is recognised in the Statement of Comprehensive Income. In June 2012 the Bank sold its 20% shareholding in Ölgerdin Egill Skallagrímsson ehf. The profit from the sale of this shareholding is ISK 375 million and is recognized in the Statement of Comprehensive Income. The sale of B.M. Vallá ehf. was finalized in May after receiving approval from Icelandic Competition Authority. The Bank received such approval on the sale of Penninn á Íslandi ehf. in August.

The quality of the Bank's balance sheet continues to improve. Good progress was made in the restructuring work on its loan book and other assets transferred from Kaupthing hf. The recovery work on loans to larger corporations is largely completed and work continues with SME's and individuals. The Supreme Court Ruling of 15 February 2012, regarding interest on FX linked loans was however a set-back in this respect. The ruling is not decisive enough and the restructuring work on SME's has therefore stalled somewhat. New rulings, that will provide further clarification, are expected in the near future. Uncertainties regarding the legality of foreign currency loans to corporations are further discussed in Note 53.

There continues to be positive signs in the Icelandic economy which grew by 3.1% in 2011 and is forecasted to grow 2.8% this year. Unemployment was at 4.4% in July, well below the EU average and the Icelandic state has demonstrated twice the ability to tap the international financial markets. The recovery of the Icelandic economy, however, remains fragile. The situation in the international markets may also have a negative effect on growth in Iceland and Icelandic corporates. Arion Bank has insignificant direct exposure to the uncertainties in the Eurozone and is, as a financially strong institution, in an ideal position to support the growth of the Icelandic economy over the coming years.

Endorsement and Statement by the Board of Directors and the CEO

Statement by the Board of Directors and the CEO

The Interim Financial Statements for the periods ended 30 June 2012 have been prepared in accordance with International Financial Reporting Standard (IAS 34 *Interim Financial Reporting*) as adopted by the EU.

It is our opinion that the Interim Financial Statements give a true and fair view of the financial performance of the Group for the periods ended 30 June 2012, its financial position as at 30 June 2012 and its cash flows for the periods ended 30 June 2012.

Further, in our opinion the Interim Financial Statements and the Endorsement of the Board of Directors and the CEO give a true and fair view of the development and performance of the Group's operations and its position and describes the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the Interim Financial Statements of Arion Bank for the periods ended 30 June 2012 and confirm them by means of their signatures.

Reykjavík, 31 August 2012

Board of Directors

Monica Caneman
Chairman

Agnar Kofoed-Hansen

Gudrún Johnsen

Måns Höglund

Freyr Thórdarson

Jón G. Briem

Chief Executive Officer

Höskuldur H. Ólafsson

Report on Review of Interim Financial Statements

To the Board of Directors and Shareholders of Arion Bank.

Introduction

We have reviewed the accompanying Interim Financial Statements of Arion Bank and its subsidiaries (the "Group"), which comprise the Interim Statement of Comprehensive Income, the Interim Statement of Financial Position as at 30 June 2012, the Interim Statement of Changes in Equity and the Condensed Interim Statement of Cash Flows for the six-month period then ended, and explanatory notes. Management is responsible for the preparation and fair presentation of these Interim Financial Statements in accordance with International Financial Reporting Standard IAS 34, "Interim Financial Reporting" as adopted by the EU. Our responsibility is to express a conclusion on these Interim Financial Statements based on our review.

Scope of review

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

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying Interim Financial Statements are not prepared, in all material respects, in accordance with IAS 34 "Interim Financial Reporting" as adopted by the EU.

Reykjavík, 31 August 2012

Ernst & Young ehf.

Margrét Pétursdóttir, Partner

Interim Statement of Comprehensive Income
for the Period from 1 January to 30 June 2012

	Notes	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Interest income		32,153	23,620	16,855	12,503
Interest expense		(18,273)	(12,460)	(9,189)	(7,229)
Net interest income	12	13,880	11,160	7,666	5,274
Increase in book value of loans and receivables	13	7,168	29,338	7,049	27,281
Impairment of loans and receivables	14	(4,636)	(5,801)	(4,441)	(6,241)
Changes in compensation instrument	37	-	(19,593)	-	(16,683)
Net interest income less valuation changes on loans and receivables		16,412	15,104	10,274	9,631
Fee and commission income		7,968	8,379	4,162	4,255
Fee and commission expense		(2,630)	(3,280)	(1,160)	(1,648)
Net fee and commission income	15	5,338	5,099	3,002	2,607
Net financial income (expense)	16-19	330	(38)	(16)	(767)
Net foreign exchange gain (loss)	20	(149)	1,977	(1,232)	2,289
Share of profit or loss of associates	39	7	(1)	2	16
Other operating income	21	2,999	2,351	2,052	1,235
Operating income		24,937	24,492	14,082	15,011
Salaries and related expense	23	(6,169)	(5,516)	(3,124)	(2,858)
Administration expense		(4,147)	(3,768)	(2,042)	(1,859)
Depositors' and investors' guarantee fund	50	(445)	(557)	(207)	(377)
Depreciation and amortisation		(463)	(430)	(246)	(222)
Other operating expense	24	(420)	(498)	(223)	(332)
Earnings before tax		13,293	13,723	8,240	9,363
Income tax expense	25	(2,913)	(2,517)	(1,852)	(1,472)
Bank Levy	26	(510)	(446)	(242)	(379)
Net earnings from continuing operations		9,870	10,760	6,146	7,512
Net gain (loss) from discontinued operations, net of tax	27	1,379	(568)	652	(286)
Net earnings		11,249	10,192	6,798	7,226
Attributable to:					
Shareholders of Arion Bank		11,052	9,825	6,741	7,034
Non-controlling interest		197	367	57	192
Net earnings		11,249	10,192	6,798	7,226
Other comprehensive income					
Exchange difference on translating foreign subsidiaries		-	114	(2)	(67)
Total comprehensive income for the period		11,249	10,306	6,796	7,159
Earnings per share from continuing operations					
Basic and diluted earnings per share from continuing operations attributable to the shareholders of Arion Bank (ISK)	28	4.84	5.20	3.04	3.66

The Q2 result (and implied Q1 result) were not audited or reviewed.
The notes on pages 10 to 43 are an integral part of these Interim Financial Statements.

Arion Bank Interim Financial Statements 30 June 2012 6 Amounts are in ISK millions

Interim Statement of Financial Position
as at 30 June 2012

Assets	Notes	30.06.2012	31.12.2011	30.06.2011
Cash and balances with Central Bank	29	16,280	29,200	23,867
Loans and receivables to credit institutions	30-31	71,769	69,103	72,063
Loans and receivables to customers	32-33, 55	578,886	561,550	447,715
Bonds and debt instruments	34-35	128,853	140,568	141,327
Shares and equity instruments with variable income	34	15,408	14,045	15,020
Derivatives	34,46	1,363	674	1,108
Securities used for hedging	34	1,516	2,372	1,311
Investment property	38	28,379	27,100	26,484
Investments in associates	39	3,020	2,987	5,282
Property and equipment		6,232	6,271	7,214
Intangible assets		5,008	4,765	4,684
Tax assets	40	548	724	221
Non-current assets and disposal groups held for sale	41	16,303	23,886	38,641
Other assets	42	6,485	8,876	20,363
Total Assets		880,050	892,121	805,300
Liabilities				
Due to credit institutions and Central Bank	34	20,837	16,160	75,345
Deposits	34	445,249	489,995	448,701
Financial liabilities at fair value	34	10,439	4,907	7,886
Tax liabilities	40	4,028	3,421	6,707
Non-current liabilities and disposal groups held for sale	41	4,174	4,950	11,911
Other liabilities	43	45,052	38,822	37,363
Borrowings	34,44	192,953	187,203	66,894
Subordinated liabilities	34,45	32,175	32,105	33,244
Total Liabilities		754,907	777,563	688,051
Equity				
Share capital	47	2,000	2,000	2,000
Share premium	47	73,861	73,861	73,861
Other reserves	48	1,637	1,637	1,639
Retained earnings		44,002	32,950	32,283
Total Shareholders' Equity		121,500	110,448	109,783
Non-controlling interest		3,643	4,110	7,466
Total Equity		125,143	114,558	117,249
Total Liabilities and Equity		880,050	892,121	805,300

The notes on pages 10 to 43 are an integral part of these Interim Financial Statements.

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Interim Statement of Changes in Equity
for the Period from 1 January to 30 June 2012

	Share capital and share premium	Other reserves	Retained earnings	**Total Share-holders' equity**	Non-controlling interest	**Total equity**
Changes in equity from 1 January to 30 June 2012:						
Equity 1 January 2012	75,861	1,637	32,950	110,448	4,110	114,558
Total comprehensive income for the period attributable to the shareholders of Arion Bank			11,052	11,052		11,052
Total comprehensive income for the period attributable to the non-controlling interest					197	197
Acquisition of non-controlling interests					(664)	(664)
Equity 30 June 2012	75,861	1,637	44,002	121,500	3,643	125,143
Changes in equity from 1 January to 30 June 2011:						
Equity 1 January 2011	75,861	1,525	28,531	105,917	3,619	109,536
Dividend paid			(6,073)	(6,073)		(6,073)
Total comprehensive income for the period attributable to the shareholders of Arion Bank		114	9,825	9,939		9,939
Total comprehensive income for the period attributable to the non-controlling interest					367	367
Disposal of non-controlling interests					3,480	3,480
Equity 30 June 2011	75,861	1,639	32,283	109,783	7,466	117,249

The notes on pages 10 to 43 are an integral part of these Interim Financial Statements.

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Condensed Interim Statement of Cash Flows
for the Period from 1 January to 30 June 2012

	Notes	2012 1.1.-30.6.	2011 1.1.-30.6.
Cash flows from (used in) operating activities			
Earnings from continuing operations before income tax		13,293	13,723
Adjustments to reconcile earnings before income tax to net cash from (used in) operating activities:			
Non-cash items included in net earnings before income tax and other adjustments		371	(7,411)
Changes in operating assets and liabilities	54	(28,032)	(13,991)
Income taxes paid		(2,129)	(268)
Net cash from (used in) operating activities		(16,497)	(7,947)
Net cash from (used in) investing activities		9,439	4,821
Net increase (decrease) in cash and cash equivalents		(7,058)	(3,126)
Cash and cash equivalents at beginning of the period		82,815	72,797
Cash and cash equivalents acquired through business combinations		-	5
Effect of exchange rate changes on cash and cash equivalents		879	1,881
Cash and cash equivalents at the end of the period		76,636	71,557
Cash and cash equivalents comprises			
Cash in hand and demand deposits		16,280	23,867
Due from credit institutions		67,951	55,419
Mandatory reserve with Central Bank		(7,595)	(7,729)
Cash and cash equivalents at period-end		76,636	71,557
Non-cash investing and financing transactions:			
Tier II subordinated notes issued in settlement of dividend		-	(6,073)
Change in retained earnings for settlement of dividend with Icelandic State		-	6,073

The notes on pages 10 to 43 are an integral part of these Interim Financial Statements.

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Accounting Policies

General information

1. Reporting entity

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Interim Financial Statements for the period ended 30 June 2012 comprise the Parent Company and its subsidiaries (together referred to as "the Group"). The Group offers integrated financial services to companies, institutional investors and individuals. These services include corporate banking, retail banking, investment banking services and asset management and comprehensive wealth management for private banking clients.

The Interim Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 31 August 2012.

