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Confirmation of your representation: This electronic transmission and the attached document are delivered to you on the basis that you are deemed to have represented to Arion Banki hf. (the "**Bank**") and each of Carnegie Investment Bank AB (publ), Citigroup Global Markets Limited, Morgan Stanley & Co. International plc, Deutsche Bank AG, London Branch, Goldman Sachs International, Svenska Handelsbanken AB (publ), Fossar Markadir hf., Íslandsbanki hf. and Landsbankinn hf. (together with the Bank, the "**Managers**") that you have understood and agree to the terms set forth herein and confirm that you are a person that is outside the United States for the purpose of Regulation S or a QIB inside the United States and, in the latter case, you are acquiring the Securities for your own account and/or for the account of another

QIB, and you further confirm that either (i) you are a person in either Iceland or Sweden, (ii) you are a person in a member state of the EEA, other than Iceland, Sweden or the United Kingdom, and you are a Qualified Investor and/or a Qualified Investor acting on behalf of Qualified Investors or Relevant Persons, to the extent that you are acting on behalf of persons or entities in the EEA (other than Iceland or Sweden) or the United Kingdom, (iii) you are a person in the United Kingdom and you are a Relevant Person and/or a Relevant Person acting on behalf of Relevant Persons or Qualified Investors, to the extent that you are acting on behalf of persons or entities in the United Kingdom or in the EEA (other than Iceland or Sweden), or (iv) you are an institutional investor that is otherwise eligible to receive this electronic transmission and the attached document in accordance with the laws of the jurisdiction in which you are located.

You shall also be deemed to have represented to the Bank and each of the Managers that you consent to delivery by electronic transmission.

You are reminded that you have received this electronic transmission and the attached document on the basis that you are a person into whose possession this electronic transmission and the attached document may be lawfully delivered in accordance with the laws of the jurisdiction in which you are located and you may not, nor are you authorised to, deliver this electronic transmission or the attached document, electronically or otherwise, to any other person. If a jurisdiction requires that the private offer to certain institutional and professional investors (the "**Offering**") to which this electronic transmission and the attached document relate be made by a licensed broker or dealer and any Manager or any affiliate of a Manager is a licensed broker or dealer in such jurisdiction, the Offering shall be deemed to be made by such Manager or affiliate on the behalf of the Bank in such jurisdiction.

You are reminded that documents transmitted electronically may be altered or changed during the process of transmission and, consequently, neither the Bank, nor the Managers nor any of their respective affiliates accepts any liability or responsibility whatsoever in respect of any difference between the attached document delivered by electronic transmission and the hard copy version. Your receipt of this document is at your own risk and you are responsible for protecting against viruses and other destructive items.

Restriction: Nothing in this electronic transmission constitutes, and may not be used in connection with, an offer of the Securities for sale to persons other than certain institutional and professional investors described above and at whom it is directed, and access has been limited so that it shall not constitute a general solicitation. If you have gained access to this electronic transmission contrary to the foregoing restrictions, you will be unable to purchase any of the Securities.