2. Basis of preparation

a) *Statement of compliance*

The Interim Financial Statements have been prepared in accordance with International Financial Reporting Standard IAS 34, Interim Financial Reporting as endorsed by the European Union. The Interim Financial Statements do not include all the information and disclosures required in the annual financial statements, and should be read in conjunction with Arion Bank´s annual Financial Statements for the year 2011. The statements are available at Arion Bank´s website www.arionbanki.is.

b) *Basis of measurement*

The Interim Financial Statements are prepared on the historical cost basis except for the following:

– Financial assets/liabilities held for trading are measured at fair value;

– Financial assets/liabilities designated at fair value through profit and loss are measured at fair value;

– Investment properties are measured at fair value; and

Non-current assets (or disposal groups) classified as held for sale are stated at the lower of their carrying amount and fair value less costs to sell. Immediately before the initial classification, or where the assets and liabilities are not within the scope of IFRS 5, the carrying amounts are measured in accordance with applicable IFRSs.

c) *Functional and presentation currency*

The Interim Financial Statements are presented in Icelandic króna (ISK), which is the Parent Company's functional currency, rounded to the nearest million unless otherwise stated.

d) *Use of estimates and judgements*

The preparation of the Interim Financial Statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, contingent liabilities as well as income and expenses in the Interim Financial Statements presented. Use of available information and application of judgement are inherent in the formation of estimates. Actual results in the future could differ from such estimates and the differences may be material to the Interim Financial Statements.

Estimates and underlying assumptions are reviewed on an on going basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

Judgements made by management that have a significant effect on the Interim Financial Statements and estimates with a significant risk of material adjustment within the next financial year are discussed in Note 4 in these Interim Financial Statements and in the annual Financial Statements 2011.

Significant accounting policies

The accounting policies adopted in the preparation of these Interim Financial Statement are consistent with those followed in the preparation of the Group's annual Financial Statements for the year ended 31 December 2011.

3. Going concern assumption

The Group's management has made an assessment of the ability to continue as a going concern and is satisfied that the Group has the resources to continue. In making this assessment management has taken into consideration the risk exposures facing the Group which are further described in the Risk Management Disclosures.

4. Critical accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

These disclosures supplement the risk management disclosures, provided elsewhere in these Interim Financial Statements.

Key sources of estimation uncertainty

i) Impairment losses on loans and receivables

The Group reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the Statement of Comprehensive Income, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

ii) Foreign currency linked loans

The Group is evaluating the impact of the Supreme Court judgment of 15 February 2012 on the currency-linked loan portfolio. The Group's preliminary evaluation is that currency linked loans can be recalculated with the non-indexed interest rate set by the Central Bank of Iceland. However, if the borrower has paid according to the Bank‘s payment slips, then the Bank can not normally claim a larger amount of interest on the loan than the interest the borrower has actually paid.

As set out in Note 53 of these Interim Financial Statements, the Group recognised impairment of the currency linked loan portfolio at period-end for the estimated loss arising from the above judgment. The Group remains exposed to significant uncertainty regarding foreign currency linked loans arising from firstly, uncertainty over its interpretation of this judgment and secondly, uncertainty over the outcome of future legal decisions and new or amended government legislation.

Management judgment is required in the determination of the individual borrowers that require recalculation, and the estimated loss is based on assumptions that may be revised when it becomes clear how to interpret the Supreme Court‘s judgement. In addition, the outcome of future legal decisions and new or amended government legislation may require recalculation of other categories of foreign currency loans that the Group has not previously considered as vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome.

iii) Fair value of financial instruments

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. Where valuation techniques (for example, models) are used to determine fair values, they are validated and periodically reviewed by qualified personnel independent of the area that created them. All models are certified before they are used, and models are calibrated to ensure that outputs reflect actual data and comparative market prices. To the extent practical, models use only observable data, however areas such as credit risk (both own and counterparty), volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect reported fair value of financial instruments.

iv) Assets classified as held for sale

The Group classifies assets as held for sale if the assets are available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets and the sale is considered highly probable. For the sale to be highly probable management must be committed to sell the assets and be actively looking for a buyer, the assets must be actively marketed at a price that is reasonable in relation to their fair value and the sale is expected to be completed within one year. An extension of the period required to complete a sale does not preclude an asset or disposal group from being classified as held for sale if the delay is caused by events or circumstances beyond the Group's control and there is sufficient evidence that the Group remains committed to its plan to sell the assets or disposal groups.

When classifying assets as held for sale the Group has determined that the requirements of IFRS 5 have been met.

As set out in Note 21 in the annual Financial Statements for the year 2011, disposal groups being legal entities acquired exclusively with view to resale are measured at the lower of carrying amount and fair values less costs to sell. For the most part, fair values at the date of classification of these legal entities were calculated using valuation models based on discounted future cash flows that incorporated significant non-market observable inputs and assumptions. The use of reasonably possible alternative inputs and assumptions to these models, in particular changes to the discount rate employed (representing the required rate of return on equity), would have a significant impact on the fair value of these disposal groups.

Notes to the Interim Financial Statements

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v) Fair value of Investment Property

As the property market in Iceland is relatively inactive and assets are often quite dissimilar it is difficult to obtain reliable estimates of fair values of investment properties. The international financial crises and the financial crisis in Iceland had significant influence on the real estate market in Iceland. The effects of that resulted in a relatively passive market and with disparate properties on the market it can be complicated to use prices from recent market transactions in order to determine values of comparable properties. This being the case there is great uncertainty about the actual fair value of the properties.

vi) Intangible assets

The value of intangible assets with indefinite useful lives is not amortised, but the assets are tested for impairment at least once a year.

Changes within the Group

5. Verdis hf.

The boards of Arion Bank and the Bank´s wholly owned subsidiary Verdis hf. approved the merger of these two entities. On 29 June 2012 FME approved the merger. The merger took effect from 1 January 2012.

6. Acquisition of mortgage portfolio

At year-end 2011 Arion Bank and Kaupthing hf. reached agreement for Arion Bank to acquire a mortgage portfolio which has been managed in a special fund owned by Kaupthing hf. The agreement also specifies that the deal is funded by the assumption of covered bonds by Arion Bank.

Under the agreement Arion Bank replaced Kaupthing hf. as issuer of the covered bonds. The covered bonds will be listed on Nasdaq OMX Iceland in the second half 2012.

Through this acquisition total assets of the Group increased by ISK 94.4 billion and total liabilities increased by ISK 96.7 billion.

7. Acqusition of subsidiaries

In April 2012 the Group acquired a further 7.2% share in Valitor Holding hf. After the acquisition the Group holds 60.8% share in Valitor Holding hf.

8. Disposal of subsidiaries

The subsidiary Ekort ehf. was merged into Arion Bank 1 January 2012. Prior to the merger part of the operation of Ekort ehf. was transferred to Einkaklúbburinn ehf. which is a new subsidiary of Arion Bank. The subsidiaries AB-fjárfestingar ehf., ENK 1 ehf. and Vesturland ehf. were liquidated in the first quarter of 2012.

In October 2011 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in B.M. Vallá ehf., which was approved by the Icelandic Competition Authority in April 2012. The effects from the sale of this entity has minor effects on the Statement of Comprehensive income in the second quarter of 2012.

Notes to the Interim Financial Statements

Operating Segment Reporting

9. Segment information is presented in respect of the Group's operating segments based on the Group´s management and internal reporting structure. Segment performance is evaluated based on earnings before tax.

   Inter segment pricing is determined on an arm's length basis. Business segments pay and receive interest to and from Treasury on an arm's length basis to reflect the allocation of capital and funding cost.

   Segment capital expenditure is the total cost incurred during the period to acquire property and equipment and intangible assets.

   Operating segments

   The Group comprises six main operating segments:

   Corporate Banking serves large enterprises and professional investors. The role of the division is to provide universal financial services as well as tailored services to meet the needs of each customer. *Corporate Banking* is divided into a *Corporate Banking* unit, *Factoring* services and a *Corporate Recovery* unit. *Corporate Banking* and *Factoring* together provide a wide range of credit solutions while the *Recovery* unit is responsible for the financial restructuring of companies which need to reorganise their capital structure.

   Retail Banking, Arion Bank Mortgages Institutional Investor Fund (ABMIIF), AFL sparisjódur and Sparisjódur Ólafsfjardar provide a comprehensive range of services, including advice on deposits and loans, savings, payment cards, pension savings, insurance, securities, funds and more. To maximize operational efficiency the branch network is divided into seven clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Customers of Retail Banking's 24 branches all around Iceland are over 100,000.

   Asset Management and Stefnir hf. manage assets on behalf of its clients, who include institutional investors, corporations, high net wealth clients and retail investors. The entities offer clients variety of mutual funds, alternative vehicles, pension plan schemes and customized asset allocation strategies designed to meet the diverse needs of investors. The subsidiary Stefnir operates the fund management business.

   Investment Banking is divided into Corporate Finance, Capital Markets and Research. *Corporate Finance* provides M&A advisory services and capital markets transaction services to corporate clients and investors. *Capital Markets* provides securities brokerage and FX sales for institutional investors and corporate clients. *Research* is split into Equity, Fixed Income and Macro Analysis with clients such as asset management companies, institutional investors, and other divisions of the Group.

   Treasury is responsible for the Bank's liquidity management as well as currency and interest rate management. The other main functions of Treasury are the internal pricing of interest rates and currency, liaison with other financial institutions, Proprietary trading and market making in domestic securities and currencies.

   Other Divisions and Subsidiaries include Proprietary trading and the subsidiaries Eignabjarg ehf., Landey ehf., Landfestar ehf., Okkar líftryggingar hf., Valitor holding hf. and other smaller entities of the Group.

   Headquarters: Overhead, Risk Management, Finance, Legal, Operations, Corporate Development and activities of other non-core entities.

Notes to the Interim Financial Statements

10. Summary of the Group's business segments:

1.1.-30.6.2012	Corporate Banking	Retail Banking	Asset Managem. and Stefnir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Headquart. and Elimination	Total
Net interest income	5,493	5,083	1,031	100	3,132	(908)	(51)	13,880
Other income	2,808	(581)	1,087	3,313	(90)	4,358	162	11,057
Operating income	8,301	4,502	2,118	3,413	3,042	3,450	111	24,937
Operating expense	(314)	(2,768)	(561)	(293)	(90)	(2,610)	(5,008)	(11,644)
Allocated cost	(956)	(2,301)	(393)	(311)	(366)	(86)	4,413	-
Earnings before tax	7,031	(567)	1,164	2,809	2,586	754	(484)	13,293
Net seg. rev. from ext. cust.	13,455	11,068	(414)	3,477	(7,708)	4,352	707	24,937
Net seg. rev. from oth. seg.	(5,154)	(6,566)	2,532	(64)	10,750	(902)	(596)	-
Operating income	8,301	4,502	2,118	3,413	3,042	3,450	111	24,937
Depreciation and amortisation	-	84	-	-	-	109	270	463
Total assets 30.06.2012	269,326	314,155	3,603	19,709	180,141	93,116	-	880,050
Allocated equity 30.06.2012	43,092	24,557	2,598	3,153	41,072	10,671	-	125,143

1.1.-30.6.2011	Corporate Banking	Retail Banking	Asset Managem. and Stefnir	Investment Banking	Treasury	Other Divisions and Subsidiaries	Headquart. and Elimination	Total
Net interest income	6,159	6,310	674	(4)	(414)	(1,478)	(87)	11,160
Other income	8,720	(1,120)	1,221	1,033	(1,539)	5,498	(481)	13,332
Operating income	14,879	5,190	1,895	1,029	(1,953)	4,020	(568)	24,492
Operating expense	(226)	(2,715)	(491)	(335)	(95)	(2,622)	(4,285)	(10,769)
Allocated cost	(782)	(2,208)	(417)	(111)	(338)	(129)	3,985	-
Earnings before tax	13,871	267	987	583	(2,386)	1,269	(868)	13,723
Net seg. rev. from ext. cust.	15,054	2,875	98	1,016	(1,724)	5,578	1,595	24,492
Net seg. rev. from oth. seg.	(175)	2,315	1,797	13	(229)	(1,558)	(2,163)	-
Operating income	14,879	5,190	1,895	1,029	(1,953)	4,020	(568)	24,492
Depreciation and amortisation	-	80	-	-	-	103	247	430
Total assets 31.12.2011	271,208	299,207	3,621	16,477	207,099	94,509	-	892,121
Allocated equity 31.12.2011	43,297	32,580	2,673	1,269	18,062	16,677	-	114,558

The vast majority of the revenues from external customers is attributable to customers in Iceland.

Discontinued operations are excluded from the segmental information.

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Notes to the Interim Financial Statements

Quarterly Statements

11. Operations by quarters:

2012	Q2[1]	Q1[1]	Total
Net interest income	7,666	6,214	13,880
Increase in value of loans and receivables	7,049	119	7,168
Impairment on loans and receivables	(4,441)	(195)	(4,636)
Net fee and commission income	3,002	2,336	5,338
Net financial income (expense)	(16)	346	330
Net foreign exchange (loss) gain	(1,232)	1,083	(149)
Other operating income	2,054	952	3,006
Operating income	14,082	10,855	24,937
Administration expense	(5,619)	(5,605)	(11,224)
Other operating expense	(223)	(197)	(420)
Earnings before tax	8,240	5,053	13,293
Income tax expense	(1,852)	(1,061)	(2,913)
Bank Levy	(242)	(268)	(510)
Net earnings from continuing operations	6,146	3,724	9,870
Net gain (loss) from discontinued operations net of tax	652	727	1,379
Net earnings	6,798	4,451	11,249

2011			
Net interest income	5,274	5,886	11,160
Increase in value of loans and receivables	27,281	2,057	29,338
Impairment on loans and receivables	(6,241)	440	(5,801)
Changes in compensation instrument	(16,683)	(2,910)	(19,593)
Net fee and commission income	2,607	2,492	5,099
Net financial income (expense)	(767)	729	(38)
Net foreign exchange (loss) gain	2,289	(312)	1,977
Other operating income	1,251	1,099	2,350
Operating income	15,011	9,481	24,492
Administration expense	(5,316)	(4,955)	(10,271)
Other operating expense	(332)	(166)	(498)
Earnings before tax	9,363	4,360	13,723
Income tax expense	(1,472)	(1,045)	(2,517)
Bank Levy	(379)	(67)	(446)
Net earnings from continuing operations	7,512	3,248	10,760
Net gain (loss) from discontinued operations net of tax	(286)	(282)	(568)
Net earnings	7,226	2,966	10,192

1. The Q1 and Q2 results and split between quarters were not audited or reviewed.

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Notes to the Interim Financial Statements

Notes to the Interim Statement of Comprehensive Income

Net interest income

12. Interest income and expense is specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Cash and balances with Central Bank	301	247	130	143
Loans and receivables	27,478	19,137	14,594	10,241
Securities	4,164	3,799	2,017	1,880
Compensation instrument	-	322	-	149
Other	210	115	114	90
Interest income	32,153	23,620	16,855	12,503
Deposits	9,621	10,155	4,686	5,864
Borrowings	7,751	1,315	4,105	713
Subordinated loans	811	971	381	642
Other	90	19	17	10
Interest expense	18,273	12,460	9,189	7,229
Net interest income	13,880	11,160	7,666	5,274
Interest income from assets and liabilities at fair value	4,164	4,121	2,017	2,202
Interest income from assets and liabilities not at fair value through profit or loss	27,989	19,499	14,838	10,301
Interest expense from assets and liabilities not at fair value through profit or loss	(18,273)	(12,460)	(9,189)	(7,229)
Net interest income	13,880	11,160	7,666	5,274

Increase in book value of loans and receivables

13. The increase in book value of loans and receivables is determined in accordance with the accounting policy presented in the annual Financial Statements 2011. Increase in book value of loans and receivables consists of adjustment to reflect actual and estimated cash flows.

Impairment of loans and receivables

14. Impairment of loans and receivables is specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Impairment of loans and receivables to credit institutions	(2)	(448)	(31)	(769)
Impairment of loans and receivables to customers	4,638	6,249	4,472	7,010
Impairment of loans and receivables	4,636	5,801	4,441	6,241

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Notes to the Interim Financial Statements

Net fee and commission income

15. Fee and commission income and expense is specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Fee and commission income				
Asset management	1,214	1,248	691	645
Cards	4,477	5,075	2,232	2,529
Collection and payment services	494	568	198	287
Derivatives	90	91	37	49
Interbank clearing	349	339	174	175
Lending and guarantees	452	326	264	214
Security trading	87	98	35	50
Other fee and commission income	805	634	531	306
Fee and commission income	7,968	8,379	4,162	4,255
Fee and commission expense				
Asset management	37	55	18	27
Cards	1,910	2,643	846	1,308
Collection and payment services	9	14	4	11
Interbank clearing	360	354	180	182
Security trading	109	96	48	47
Other fee and commission expense	205	118	64	73
Fee and commission expense	2,630	3,280	1,160	1,648
Net fee and commission income	5,338	5,099	3,002	2,607

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

Net financial income

16. Net financial income is specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Dividend income	21	6	19	3
Net gain (loss) on financial assets and liabilities classified as held for trading	(307)	(393)	(254)	(205)
Net gain (loss) on financial assets and liabilities designated at fair value through profit or loss	616	349	219	(565)
Net financial income	330	(38)	(16)	(767)

17. Dividend income is specified as follows:

Dividend income on trading assets	15	4	13	3
Dividend income on financial assets designated at fair value through profit or loss	6	2	6	0
Dividend income	21	6	19	3

18. Net gain (loss) on trading assets and liabilities is specified as follows:

Net gain (loss) on equity instruments and related derivatives	86	107	(12)	101
Net gain (loss) on interest rate instruments and related derivatives	(454)	(554)	(177)	(397)
Net gain (loss) on other derivatives	61	54	(65)	91
Net gain (loss) on trading portfolio	(307)	(393)	(254)	(205)

Arion Bank Interim Financial Statements 30 June 2012 18 Amounts are in ISK millions

Notes to the Interim Financial Statements

19. Net gain (loss) on assets/liabilities designated at fair value through profit or loss is specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Net gain (loss) on interest rate instruments designated at fair value	373	(264)	(30)	(354)
Net gain (loss) on equity instruments designated at fair value	243	613	249	(211)
Net gain (loss) on assets/liabilities designated at fair value through profit and loss	616	349	219	(565)

Net foreign exchange gain (loss)

20. Net foreign exchange gain (loss) is specified as follows:

FX gain (loss) of loans and receivables	324	6,913	(5,132)	4,525
FX gain (loss) on bank accounts	879	1,881	(1,468)	(186)
FX gain (loss) from deposits and borrowings	(1,359)	(5,575)	4,349	(1,847)
FX gain (loss) from subordinated liabilities	(65)	(1,823)	1,876	(486)
FX gain (loss) on bonds, equity and derivatives	113	103	(676)	66
FX gain (loss) from compensation instrument	-	325	-	219
FX gain (loss) on other assets and liabilities	(41)	153	(181)	(2)
Net foreign exchange gain (loss)	(149)	1,977	(1,232)	2,289

Other operating income

21. Other operating income is specified as follows:

Rental income from investment properties	1,004	1,129	516	587
Fair value changes on investment property	719	-	686	-
Realised gain on investment property	97	-	80	-
Earned premiums, net of reinsurance	421	427	207	225
Net gain (loss) on disposals of assets other than held for sale	385	(5)	367	(9)
Other income	373	800	196	432
Other operating income	2,999	2,351	2,052	1,235

Personnel and salaries

22. The Group's total number of employees is as follows:

Average number of full time equivalent positions during the period	1,159	1,202	1,161	1,212
Full time equivalent positions at the end of the period	1,173	1,203	1,173	1,203

The Parent company's total number of employees is as follow:

Average number of full time equivalent positions during the period	912	911	914	910
Full time equivalent positions at the end of the period	920	899	920	899

Former employees of Verdis are included in parent numbers for 2012

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Notes to the Interim Financial Statements

23. Salaries and related expense are specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Salaries	4,710	4,442	2,361	2,299
Defined contribution pension plans	645	600	322	311
Salary related expense	814	474	441	248
Salaries and related expense	6,169	5,516	3,124	2,858

Salaries and related expense for the Parent company are specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Salaries	3,643	3,286	1,823	1,723
Defined contribution pension plans	499	444	250	233
Salary related expense	652	358	341	190
Salaries and related expense	4,794	4,088	2,415	2,146

Former employees of Verdis are included in parent numbers for 2012

Other operating expense

24. Other operating expense:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Direct operating expense (including repairs and maintenance) arising on rental-earning investment properties	247	253	132	158
Claims incurred, net of reinsurance	173	211	91	140
Other operating expense	-	34	-	34
Other operating expense	420	498	223	332

Tax expense

25. Income tax recognised in the Statement of Comprehensive Income is specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Current tax expense				
Current period	2,996	1,916	2,164	886
Deferred tax expense				
Changes in temporary differences	(83)	601	(312)	586
Total income tax expense	2,913	2,517	1,852	1,472

Reconciliation of effective tax rate:

	1.1.-30.6.2012		1.1.-30.6.2011	
Earnings before income tax		13,293		13,723
Income tax using the Icelandic corporation tax rate	20.0%	2,658	20.0%	2,744
Additional 6% tax on financial institutions	5.2%	696	0.0%	-
Non-deductible expense	0.1%	14	0.1%	8
Tax exempt revenues	(0.6%)	(78)	(1.0%)	(126)
Tax incentives not recognised in the Income Statement	(2.7%)	(365)	0.0%	-
Non-deductible taxes	0.7%	98	(0.8%)	(109)
Other changes	(0.8%)	(110)	0.0%	-
Effective tax rate	21.9%	2,913	18.3%	2,517

26. Bank Levy

Bank levy is calculated according to law. The levy is 0.1285% on total debt excluding tax liabilities at end of period. Non-financial subsidiaries are exempt from this tax.

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Notes to the Interim Financial Statements

Net gain (loss) from discontinued operations net of tax

27. Net gain (loss) from discontinued operations net of tax is specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.4.-30.6.	2011 1.4.-30.6.
Net gain (loss) from legal entities	900	560	97	435
Net gain (loss) from associated companies	868	-	868	-
Net gain (loss) from other assets	(303)	(115)	(270)	7
Net gain (loss) on revaluation and disposal of real estate	(86)	(248)	(43)	(235)
Impairment loss on remeasurement to fair value of legal entities	-	(2,027)	-	(805)
Effect of compensation instrument	-	1,262	-	312
Net gain (loss) from discontinued operations net of tax	1,379	(568)	652	(286)

Net gain (loss) from legal entities comprises the Group's share of net profit after tax from operations of legal entities that were classified as held for sale during the period.

Earnings per share

28. Earnings per share are specified as follows:

	Excluding		Including	
	Discontinued operations			
	2012 1.1.-30.6.	2011 1.1.-30.6.	2012 1.1.-30.6.	2011 1.1.-30.6.
Net earnings attributable to the shareholders of Arion Bank	9,673	10,393	11,052	9,825
Weighted average share capital:				
Weighted average number of outstanding shares for the period, million	2,000	2,000	2,000	2,000
Basic earnings per share	4.84	5.20	5.53	4.91
Diluted earnings per share	4.84	5.20	5.53	4.91
Number of outstanding shares at the end of the period, million	2,000	2,000	2,000	2,000
Number of total shares at the end of the period, million, diluted	2,000	2,000	2,000	2,000

There were no instruments at period-end that could potentially dilute basic earnings per share.

Notes to the Interim Statement of Financial Position

Cash and balances with Central Bank

29. Cash and balances with Central Bank are specified as follows:

	30.06.2012	31.12.2011
Cash on hand	3,975	2,954
Cash with Central Bank	4,710	17,686
Mandatory reserve deposit with Central Bank	7,595	8,560
Cash and balances with Central Bank	16,280	29,200

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

Loans and receivables to credit institutions

30. Loans and receivables to credit institutions specified by types of loans:

Bank accounts	67,951	62,175
Money market loans	822	4,720
Overdrafts	8	19
Other loans	3,760	2,963
Provision on loans and receivables	(772)	(774)
Loans and receivables to credit institutions	71,769	69,103

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Notes to the Interim Financial Statements

31. Changes in the provision for losses on loans and receivables to credit institutions are specified as follows:

	30.06.2012	31.12.2011
Balance at the beginning of the period	774	1,359
Provision for losses during the period	(2)	199
Write-offs during the period	-	(784)
Balance at the end of the period	772	774

Loans and receivables to customers

32. Loans and receivables to customers specified by types of loans:

Overdrafts	44,453	43,178
Subordinated loans	544	550
Other loans and receivables	591,041	574,111
Provision on loans and receivables	(57,152)	(56,289)
Loans and receivables to customers	578,886	561,550

The total book value of pledged loans at 30 June 2012 was ISK 172 billion (31.12.2011: ISK 171 billion). Pledged loans at period-end comprised mortgage loans to individuals, loans to municipals and loans to state related entities that were pledged against amounts borrowed.