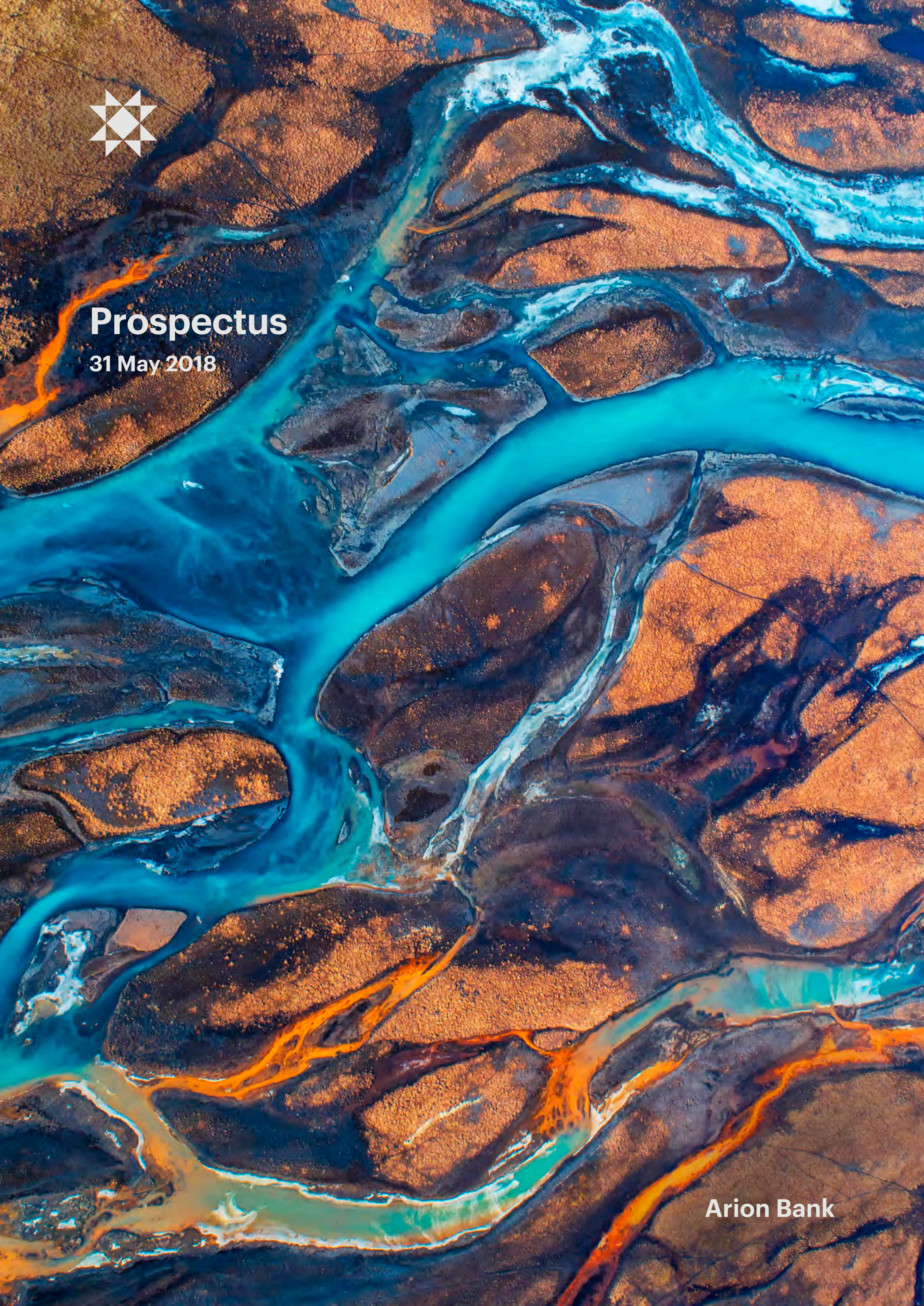
None of the Managers nor any of their respective affiliates accepts any responsibility whatsoever for the contents of this electronic transmission or the attached document or for any statement made or purported to be made by them, or on their behalf, in connection with the Bank, the Securities or the Offering referred to herein. Each of the Managers and each of their respective affiliates accordingly disclaim all and any liability whether arising in tort, contract or otherwise which they might otherwise have in respect of such electronic transmission, the attached document and/or any such statement. No representation or warranty, express or implied, is made by any of the Managers or any of their respective affiliates as to the accuracy, completeness or sufficiency of the information set out in this electronic transmission or the attached document.