33. Changes in the provision for losses on loans and receivables to customers are specified as follows:

	30.06.2012	31.12.2011
Balance at the beginning of the period	56,289	41,843
Provision for losses during the period	4,638	27,225
Write-offs during the period	(3,966)	(13,230)
Payment of loans previously written off	191	451
Balance at the end of the period	57,152	56,289
Specific	51,975	46,776
Collective	5,177	9,513
	57,152	56,289

Information about the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in Note 56 c).

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Notes to the Interim Financial Statements

Financial assets and liabilities

34. Financial assets and liabilities are specified as follows:

30.06.2012	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
Cash and balances with Central Bank	16,280	-	-	-	16,280
Loans and receivables to credit institutions	71,769	-	-	-	71,769
Loans and receivables to customers	578,886	-	-	-	578,886
Loans and receivables	666,935	-	-	-	666,935
Bonds and debt instruments					
Listed	-	5,070	53,170	-	58,240
Unlisted	-	62	70,551	-	70,613
Bonds and debt instruments	-	5,132	123,721	-	128,853
Shares and equity instruments with variable income					
Listed	-	1,643	1,340	-	2,983
Unlisted	-	714	8,000	-	8,714
Bond funds with variable income	-	1,976	1,735	-	3,711
Shares and equity instruments	-	4,333	11,075	-	15,408
Derivatives					
OTC derivatives	-	1,363	-	-	1,363
Derivatives	-	1,363	-	-	1,363
Securities used for hedging					
Bonds and debt instruments	-	418	-	-	418
Shares and equity instruments	-	1,098	-	-	1,098
Securities used for hedging	-	1,516	-	-	1,516
Other financial assets	-	-	-	5,440	5,440
Financial assets	666,935	12,344	134,796	5,440	819,515
Liabilities at amortised cost					
Due to credit institutions and Central Bank	-	-	-	20,837	20,837
Deposits	-	-	-	445,249	445,249
Borrowings	-	-	-	192,953	192,953
Subordinated liabilities	-	-	-	32,175	32,175
Liabilities at amortised cost	-	-	-	691,214	691,214
Financial liabilities at fair value					
Short position in bonds held for trading	-	10,008	-	-	10,008
Derivatives	-	431	-	-	431
Financial liabilities at fair value	-	10,439	-	-	10,439
Other financial liabilities	-	-	-	39,230	39,230
Financial liabilities	-	10,439	-	730,444	740,883

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Notes to the Interim Financial Statements

34. cont.

31.12.2011	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
Cash and balances with Central Bank	29,200	-	-	-	29,200
Loans and receivables to credit institutions	69,103	-	-	-	69,103
Loans and receivables to customers	561,550	-	-	-	561,550
Loans and receivables	659,853	-	-	-	659,853
Bonds and debt instruments					
Listed	-	2,919	52,688	-	55,607
Unlisted	-	44	84,917	-	84,961
Bonds and debt instruments	-	2,963	137,605	-	140,568
Shares and equity instruments with variable income					
Listed	-	153	1,163	-	1,316
Unlisted	-	657	8,382	-	9,039
Bond funds with variable income	-	1,774	1,916	-	3,690
Shares and equity instruments	-	2,584	11,461	-	14,045
Derivatives					
OTC derivatives	-	674	-	-	674
Derivatives	-	674	-	-	674
Securities used for hedging					
Bonds and debt instruments	-	1,922	-	-	1,922
Shares and equity instruments	-	450	-	-	450
Securities used for hedging	-	2,372	-	-	2,372
Other financial assets	-	-	-	8,004	8,004
Financial assets	659,853	8,593	149,066	8,004	825,516
Liabilities at amortised cost					
Due to credit institutions and Central Bank	-	-	-	16,160	16,160
Deposits	-	-	-	489,995	489,995
Borrowings	-	-	-	187,203	187,203
Subordinated liabilities	-	-	-	32,105	32,105
Liabilities at amortised cost	-	-	-	725,463	725,463
Financial liabilities at fair value					
Short position in bonds held for trading	-	3,711	-	-	3,711
Derivatives held for trading	-	1,196	-	-	1,196
Financial liabilities at fair value	-	4,907	-	-	4,907
Other financial liabilities	-	-	-	33,764	33,764
Financial liabilities	-	4,907	-	759,227	764,134

Included in unlisted Bonds and debt instruments designated at fair value is Drómi bond, which the Group received when acquiring deposits from SPRON in March 2009.

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35. Bonds and debt instruments designated at fair value specified by issuer:

	30.06.2012	31.12.2011
Financial institutions	68,981	70,640
Public	46,317	59,368
Corporates	8,423	7,597
Bonds and debt instruments designated at fair value	123,721	137,605

The total amount of pledged bonds at 30 June 2012 was ISK 21.3 billion (31.12.2011: Nil).

36. Fair value hierarchy

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

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

The following table shows an analysis of financial instruments recorded at fair value by level of the fair value hierarchy:

30.06.2012	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL	6,130	126,844	1,822	134,796
Financial assets held for trading	8,218	4,104	22	12,344
	14,348	130,948	1,844	147,140
Financial liabilities held for trading	10,008	431	-	10,439
31.12.2011				
Financial assets designated at FV through PL	6,222	140,844	2,000	149,066
Financial assets held for trading	5,391	3,181	21	8,593
	11,613	144,025	2,021	157,659
Financial liabilities held for trading	3,711	1,196	-	4,907

The classification of assets between financial assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2012 is consistent with the classification used in 2012

The following table shows transfers between Level 1 and level 2 on the fair value hierachy for financial assets and financial liabilities which are recorded at fair value:

	Transfers from Level 1 to Level 2	
Financial assets	30.06.2012	31.12.2011
Financial assets designated at FV through PL	0	886

The above financial assets were transferred from Level 1 to Level 2 as they have ceased to be actively traded during the period and fair values were consequently obtained using valuation techniques using observable market inputs. There have been no transfers from Level 2 to Level 1 during the period.

Movements in Level 3 financial instruments measured at fair value

The level of the fair value hierarchy of financial instruments is determined at the beginning of each reporting period. The following table shows a reconciliation of the opening and closing amounts of Level 3 financial assets and liabilities which are recorded at fair value.

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36. cont.

The following table shows the movements of Level 3 financial assets and liabilities (excluding the Compensation Instrument):

	30.06.2012	31.12.2011
Balance at the beginning of the period	2,021	1,688
Gain (loss) recognised in Statement of Comprehensive Income	114	771
Acquisition	88	160
Disposal	(388)	(599)
Transfer into Level 3	9	1
Balance at the end of the period	1,844	2,021

The following table shows the line items in the Statement of Comprehensive Income where gains (losses) related to fair value measurements in Level 3 are recognised:

	30.06.2012	31.12.2011
Net interest income	88	176
Net financial income (expense)	(1)	520
Net foreign exchange gain (loss)	27	75
Gain (loss) recognised in the Statement of Comprehensive Income	114	771

Compensation instrument

37. The compensation instrument was originated due to the difference in the fair value of the transferred assets, liabilities and contingent liabilities from Kaupthing hf. to Arion Bank in 2008. On 30 June 2011 a Settlement and release of claims agreement was signed by Arion Bank and Kaupthing hf. to finalize a settlement of the Compensation Instrument and various other claims lodged against Kaupthing hf. by Arion Bank. By signing the agreement the Compensation Instrument was terminated and neither party has any payment obligations towards the other under the Instrument. For further information regarding the Compensation instrument see Arion Banks' annual Financial Statements for the year 2011.

Compensation instrument is specified as follows:	31.12.2011
Balance 1 January 2011	24,188
Changes due to the Escrow and Contingent Value Rights Agreement	
Continuing operations	(19,593)
Discontinued operations	1,578
Accrued interest	322
Foreign exchange rate differences	325
Assets and liabilities upon settlement	(6,820)
Balance 31 December 2011	-

Investment property

38. Investment property is specified as follows:	Investment property	Investment property in progress	Total 30.06.2012	Total 31.12.2011
Balance at the beginning of the period	21,949	5,151	27,100	27,642
Additions during the period	70	2,252	2,322	3,527
Disposals during the period	-	(1,762)	(1,762)	(5,760)
Transferred from property and equipment	-	-	-	775
Fair value adjustments	34	685	719	916
Investment property	22,053	6,326	28,379	27,100

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Notes to the Interim Financial Statements

Investments in associates

39. The Group´s interest in its principal associates are as follows:

	30.06.2012	31.12.2011
Audkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20.0%	20.0%
Bakkavör Group ehf., Thorvaldsenstræti 6, 101 Reykjavík, Iceland	31.3%	-
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	43.5%	43.5%
GO fjárfesting ehf., Undirheimar, 845 Flúdir, Iceland	30.0%	30.0%
Hótel Borgarnes hf., Egilsgata 16, 310 Borgarnes, Iceland	-	20.6%
Klakki ehf., Ármúli 3, 108 Reykjavík, Iceland	36.3%	44.9%
Kríuvarp ehf., Borgartún 35, 105 Reykjavík, Iceland	25.0%	25.0%
Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland	23.3%	23.3%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42.7%	42.7%
Sementsverksmidjan ehf., Mánabraut 20, 300 Akranes, Iceland	23.6%	23.6%
SMI ehf., Smáratorg 3, 210 Kópavogur, Iceland	39.1%	39.1%
Ölgerdin Egill Skallagrímsson ehf., Grjótháls 7-11, 110 Reykjavík, Iceland	-	20.0%

Investments in associates are specified as follows:

Carrying amount at the beginning of the period	2,987	2,713
Additions during the period	26	2,854
Transferred to held for sale assets	-	(2,525)
Transferred from associates due to step acquisition	-	(9)
Impairment	-	(54)
Share of profit (loss)	7	8
Carrying amount at the end of the period	3,020	2,987

In May 2012 the Bank acquired 31.3% share in Bakkavör Group ehf. as a result of the conversion of the Bank´s convertible loans to equity.

In March the Bank sold its 20.6% shareholding in Hótel Borgarnes hf. The effects from the sale has minor effects on the Statement of Comprehensive Income. In June the Bank sold its 20% shareholding in Ölgerdin Egill Skallagrímsson ehf. The profit from the sale is ISK 375 million and is recognized in the Statement of Comprehensive Income.

The Group's equity interest in Klakki ehf. has been diluted from 44.9% to 36.3% following the conversion of further creditor claims on Klakki ehf. to equity shareholdings.

Tax assets and tax liabilities

40. Tax assets and liabilities are specified as follows:

	30.06.2012		31.12.2011	
	Assets	Liabilities	Assets	Liabilities
Current tax	13	2,992	6	2,284
Deferred tax	535	1,036	718	1,137
Tax assets and liabilities	548	4,028	724	3,421

Non-current assets and disposal groups held for sale

41. Non-current assets and disposal groups held for sale are specified as follows:

	30.06.2012	31.12.2011
Legal entities	6,810	8,458
Associates	6,023	12,073
Real estates	2,740	2,875
Other assets	730	480
Non-current assets and disposal groups held for sale	16,303	23,886

The legal entities are subsidiaries that were acquired exclusively with view to resale and are classified as disposal groups held for sale in accordance with IFRS 5. At period-end the largest entities are Fram Foods ehf. and Penninn á Íslandi ehf. Both are held by the Group's holding company Eignabjarg ehf.

Arion Bank Interim Financial Statements 30 June 2012 27 Amounts are in ISK millions

41. cont.

On 28 September 2011 an agreement to sell the Groups 38.9% shareholding in its associate N1 hf. was signed. A condition precedent for the sale was approval by the Icelandic Competition Authority. Approval was obtained in June 2012. The gain resulting from this transaction was ISK 868 million and is recognized in the Statement of Comprehensive Income.

On 4 October 2011 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in B.M. Vallá ehf. A condition precedent for the sale was approval by the Icelandic Competition Authority, which was obtained in April 2012. The effects from the sale of this entity has minor effects on the Statement of Comprehensive Income.

On 15 June 2012 Eignabjarg ehf. signed an agreement for the sale of its 100% shareholding in Penninn á Íslandi ehf. A condition precedent for the sale is approval by the Icelandic Competition Authority, which was pending at period-end. The effects from the sale of this entity will have minor effects on the Statement of Comprehensive Income.

The associate classified as disposal groups held for sale in accordance with IFRS 5 is HB Grandi hf.

At end of 2011 the Group held 20.9% effective share in Hagar hf. During the period the Group sold 15.7% effective share in Hagar hf. The gain resulting from this transaction was ISK 875 million and is recognized in the Statement of Comprehensive Income.

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

Liabilities associated with the legal entities held for sale are as follows:	30.06.2012	31.12.2011
Legal entities, total liabilities	4,174	4,950

Other assets

42. Other assets are specified as follows:

	30.06.2012	31.12.2011
Unsettled securities trading	1,135	708
Accounts receivable	2,805	6,511
Accrued income	654	455
Prepaid expenses	839	678
Sundry assets	1,052	524
Other assets	6,485	8,876

Unsettled securities trading was settled in less than three days from the reporting date.

Other liabilities

43. Other liabilities are specified as follows:

	30.06.2012	31.12.2011
Accounts payable	20,392	18,944
Kaupthing hf. due to investment in ABMIIF	-	3,048
Withholding tax	487	2,186
Depositors' and investors' guarantee fund	3,126	3,018
Insurance claim	2,120	2,023
Unsettled securities and loans	3,539	132
Sundry liabilities	15,388	9,471
Other liabilities	45,052	38,822

Unsettled securities and loans was settled in less than three days from the reporting date.

Arion Bank Interim Financial Statements 30 June 2012 28 Amounts are in ISK millions

Notes to the Interim Financial Statements

Borrowings

44. Borrowings are specified as follows:

	30.06.2012	31.12.2011
Bonds issued	131,087	124,524
Other loans	61,866	62,679
Borrowings	192,953	187,203

The Group did not repurchase any own debts during the first six months of 2012 (31.12.2011: 442 million).

At the end of 2011 Arion Bank took over the issuance of covered bonds which had originally been issued by Kaupthing hf. in 2006 to 2008. The bonds in question are covered bonds amounting to ISK 119.8 billion, net outstanding, with security in mortgages and bank deposits in an institutional investment fund, Arion Bank Mortgages Institutional Investor Fund. It is a four-series issue, with two 25-year series and two 40-year series maturing in 2031, 2033, 2045 and 2048. The bonds are inflation-indexed with fixed 3.75% to 4.00% interest. Current repayment of principal is currently approximately 1.5 billion a year, currently total payment including repayment of principal, indexation and interest is 7.4 billion a year.

In February 2012 Arion Bank issued covered bonds from its EUR 1.0 billion covered bond programme. The bond issue is nominated in Icelandic króna, the amount issued was ISK 2.5 billion. The covered bond issue matures in February 2034 and is inflation indexed with a fixed 3.60% interest.

In May 2012 Arion Bank completed its first non-indexed fixed rate covered bond offering, issuing ISK 1.32 billion worth of bonds in the Series Arion CB15. In June 2012 Arion Bank completed its second offering, issuing ISK 1.2 billion worth of bonds in the same series. The series was admitted for trading on NASDAQ OMX Iceland on 21 May 2012. The bonds bear 6.50% interest and mature in 2015.

Book value of listed bonds is ISK 5,142 million at end of June 2012. Market value of those bonds is ISK 5,193 million.

Interest of other loans is 3 month Euribor/Libor +300 bps until the loans expires in 2016. The loan can be extended up to 2022 with same terms.

Subordinated liabilities

45. Subordinated liabilities are specified as follows:

	30.06.2012	31.12.2011
Tier II capital	32,175	32,105
Subordinated liabilities	32,175	32,105

The interest on the loan is 3 month Euribor/Libor +400 bps to the year 2015 and thereafter 3 month Euribor/Libor +500 bps.

Derivatives

46. Derivatives at fair value are specified as follows:

	Fair value	
30.06.2012	Assets	Liabilities
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	322	18
Interest rate and exchange rate agreements	588	338
	910	356
Bond derivatives:		
Bond swaps, agreements unlisted	69	75
Options - sold agreements	384	-
Derivatives	1,363	431
31.12.2011		
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	193	671
Interest rate and exchange rate agreements	463	415
	656	1,086
Bond derivatives:		
Bond swaps, agreements unlisted	18	110
Derivatives	674	1,196

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Notes to the Interim Financial Statements

Equity

Share capital and share premium

47. According to the Parent Company's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at Shareholders' meetings of the Group.

	Number (million)	30.06.2012	Number (million)	31.12.2011
Issued share capital	2,000	75,861	2,000	75,861
	2,000	75,861	2,000	75,861

Share premium represents excess of payment above nominal value that Shareholders have paid for shares sold by the Group.

Other reserves

48. Other reserves are specified as follows:

	30.06.2012	31.12.2011
Statutory reserve	1,637	1,637
	1,637	1,637

Off Balance Sheet information

Obligations

49. The Group has granted its customers guarantees, unused overdraft and loan commitments. These items are specified as follows:

	30.06.2012	31.12.2011
Guarantees	11,847	8,662
Unused overdrafts	35,019	34,258
Loan commitments	30,412	17,687

50. Depositors' and Investors' Guarantee fund

The Group expensed ISK 445 million in the first six months of 2012 to meet payments requirements to the Depositors´ and Investors´Guarantee fund according to act no 98/1999 as amended in 2012.

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. Due to uncertainty of the shape of future legislation the liability brought forward from previous year is not changed from the balance of ISK 2,669 million. The group has granted the Fund a guarantee for obligations amounting to ISK 3,187 million.

Assets under management and under custody

51. Assets under management and assets under custody are specified as follows:

	30.06.2012	31.12.2011
Assets under management	748,951	659,024
Assets under custody	1,536,624	1,716,230

Contingent liabilities

52. Following the financial crisis of 2008 the prospect of possible litigation against the Group became more likely. The Group has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Group makes adjustments to account for any adverse effects which the claims may have on its financial standing. At period-end, the Group had several unresolved legal claims.

Legal proceed regarding Drómi

One significant court case is a case between Drómi and the Group. Following a decision issued by the Icelandic Financial Supervisory Authority (FME) on 21 March 2009, the Group acquired the deposits of SPRON. According to the decision the resolution committee of SPRON is supposed to establish a specific limited liability company owned by SPRON, later Drómi, designed to receive all the assets of the savings banks and all security interests, including all liens, guarantees and other comparable interests linked to SPRON's claims. The subsidiary was then supposed to take over all SPRON's obligations to the Group relating to the acquisition of SPRON's deposit obligations and was supposed to issue a bond to the Group as compensation for the deposit obligations. This obligation to the Group was documented with an agreement on repaying the debt. The agreement states that the interest rate on the debt principal shall be determined by the FME at any given time. The FME decided that the debt should bear a given annual interest rate plus an interest premium from that time until the debt has been paid in full. It was also specified that the FME was permitted to review the decision upon request by the parties every six months. In a letter dated 2 December 2009 Drómi insisted that the FME review its former interest rate decision. On 4 February 2011 the FME decided that the debt should bear an annual interest rate which should be the original given interest rate plus the original given interest premium from the takeover date until 30 June 2010, but without an interest premium from that time until the debt has been paid in full. The Group has brought legal action against the FME and Drómi in an attempt to annul the FME's decision of 4 February 2011. On 4 May 2011 Drómi brought legal action against the FME and the Group. Drómi principally demands the annulment of all decisions by the FME on interest rates, and secondly demands a different interest rate from the outset. On 23 April 2012 the District Court of Reykjavík dismissed both of these cases. On 4 May 2012 the Group and Drómi appealed these decisions to the Supreme Court. On 6 June 2012, the Supreme Court issued a judgment in the case of Arion Bank v. Drómi, where the district court's decision to dismiss the case was disqualified and the case was readmitted to the district court. In another Supreme Court judgment from the same date in the case of Drómi v. Arion Bank, the district court's verdict of dismissal was, however, upheld in its entirety, with the exception of one part of Drómi´s main claim, which was readmitted to the district court. The cases are scheduled to be heard at district court in October 2012. The Bank has not recognized provisions in these Interim Financial Statements in relation to legal proceed regarding Drómi.

Claims from Private Banking clients

The Group has made agreements with clients of Private Banking to buy their approved claims against the estate of Kaupthing Bank. The claims relate to claims for damages by clients made against the estate of Kaupthing Bank. These claims were initially rejected but Kaupthing Bank has since offered these parties a settlement. The claims involved are general claims against the Kaupthing Bank estate and as a compromise to the clients, the Group has acquired the claims at 30% of the claim value and paid them immediately instead of making the clients wait until the estate has been wound up. ISK 90 million of claims have already been acquired and it is likely that a similar amount will be paid for claims which will probably be agreed to by Kaupthing Bank. There is still uncertainty over the recovery of these claims from Kaupthing Bank when the company is wound up or makes composition with creditors.

Legal proceeds regarding foreign exchange loans

There are also a number of court cases, to which the Group is a party, whereby the legality of the Group's FX loans are called into question. In some of the cases, the interest rate which is used in the recalculation of said loans is called into question, and also if the Group is obligated to reimburse borrowers because of foreign currency linked loans which the borrower had repaid in full before the Group was founded in October 2008. If the courts side with the borrowers in the said cases, and for example, state that the Group is obligated to reimburse borrowers which had repaid before the Group was founded, the impact on the Bank's loan portfolio would be significant.

On 21 March 2012 Hagar hf. announced that it had decided to take legal action against the Group regarding Hagar hf.'s foreign currency linked loans, which it had reimbursed in full to the Group in 2009. Hagar hf.'s foreign currency linked loans were recalculated by the Group in accordance with the Group's notification of 15 June 2011. The outcome from the recalculation showed that the Group owed Hagar hf. approximately ISK 515 million, which the Group subsequently paid to Hagar hf. After the Supreme Court had passed its judgment of 15 February 2012, Hagar hf. expressed its view to the Group that, in light of the above judgment, Hagar hf. believed it had a further claim, amounting to ISK 824 million, against the Group regarding said foreign currency linked loans. The Group rejected Hagar hf.'s claim. In an announcement to the Stock Exchange on 21 March 2012, Hagar hf. announced that the company had decided to initiate legal proceedings against the Group for the payment of ISK 824 million.

Legal proceeds concerning Stefnir hf.

In 2011 Stefnir hf. received two demands for the rescission of contract from the winding-up committee of Landsbanki Íslands hf. Firstly, the rescission of the sale of bonds, issued by Eimskipafélag Íslands hf. and owned by Peningamarkadssjódur, to Landsbanki Íslands hf. less than a month before the collapse of the bank in 2008. The total amount involved is ISK 1,600 million plus interest. Secondly, the demand to rescind Landsbanki Íslands hf.'s payment of money market deposits which matured early in October 2008 to five funds managed by Stefnir hf. The amount involved is ISK 1,451 million plus interest and the winding-up committee has filed cases in court for two of these payments. The amount of those two cases is ISK 450 million plus interest. Stefnir hf. has protested against the claims and believes that they are unfounded.

52. cont.

Investigation by the EFTA Surveillance Authority

Two formal investigations involving the Bank were launched by the EFTA Surveillance Authority (ESA) in 2010, which have now both been concluded.