The Managers are acting exclusively for the Bank and Kaupskil ehf. and Trinity Investments Designated Activity Company (the "**Selling Shareholders**") and no one else in connection with the Offering. They will not regard any other person (whether or not a recipient of this electronic transmission or the attached document) as their clients in relation to the Offering and will not be responsible to anyone other than the Bank and the Selling Shareholders for providing the protections afforded to their clients or for giving advice in relation to the Offering and the listing or any transaction, matter or arrangement referred to herein.

Prospectus

31 May 2018

Arion Bank



Arion Banki hf.

(Arion banki hf., a public limited company established under the laws of the Republic of Iceland)

Admission to listing and trading on NASDAQ Iceland of ordinary shares
Admission to listing and trading on NASDAQ Stockholm of Swedish depository receipts
Public offering of up to 724,000,000 ordinary shares in the form of ordinary shares and Swedish depository receipts

This is the initial offering of up to 724,000,000 ordinary shares, in the form of existing Shares (as defined below) (the "**Existing Offer Shares**") and Swedish depository receipts ("**SDRs**", together with the Existing Offer Shares and, unless the context indicates otherwise, together with the Over-Allotment Securities (as defined below), the "**Offer Securities**") of Arion banki hf. (the "**Bank**" or "**Arion Bank**"), a public limited company established under the laws of the Republic of Iceland ("**Iceland**"), by Kaupskil ehf. ("**Kaupskil**") and Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP) (together, the "**Selling Shareholders**"). The terms "Arion Bank", the "Bank" and the "**Group**" refer to Arion Bank and its consolidated subsidiaries, unless the context otherwise requires. Assuming no exercise of the Over-Allotment Option (as defined below), the Offer Securities will constitute up to 40.0% of the issued and outstanding ordinary shares, each with a par value of Icelandic krona ("**Icelandic Krona**" or "**ISK**") 1.00 (together with the issued ordinary shares held in treasury by the Bank, the "**Shares**"). Each SDR represents an interest in one Share. If the Over-Allotment Option is fully exercised, the Offer Securities will constitute up to 46.0% of the issued and outstanding Shares.

The offering of the Offer Securities (the "**Offering**") consists of (i) a public offering in Iceland of the Offer Securities and in Sweden of the SDRs, in each case to institutional and retail investors and (ii) a private placement to certain institutional investors in various other jurisdictions. The Offer Securities are being offered (i) within the United States of America (the "**United States**" or "**U.S.**"), to persons reasonably believed to be "qualified institutional buyers" ("**QIBs**") as defined in, and in reliance on, Rule 144A ("**Rule 144A**") under the U.S. Securities Act of 1933, as amended (the "**U.S. Securities Act**"), or pursuant to another exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act and applicable state and other securities laws of the United States and (ii) outside the United States, where all offers and sales of the Offer Securities will be made in compliance with Regulation S under the U.S. Securities Act ("**Regulation S**").

Prior to the Offering, there has been no public market for the Offer Securities. Application has been made to list and admit all of the Shares to trading under the symbol "ARION" on NASDAQ Iceland ("**NASDAQ Iceland**") and up to 2,000,000,000 SDRs under the symbol "ARIONs" on NASDAQ Stockholm ("**NASDAQ Stockholm**"). Subject to acceleration or extension of the timetable for the Offering, trading on an "as-if-and-when-delivered" basis, conditional on admission (otherwise known as "conditional trading"), in the Offer Securities on NASDAQ Iceland and NASDAQ Stockholm is expected to commence on or about 15 June 2018 (the "**First Trading Date**"). Admission to listing and unconditional trading of the Shares on NASDAQ Iceland and of the SDRs on NASDAQ is expected to occur on or about 19 June 2018.

The price range of the Offer Securities (the "Offer Price Range") is ISK 68 to ISK 79 per Existing Offer Share / SDR

The price at which the Offer Securities will be sold (the "**Offer Price**") is expected to be between ISK 68 and ISK 79 per Existing Offer Share and SDR and will be determined through a book-building process. The Offer Price will be set in ISK and, for purposes of sales of SDRs via NASDAQ Stockholm, will be translated to SEK ("**Swedish Krona**" or "**SEK**") based on the prevailing selling rate of exchange published by the Central Bank of Iceland (*Sedlabanki Íslands*) (the "**Icelandic Central Bank**") on 14 June 2018. The Offer Price and the exact number of the Offer Securities to be sold is expected to be announced on or about 15 June 2018.