The first investigation, commenced in September 2010, relates to whether or not the purchases by each of the new banks, i.e. the Group, Íslandsbanki hf. and Landsbankinn hf., of assets of money market funds in the autumn of 2008 should be considered to be state aid under the Agreement on the European Economic Area (EEA Agreement). The Group, which was state-owned at the time, acquired assets worth ISK 7.7 billion from the funds of Rekstrarfélag Kaupþings banka hf. (now Stefnir hf.) on 30 October 2008. On 11 July 2012, ESA concluded that the Icelandic authorities had granted state aid with the acquisition by each of the new banks of the assets in the above funds. However, ESA found the aid to be compatible with the EEA Agreement ESA considered that the Government had to implement extraordinary measures in an attempt to stabilize the economy and that the the measures at issue were necessary in order to try to restore faith in the financial sector. In this respect it was necessary and appropriate to protect the investors from even greater losses on their savings.

The second investigation was launched in December 2010 and relates to the state aid granted in the restoration of certain operation of Kaupthing Bank hf. (now Kaupthing hf.) and the establishment and capitalisation of the Group. Similar investigations were launched in relation to the restoration and capitalisation of Íslandsbanki hf. and Landsbankinn hf. In its investigation, ESA considered the appropriateness of the capitalisation measures taken by the Icelandic authorities, which were not notified to the ESA in advance of their implementation. On 11 July 2012, ESA concluded that the aid measures taken constitute state aid compatible with the EEA Agreement. In connection with this decision, Arion Bank has undertaken certain commitments to increase competition. Arion bank will provide information on its website how customers can move their business to another bank. Arion Bank has also undertaken not acquire other financial companies until the 1st of December 2014, except if it obtains the Authority´s approval beforehand. In the ESA decision it is stated that this means that further concentration of the Icelandic financial market through acquisitions by Arion bank can be prevented, unless further mergers would be necessitated by financial stability considerations. Arion bank commits to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring in line with Article 22 of the Act on Financial Undertakings No. 161/2002. The bank commits to follow the procedure and time-limits, which are set out in this provision and as interpreted by the FME. This commitment is a legal obligation already present. The bank furthermore committed to maintain up-to-date information on its website or of a subsidiary on subsidiaries and shareholding that are held for sale.

Investigation by the Icelandic Competition Authority

The Icelandic Competition Authority (ICA) has opened a formal investigation into alleged abuse of a dominant position and collusion between all card issuers in Iceland, including the Group, following a complaint by Kortaþjónustan hf., a credit card payment acquirer, made in 2009. The ICA has also opened a formal investigation into the alleged abuse of their alleged collective dominant position by the three largest retail banks, including the Group. The investigation was initiated by separate complaints from BYR bank hf. and MP bank hf. made in 2010. The ICA received a similar complaint from Tryggingamiðstöðin hf. in 2010. The complaints from BYR bank hf. and MP bank hf. concern the terms of the banks' mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition. The complaint from Tryggingamiðstöðin hf. concerns the banks' alleged tying of banking services and insurances. The Group has made objections to all of the complaints. The extent of the investigations and outcome of the cases is still uncertain as well as any effect on the Group.

Other matters

The Group is party to a court case, whereby the claimant, a guarantor to a loan issued to the Group, claimed that the Group did not adhere to the rules of an agreement from 2001 on the use of guarantees for individual debts. According to the claimant, the Bank did not provide the claimant with a credit valuation of the debtor to be signed by the guarantor. With a judgment on 23 February 2012, the district court of Reykjavík sided with the Bank in the court case. The disputed amount in this case is not material for the Group but could affect the validity of guarantees held by the Group for a number of other loans to individuals.

The Bank has provided certain warranties and "hold harmless" commitments in relation to the sale of legal entities arising from previous foreclosures. Provisions are recognised for such warranties and commitments when it is probable that an outflow of resources will be required and a reliable estimate can be made.

The uncertainty regarding the book value of foreign currency lending

53. In two very similar judgments on 16 June 2010, the Supreme Court of Iceland stated that two car loans were in fact loans in Icelandic krona indexed to a foreign currency exchange rate (rather than loan agreements denominated in foreign currency) and that Act No. 38/2001 on Interest and Price Indexation made such indexation illegal. These judgments were mainly based on the wording of the respective loan documents. In a judgment on 16 September 2010, the Supreme Court of Iceland stated that a loan agreement, which was ruled to be in Icelandic krona indexed to a foreign currency exchange rate, should bear the non-indexed Icelandic krona interest rate posted by the Central Bank of Iceland.

53. cont.

On 18 December 2010, the Icelandic Parliament passed an act (Act No. 151/2010) removing legal uncertainty on how to recalculate interest on loans in Icelandic krona indexed to a foreign currency exchange rate. According to the law, the principal of such loans shall be recalculated from the start date bearing the non-indexed interest rate for the Icelandic krona posted by the Central Bank. Furthermore, the law required that banks recalculate foreign-currency mortgage loans for personal residents before 28 March 2011. As applicable, the loan principal shall be adjusted to the outcome of the recalculation or if the borrower has overpaid, the amount shall be reimbursed. In accordance with the act, the Group has now finished recalculating all mortgage loans for personal residents in foreign currency to individuals. Over 60% of the number of foreign currency loans to individuals were affected and as of March 2011 the book value of the loans reflected the result of the calculations.

In two similar judgments on 14 February 2011, the Supreme Court stated that two foreign currency loans to small SMEs were in fact loans in Icelandic krona and indexed to a foreign currency exchange rate. Therefore, these loans were in breach of Act No. 38/2001 on Interest and Price Indexation. The Court passed another two similar judgments on 8 March 2011 dealing with foreign currency loans. In a ruling on 9 June 2011, the Supreme Court, by a 4-3 vote, stated that a foreign currency loan to a corporate entity was in fact a loan in Icelandic krona and indexed to a foreign currency exchange rate.

Even though no foreign currency indexed ISK loans made by the Group have been deemed illegal by the Supreme Court, the Group announced on 15 June 2011 that recent rulings made by the Supreme Court provide a precedent for the Group to follow, and that the loans that fall under the conditions set forth by the Supreme Court in its rulings would be recalculated. The Group has thus recalculated around 2,000 loans, to both individuals and businesses.

The recalculation came in addition to the recalculation of foreign currency linked mortgage loans which was done last year. Therefore, the lion's share of the Group's foreign currency linked ISK loans to individuals have been or will be recalculated into ISK denominated loans. In the case of businesses it is important to point out that in the summer of 2010 the legality of the Group's FX loans to businesses was assessed by a team of experts at the Group based on FME guidelines. They concluded that the legality of some FX loans to companies was beyond doubt, while others were more vulnerable, as the recent rulings of the Supreme Court have confirmed.

The first Supreme Court judgment which discussed the legality of loans owned by Arion Bank was pronounced on 15 June 2012. On that occasion the Supreme Court issued a judgment in the case Arion Bank v Háttur ehf. The case concerned the legality of a loan agreement of the company's where the loan amount is specified as "the equivalent to an amount" in Icelandic krónur; the loan amount was paid to the borrower in foreign currency and the majority of the loan was repaid in foreign currency. The majority of the Supreme Court concluded that it was a legitimate loan, particularly with reference to the name of the loan agreement, the specification of the loan amount and interest and the way in which the loan was paid out and how repayments and interest were repaid, as it was considered that both parties had discharged their duties with amounts in foreign currencies having changed hands. Arion Bank believes that comparable loan agreements with companies and individuals at the Bank are subject to the precedent set by the judgment.

It is therefore clear that a decision has been reached in the legality, or in some circumstances illegality, of the majority of the Bank's foreign loans to companies and individuals. However, it should be pointed out that the Supreme Court has not ruled on all types of the Bank's foreign loans.

On 15 February 2012, the Supreme Court passed a judgment in the case of Frjálsi fjárfestingarbankinn. As the judgment dealt with a dispute which rose from special circumstances, its precedent is not entirely clear. On first instance, it is likely the judgment does stipulate that loans, which are deemed to be currency-linked, can be recalculated with the non-indexed interest rate set by the Central Bank of Iceland, however the Bank cannot claim from the borrower a higher payment of interest of the loan than the interest the borrower actually paid, if the borrower has paid according to the Bank's payment slips. Therefore, it is likely that the recalculation of certain foreign currency linked loans will have to be modified in accordance with the judgment. This also means that certain foreign currency linked loans, which have already been recalculated, will have to be recalculated again. It is worth noting that the Bank's review of the judgment is not over, so the above view of the judgment could change. The Group entered into a partnership, according to a decision by the Icelandic Competition Authority on 9 March 2012, with the member companies of the Icelandic Financial Services Association to coordinate actions in regards to the Judgment of the Supreme Court of 15 February 2012. This partnership has now concluded and the result of this work is that it is proposed to take eleven disputes to court so that disputes which have arisen since the judgment can be resolved. At present it is uncertain when a conclusion on these cases will be reached but it is hoped that it will before the end of 2012.

The Group currently estimates that the loss to the Group's foreign loan portfolio arising from the judgment of 15 February is ISK 13.8 billion. In calculating this estimate, the Group elected to follow the methodology prescribed in an impact analysis conducted by the FME. From the four scenarios prescribed in the FME's analysis, the Group has selected the one considered to be the most plausible interpretation of the judgment.

Despite the recognition of impairment for the above estimated loss, the Group remains exposed to significant uncertainty regarding foreign currency linked loans in two respects:

Firstly, the estimation uncertainty associated with the Group's interpretation of the impact of the Supreme Court judgment of 15 February 2012. Uncertainty exists with regard to firstly, the Group's preliminary determination of the specific loans that require recalculation and secondly, uncertainty with regard to assumptions used in the method of recalculation of loans to customers that were determined to fall within the scope of the judgment. As noted above, this uncertainty is somewhat mitigated by the use of FME prescribed methodology. In the event the Group's interpretation of the judgment of 15 February 2012 were to change, the loss could be significantly greater or less than the current estimate of ISK 13.8 billion. Secondly, the legal uncertainty over the outcome of future legal decisions and new or amended government legislation that may require the recalculation of other categories of foreign currency loans that the Group has not previously considered as vulnerable. This will be determined by future court rulings and government actions, for which it is not currently possible to predict an outcome.

Significant uncertainty exists over the impact of the above matters on the carrying value of the Bank's portfolio of foreign currency linked loans at period-end.

Notes to the Interim Financial Statements

Notes to the Condensed Interim Statement of Cash Flow

54. Changes in operating assets and liabilities specified as follows:

	2012 1.1.-30.6.	2011 1.1.-30.6.
Mandatory reserve with Central Bank	965	40
Loans and receivables to credit institutions	3,017	1,712
Loans and receivables to customers	(14,676)	34,847
Bonds and debt instruments	12,858	(20,823)
Shares and equity instruments	(548)	-
Derivatives and financial liabilities at fair value	5,062	6,997
Other assets	113	1,346
Due to credit institutions and Central Bank	4,677	(20,301)
Deposits	(44,663)	(11,010)
Borrowings	1,080	(3,039)
Other liabilities	4,083	(3,760)
Changes in operating assets and liabilities	(28,032)	(13,991)

Risk Management Disclosures

Further information regarding risk management is available in the annual Financial Statements 2011.

Credit risk

55. Credit risk

a) Maximum exposure to credit risk related to on balance sheet assets:

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position at the end of the reporting period before the effect of mitigation due to collateral agreements or other credit enhancements.

Maximum exposure to credit risk related to on balance sheet assets:

	30.06.2012	31.12.2011
Cash and balances with Central Bank	16,280	29,200
Loans and receivables to credit institutions	71,769	69,103
Loans and receivables to customers	578,886	561,550
Overdrafts	44,453	38,885
Subordinated loans	544	550
Other loans	533,889	522,115
Bonds and debt instruments	128,853	140,568
Listed	58,240	55,614
Unlisted	70,613	84,954
Derivatives	1,363	674
Bonds and debt instruments, hedging	418	1,922
Listed	418	1,922
Other assets with credit risk	5,440	8,004
On balance sheet maximum exposure to credit risk	803,009	811,021

Maximum exposure to credit risk related to off balance sheet items:

Guarantees	11,847	8,662
Unused overdrafts	35,019	34,258
Loan Commitments	30,412	17,687
Off balance sheet maximum exposure to credit risk	77,278	60,607
Maximum exposure to credit risk	880,287	871,628

Arion Bank Interim Financial Statements 30 June 2012 34 Amounts are in ISK millions

55. cont.

b) Credit quality by class of financial assets

30.06.2012	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	16,280	-	-	16,280
Loans and receivables to credit institutions	71,769	-	-	71,769
Loans and receivables to customers				
Loans to corporates	280,699	29,156	42,597	352,452
Loans to individuals	176,910	23,428	26,096	226,434
Bonds and debt instruments	128,853	-	-	128,853
Derivatives	1,363	-	-	1,363
Securities used for hedging	418	-	-	418
Other assets	5,440	-	-	5,440
Total	681,732	52,584	68,693	803,009
31.12.2011				
Cash and balances with Central Bank	29,200	-	-	29,200
Loans and receivables to credit institutions	69,103	-	-	69,103
Loans and receivables to customers				
Loans to corporates	274,604	17,758	46,252	338,614
Loans to individuals	182,089	23,117	17,730	222,936
Bonds and debt instruments	140,568	-	-	140,568
Derivatives	674	-	-	674
Securities used for hedging	1,922	-	-	1,922
Other assets	8,004	-	-	8,004
Total	706,164	40,875	63,982	811,021

c) Past due but not impaired loans by class of loans and receivables:

30.06.2012	Less than 30 days	31 to 60 days	61 to 90 days	More than 91 days	Total
Loans to corporates	12,998	5,026	639	10,493	29,156
Loans to individuals	8,942	672	3,246	10,568	23,428
Past due but not impaired loans	21,940	5,698	3,885	21,061	52,584
31.12.2011					
Loans to corporates	5,649	824	834	10,451	17,758
Loans to individuals	2,950	3,422	2,512	14,233	23,117
Past due but not impaired loans	8,599	4,246	3,346	24,684	40,875

d) Collateral repossessed

During the period, the Group took possession of real estates with the carrying value of ISK 655 million, all which the Bank is in the process of selling, see Note 41.

Arion Bank Interim Financial Statements 30 June 2012 35 Amounts are in ISK millions

55. cont.

e) Loans and receivables to customers specified by sectors:

	30.06.2012	31.12.2011
Individuals	39.1%	39.7%
Financial and insurance activities	11.8%	10.8%
Manufacturing, mining and other industry	9.2%	7.7%
Real estate activities	10.2%	9.8%
Agriculture, forestry and fishing	9.6%	11.1%
Wholesale and retail trades, transport, accommodation and food service activities	11.1%	11.7%
Business services	5.2%	5.3%
Construction	1.3%	1.5%
Public administration, defence, education, human health and social work activities	1.3%	1.2%
Other services	1.2%	1.2%
Loans and receivables to customers	100.0%	100.0%

f) Impaired loans and receivables to customers by sector:

	30.06.2012	
	Impaired amount	Impaired loans
Individuals	19,160	45,256
Financial and insurance activities	6,549	11,709
Manufacturing, mining and other industry	2,018	8,213
Real estate activities	3,313	8,810
Agriculture, forestry and fishing	3,982	11,315
Wholesale and retail trades, transport, accommodation and food service activities	6,097	17,446
Business services	8,130	10,135
Construction	1,709	5,399
Public administration, defence, education, human health and social work activities	461	1,106
Other services	556	1,279
Impairment on loans and receivables to customers	51,975	120,668

During the period, the Bank has modified its basis for determining Impaired loans and receivables to customers by sector. The cost of recalculating the comparative information on a consistent basis outweighs the benefit in the viewpoint of the Bank and therefore no comparative information is presented.

In prior financial years, loans where the impairment did not exceed the remaining acquisition discount were not classified as impaired loans as the Bank's management wanted to disclose impaired loan information reflecting the deterioration in loan quality subsequent to acquisition. As the Bank's restructuring of acquired loans in 2008 is nearing completion, the Bank's management has reclassified the remaining acquisition discount to an impairment provision.

g) Large Exposure Disclosures

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's capital base net of eligible collateral according to FME rules No 216/2007.

The legal maximum for individual large exposures is 25% of capital base and the sum of all large exposures cannot exceed 400% of capital base.

The maximum exposure to a group of connected clients at period-end was ISK 31 billion (end of 2011: ISK 33 billion) before taking account of eligible collateral, excluding claim on Drómi. The Group has four large exposures at period-end (2011:five exposures) net of eligible collateral.

No large exposure exceeds the legal limit of 25% of the group's capital base at period-end. The Ministry of Finance has pledged that Arion Bank will be held harmless from the exposure due to the bond claim on Drómi. The FME has ruled that the Group can use the hold harmless statement as a credit enhancement towards the claim on Drómi ehf. Consequently, the Group finds that the net exposure on Drómi is zero.

The sum of all large exposures is 109% before collateral mitigation or 64% net of eligible collateral, which is well below the 400% legal maximum and the Group's internal 150% limit net of collateral.

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Market risk

56. Market risk

a) Interest rate risk

The following table shows the sensitivity of net present value of interest bearing assets and liabilities to changes in interest rate by currency and maturity in millions of ISK in the Group. Risk is quantified by assuming a 200 bps simultaneous upward shift in all yield curves in the relevant duration band. The sensitivity does not relate to variation of annual net interest income.

30.06.2012		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked	ISK	9	(1,955)	(233)	(5,137)	(2,993)
Non Indexed linked	ISK	(422)	(780)	(135)	(139)	(57)
	EUR	129	(7)	-	-	-
	Other	172	(435)	(106)	-	-
31.12.2011						
CPI Indexed linked	ISK	40	(1,509)	(1,016)	(14,001)	7,684
Non Indexed linked	ISK	(418)	(1,390)	(701)	(265)	(388)
	EUR	15	(5)	-	-	-
	Other	(27)	(785)	(109)	-	-

The table below analyses the Group's assets and liabilities at carrying amount by residual maturity.

30.06.2012 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	16,280	8,685	-	7,595	-	-	-
Loans and receivables to credit institutions	71,769	68,347	3,178	-	245	-	-
Loans and receivables to customers	578,886	11,570	53,625	79,247	220,849	213,595	-
Bonds and debt instruments	128,853	6,445	104	2,034	78,957	41,314	-
Shares and equity instruments	15,408	-	-	-	-	-	15,408
Derivatives	1,363	-	756	1	560	46	-
Assets leg	30,311	-	16,434	164	7,972	5,741	-
Liabilities leg	(28,948)	-	(15,678)	(163)	(7,412)	(5,695)	-
Securities used for hedging	1,516	418	-	-	-	-	1,098
Investment property	28,379	-	-	-	-	-	28,379
Investments in associates	3,020	-	-	-	-	-	3,020
Property and equipment	6,232	-	-	-	-	-	6,232
Intangible assets	5,008	-	-	-	-	-	5,008
Tax assets	548	-	-	-	-	-	548
Non-current assets held for sale	16,303	-	-	-	-	-	16,303
Other assets	6,485	163	2,350	2,427	403	96	1,045
Total assets 30.06.2012	880,050	95,629	60,012	91,304	301,014	255,050	77,041

Notes to the Interim Financial Statements

56. cont.

Liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Due to credit inst. and Central Bank	20,837	13,016	5,178	2,643	-	-	-
Deposits	445,249	288,224	89,967	34,540	29,730	2,788	-
Financial liabilities at fair value	10,439	-	10,101	-	297	41	-
Assets leg	(12,235)	-	(7,271)	-	(141)	(4,823)	-
Liabilities leg	12,666	-	7,364	-	438	4,864	-
Short position bonds & derivatives	10,008	-	10,008	-	-	-	-
Tax liabilities	4,028	-	-	4,034	-	-	(6)
Non-current liabilities held for sale	4,174	-	-	-	-	-	4,174
Other liabilities	45,052	7,326	6,585	21,923	3,163	231	5,824
Borrowings	192,953	-	1,432	3,397	17,377	170,747	-
Subordinated liabilities	32,175	-	-	-	-	32,175	-
Total liabilities 30.06.2012	754,907	308,567	113,263	66,537	50,567	205,981	9,992
Off balance sheet items							
Guarantees	11,847	3,092	1,195	3,465	2,556	1,539	-
Unused overdraft	35,019	985	7,100	13,197	13,710	27	-
Loan commitments	30,412	2	12,565	7,493	9,993	358	-
Off balance sheet items	77,278	4,079	20,860	24,155	26,259	1,924	-
Net interest sensitivity gap	47,865	(217,017)	(74,111)	612	224,188	47,144	67,049

31.12.2011

Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	29,200	20,640	-	8,560	-	-	-
Loans and receivables to credit institutions	69,103	62,155	6,703	-	245	-	-
Loans and receivables to customers	561,550	13,694	49,872	71,108	230,773	196,103	-
Bonds and debt instruments	140,568	3,994	515	15,256	80,125	40,678	-
Shares and equity instruments	14,045	-	-	-	-	-	14,045
Derivatives	674	-	188	3	483	-	-
Assets leg	9,589	-	5,603	299	3,687	-	-
Liabilities leg	(8,915)	-	(5,415)	(296)	(3,204)	-	-
Securities used for hedging	2,372	1,922	-	-	-	-	450
Investment property	27,100	-	-	-	-	-	27,100
Investments in associates	2,987	-	-	-	-	-	2,987
Property and equipment	6,271	-	-	-	-	-	6,271
Intangible assets	4,765	-	-	-	-	-	4,765
Tax assets	724	-	-	-	-	-	724
Non-current assets held for sale	23,886	-	-	-	-	-	23,886
Other assets	8,876	598	5,446	492	843	68	1,429
Total assets 31.12.2011	892,121	103,003	62,724	95,419	312,469	236,849	81,657

Arion Bank Interim Financial Statements 30 June 2012 38 Amounts are in ISK millions

56. cont.

Liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Due to credit inst. and Central Bank	16,160	10,341	231	5,588	-	-	-
Deposits	489,995	377,063	58,708	24,371	27,117	2,736	-
Financial liabilities at fair value	4,907	-	4,492	-	415	-	-
Assets leg	(35,374)	-	(34,697)	-	(677)	-	-
Liabilities leg	36,570	-	35,478	-	1,092	-	-
Short position bonds & derivatives	3,711	-	3,711	-	-	-	-
Tax liabilities	3,421	-	-	2,284	-	-	1,137
Non-current liabilities held for sale	4,950	-	-	-	-	-	4,950
Other liabilities	38,822	2,020	8,235	20,157	2,686	219	5,505
Borrowings	187,203	-	3,885	2,595	13,297	167,426	-
Subordinated liabilities	32,105	-	-	-	-	32,105	-
Total liabilities 31.12.2011	777,563	389,424	75,551	54,995	43,515	202,486	11,592
Off balance sheet items							
Guarantees	8,662	343	420	1,273	5,108	1,518	-
Unused overdraft	34,258	808	7,685	12,465	13,272	28	-
Loan commitments	17,687	1	2,892	8,385	4,409	2,000	-
Off balance sheet items	60,607	1,152	10,997	22,123	22,789	3,546	-
Net interest sensitivity gap	53,951	(287,573)	(23,824)	18,301	246,165	30,817	70,065

b) Inflation risk

The Group is exposed to inflation risk when there is a mismatch between inflation linked assets and liabilities. The total amount of indexed assets amount to ISK 267.4 billion (31.12.2011: ISK 230.7 billion) and the total amount of indexed liabilities amount to ISK 223.6 billion (31.12.2011: ISK 218.5 billion).

30.06.2012 Assets - CPI indexed linked	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans and receivables to customers	1,036	65,600	196,311	262,947
Bonds and debt instruments	-	549	366	915
Off balance sheet position	-	3,518	4,826	8,344
Total	1,036	69,667	201,503	272,206
Liabilities - CPI indexed linked				
Deposits	63,823	28,583	5,849	98,255
Borrowings	2,161	12,507	110,651	125,319
Total	65,984	41,090	116,500	223,574
Net on balance sheet position	(64,948)	25,059	80,177	40,288
Net off balance sheet position	-	3,518	4,826	8,344
Total CPI Balance	(64,948)	28,577	85,003	48,632
Total CPI Balance 31.12.2011	(58,423)	(1,448)	72,027	12,156

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56. cont.

c) Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is primarily exposed to currency risk through a currency mismatch between assets and liabilities. The Bank has primarily managed this mismatch through the systematic redenomination of foreign currency denominated loans to customers into ISK.

Currency risk strategy

The Bank's strategy towards currency risk is to meet the requirements of the Central Bank on foreign exchange balance at all times. Currency risk due to foreign currency loans to customers with ISK income will be eliminated. Net exposures per currency are monitored centrally in the Bank.

The following table shows the breakdown of assets and liabilities by currency at period-end:

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash with Central Bank	12,163	916	517	856	1,363	4	461	16,280
Loans to credit institutions	25,082	15,164	12,606	761	8,173	1,201	8,782	71,769
Loans and receivables to customers	422,342	48,223	25,133	28,718	8,128	23,053	23,289	578,886
Bonds and debt instruments	117,264	2	11,587	-	-	-	-	128,853
Shares and equity instruments	8,815	5,003	917	-	286	-	387	15,408
Derivatives	1,078	2	-	3	144	2	134	1,363
Securities used for hedging	1,516	-	-	-	-	-	-	1,516
Investment property	28,379	-	-	-	-	-	-	28,379
Investments in associates	3,020	-	-	-	-	-	-	3,020
Property and equipment	6,232	-	-	-	-	-	-	6,232
Intangible assets	5,008	-	-	-	-	-	-	5,008
Tax assets	548	-	-	-	-	-	-	548
Non-current assets held for sale	11,379	4,924	-	-	-	-	-	16,303
Other assets	6,182	143	113	-	29	-	18	6,485
Total assets 30.06.2012	649,008	74,377	50,873	30,338	18,123	24,260	33,071	880,050
Liabilities and Equity								
Due to credit inst. and Central Bank	18,846	1,148	183	-	70	11	579	20,837
Deposits	366,623	26,546	10,414	5,205	6,797	1,809	27,855	445,249
Financial liabilities at fair value	10,085	44	310	-	-	-	-	10,439
Tax liabilities	4,028	-	-	-	-	-	-	4,028
Non-current liabilities held for sale	878	3,296	-	-	-	-	-	4,174
Other liabilities	34,230	1,830	6,354	269	534	1,480	355	45,052
Borrowings	131,663	2,857	20,279	20,422	6,920	10,812	-	192,953
Subordinated loans	-	25,771	2,501	-	3,903	-	-	32,175
Equity	125,143	-	-	-	-	-	-	125,143
Total liabilities and Equity 30.06.2012	691,496	61,492	40,041	25,896	18,224	14,112	28,789	880,050
Net on balance sheet position	(42,488)	12,885	10,832	4,442	(101)	10,148	4,282	
Net off balance sheet position	14,716	(12,024)	(5,229)	-	3,971	(3,243)	1,809	
Net position 30.06.2012	(27,772)	861	5,603	4,442	3,870	6,905	6,091	
Net position 31.12.2011	(42,631)	8,610	9,500	9,189	2,884	5,785	6,663	
Loans to customers with ISK income	10,740	(2,063)	(560)	(4,909)	(109)	(2,925)	(174)	
Net real position 30.06.2012	(17,032)	(1,202)	5,043	(467)	3,761	3,980	5,917	
Net real position 31.12.2011	(24,191)	5,788	8,276	1,025	2,793	(122)	6,431	

A natural hedge for currency risk is no longer relevant for the Bank.

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Liquidity risk

57. Liquidity risk

The Bank's primary source of funding is deposits from individuals, corporations and financial institutions. The Bank's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, the majority of which is on demand.

Secured liquidity

The Bank calculates its secured liquidity ratio from cash on hand and cash balances with the Central Bank of Iceland, Treasury notes and Housing Fund bonds which are held specifically as liquidity reserves and other eligible assets for repo transactions with the Central Bank and compare it with the total interest bearing liabilities.

The FME has set a guideline for minimum secured liquidity ratio and a minimum cash ratio. These guidelines stipulates that the Bank should have adequate liquidity reserves to withstand an instantaneous deposit outflow of 20% (Secured liquidity ratio), and that cash and cash equivalents shall amount to at least 5% (Cash ratio) of on-demand deposits. The high liquidity reserve required by the FME reflects the uncertainty of the deposit's stickiness of the Icelandic banks and the fact that a large part of the Bank's liabilities are primarily short term or on-demand deposits while the contractual maturity of the assets is much higher. The Bank actively monitors its liquidity reserves and has made excellent progress in understanding and modelling the behaviour of its deposit base. The ratios during the period were as follows

	Liquidity ratio	Cash ratio
Period-end	32%	14%
Maximum	37%	23%
Minimum	28%	10%
Average	32%	14%

Deposit stickiness

The Group's deposit base has been split into seven different categories depending on its stickiness. The term stickiness of deposit defines the past stability of deposit and the projected behaviour over time. A deposit is described as being sticky if it has shown to be a stable funding for the Group in the past and is expected to remain stable in the future. Every depositor within a specific group shares common characteristics that can be used as a measure of stickiness. The criteria for different levels or categories of stickiness include, but not limited to, behaviour of depositor over time, behaviour of depositor in stressed condition, the depositors business relationship with the Group and the maturity of the deposit. These criteria's are based both on qualitative and quantitative methods.

– Capital controls: Deposits from customers believed to be waiting for the lifting of capital controls;

– Resolution process: Deposits from customers in a resolution process;

– Investors: Deposits from investors who may withdraw when other investment opportunities appear or competitor offers higher deposits rate;

– Deposits - legal entities: Deposits from legal entities with no other business relationship with the Group and not quantified as an active investor;

– Deposits - retail individual: Deposits from retail individual with no other business relationship with the Group and not quantified as an active investor;

– Deposits - legal entities with business relationship: Deposits from legal entities with business relationship with the Group; and

– Deposits - retail individual with business relationship: Deposits from retail individual with business relationship with the Group.

The table below shows the split between different levels of the Bank's deposit stickiness at period-end, according to the Bank's classification. The rating 7 means the stickiest deposits and the rating 1 the least sticky.

% of deposit base:

Stickiness rating		30.06.2012		31.12.2011
1 Capital controls	2%	10,961	9%	43,977
2 Resolution process	15%	69,225	11%	58,315
3 Investors	25%	118,099	25%	124,596
4 Deposits - legal entities	11%	52,529	16%	80,494
5 Deposits - retail individuals	12%	55,171	11%	57,559
6 Deposits - legal entities with business relationship	18%	78,053	11%	57,664
7 Deposits - retail individuals with business relationship	18%	82,048	17%	83,550
Total	100%	466,086	100%	506,155

The fall in Capital Controls is primarily due to a single client's withdrawal.

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Notes to the Interim Financial Statements

Capital Adequacy and ICAAP Strategy

58. Capital Adequacy Disclosures

Capital base at 30 June 2012 amounts to ISK 151,762 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 22.3%, exceeding the minimum legal requirement of 8%.

The Group, parent company and subsidiaries that are subjected to capital requirements rules comply in full with imposed capital requirements (31.12.2011: the same).

A remark about capital requirements for currency imbalance is in order. As indicated in the discussion about currency risk, there exists a risk mitigation in the form of a natural hedge when the imbalance is due to an FX loan to a borrower with ISK income. The effect of this natural hedge is no longer reflected in the RWA for market risk whereas 31.12.2011 a 37% effective contribution of the corresponding portion of the FX imbalance was been accounted for.

Capital Base	30.06.2012	31.12.2011
Share capital	2,000	2,000
Share premium	73,861	73,861
Statutory reserve	1,637	1,637
Retained earnings	44,002	32,950
Non-controlling interests	3,643	4,110
Total Equity	125,143	114,558
Deduction from Tier 1 capital	(5,556)	(5,489)
Total Tier 1 capital	119,587	109,069
Tier 2 capital	32,175	32,105
Total Capital base	151,762	141,174

Risk weighted assets	30.06.2012	31.12.2011
Credit risk	560,283	543,233
Market risk FX	28,936	31,990
Market Risk Other	33,348	30,757
Operational risk	58,976	58,976
Total Risk weighted assets	681,543	664,956
Tier 1 ratio	17.5%	16.4%
Capital adequacy ratio	22.3%	21.2%

Other information

Related parties

59. The Group has a related party relationship with Kaupskil ehf., Kaupthing hf., the Group's associates, the Board of Directors of Arion Bank, the key management personnel of the Group and close family members of individuals referred to above.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) holds a 13% stake in the Group and the Ministry of Finance is the holder of all subordinated notes that represent Tier 2 capital of the Group. Accordingly the Ministry of Finance, ISFI and government entities related to them are related parties and balances and transactions with these entities are included in the tables below under "shareholders with significant influence over the Group".

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Notes to the Interim Financial Statements

59. cont.

Balances with related parties:

30.06.2012	Assets	Liabilities	Net balance
Shareholders with significant influence over the Group	-	1,789	(1,789)
Shareholders with control over the Group	473	61,286	(60,813)
Board of Directors and key Management personnel	202	98	104
Associates and other related parties	56,805	16,263	40,542
	57,480	79,436	(21,956)
31.12.2011			
Shareholders with significant influence over the Group	-	1,730	(1,730)
Shareholders with control over the Group	493	41,376	(40,883)
Board of Directors and key Management personnel	104	367	(263)
Associates and other related parties	74,135	29,088	45,047
	74,732	72,561	2,171

Events after Balance Sheet date

60. Events after Balance Sheet date

a) Penninn á Íslandi ehf.

In June 2012 Eignabjarg signed an agreement for the sale of its 100% shareholding in Penninn á Íslandi ehf. Approval from the Icelandic Competition Autority was obtained in August 2012.

b) Sparisjóður Ólafsfjarðar

In June 2012 the boards of Arion Bank and its wholly owned subsidiary Sparisjóður Ólafsfjarðar agreed on a merger of these two entities. Approval from FME is pending at period-end.

c) Fram Foods ehf.

On 3 July 2012 Fram Foods ehf. sold its subsidiary Boyfood Oy in Finland. Fram Foods ehf. is a wholly owned subsidiary of Eignabjarg ehf. The effects from the sale of this entity will have minor effects on the Statement of Comprehensive Income in the third quarter of 2012.

Subsidiaries

61. Shares in subsidiaries in which Arion Bank held a direct interest at period-end were as follows:

Company:	Country	Currency	Equity interest accum. %
AFL - sparisjódur, Adalgata 34, 580 Siglufjördur	Iceland	ISK	94.5
EAB 1 ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Eignabjarg ehf., Borgartún 26, 105 Reykjavík	Iceland	ISK	100.0
Eignarhaldsfélagið Landey ehf., Hátún 2b, 105 Reykjavík	Iceland	ISK	100.0
Einkaklúbburinn ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Gen hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
GIR Fund Management Ltd., Walker House Mary Street, George Town.	Cayman Isl.	ISK	100.0
Kaupthing Management Company S.A., 35a, avenue J.F. Kennedy	Luxemb.	EUR	100.0
Landfestar ehf., Borgartún 26, 105 Reykjavík	Iceland	ISK	100.0
NS1 ehf., Digranesgata 2, 310 Borgarnes	Iceland	ISK	100.0
Okkar líftryggingar hf., Sóltún 26, 105 Reykjavík	Iceland	ISK	100.0
Sparisjódur Ólafsfjardar, Adalgata 14, 625 Ólafsfjördur	Iceland	ISK	100.0
Stefnir hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	100.0
Tekjuvernd ehf., Hlídasmári 17, 201 Kópavogur (former KB Rádgjöf ehf.)	Iceland	ISK	100.0
Valitor Holding hf., Laugavegur 77, 101 Reykjavík	Iceland	ISK	60.8

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