Payment for, and issue and delivery of, the Offer Securities ("**Settlement**") is expected to take place on or about 19 June 2018 (the "**Settlement Date**"). If Settlement does not take place on the Settlement Date as planned or at all, the Offering may be withdrawn, in which case all subscriptions for the Offer Securities will be disregarded, any allotments made will be deemed not to have been made and any subscription payments made will be returned without interest or other compensation. Any dealings in the Offer Securities prior to Settlement are at the sole risk of the parties concerned. None of the Bank, the Selling Shareholders, the Managers (as defined below), NASDAQ Iceland or NASDAQ Stockholm accepts responsibility or liability towards any person as a result of the withdrawal of the Offering or the related annulment of any transaction in the Offer Securities.

Each of Miton Asset Management Limited and Lansdowne Partners (UK) LLP (the "**Cornerstone Investors**") has committed to acquire at the Offer Price (and at any such price throughout the Offer Price Range set forth above) a number of Offer Securities equivalent to US$ 22.5 million and US$ 38.0 million, respectively, converted into ISK at the mid-rate of the Icelandic Central Bank on, in the case of Miton, the date the Offer Price is set and, in the case of Lansdowne, 30 May 2018. The Cornerstone Investors' commitments are subject to certain conditions as described in "*Plan of Distribution and Transfer Restrictions—Cornerstone Investments*". The Cornerstone Investors will not be subject to a lock-up in respect of their allocations.

INVESTING IN THE OFFER SECURITIES INVOLVES RISKS. SEE "RISK FACTORS" BEGINNING ON PAGE 20 OF THIS PROSPECTUS FOR A DESCRIPTION OF CERTAIN RISKS THAT SHOULD BE CAREFULLY CONSIDERED BEFORE INVESTING IN THE OFFER SECURITIES.

The Offer Securities will be delivered in book-entry form through the facilities of Nasdaq CSD Iceland hf. ("**Nasdaq CSD Iceland**") and Euroclear Sweden AB ("**Euroclear Sweden**").

The Selling Shareholders have granted the Managers an option (the "**Over-Allotment Option**"), exercisable in whole or in part by Citigroup Global Markets Limited, as stabilising manager (the "**Stabilising Manager**"), for 30 calendar days after the Settlement Date, pursuant to which the Managers may require the Selling Shareholders to sell at the Offer Price up to 108,600,000 additional Shares (either in the form of Existing Offer Shares or SDRs), comprising up to 15% of the total number of Existing Offer Shares and SDRs sold in the Offering (the "**Over-Allotment Shares**"), to cover short positions resulting from any over-allotments made in connection with the Offering or stabilisation transactions, if any. Arion banki hf., Carnegie Investment Bank AB (publ), Citigroup Global Markets Limited and Morgan Stanley & Co. International plc are acting as joint global coordinators and joint bookrunners (in such and any other capacity, the "**Joint Global Coordinators**"), Deutsche Bank AG, London Branch and Goldman Sachs International are acting as joint bookrunners for the Offering (together with the Joint Global Coordinators, the "**Joint Bookrunners**") and Svenska Handelsbanken AB (publ), Fossar Markadir hf., Íslandsbanki hf. and Landsbankinn hf. are acting as co-lead managers (the "**Co-Lead Managers**" and, together with the Joint Bookrunners, the "**Managers**").

The Offer Securities have not been, and will not be registered, under the U.S. Securities Act or with any securities regulatory authority of any state of the United States and may not be offered or sold within the United States unless the Offer Securities are registered under the U.S. Securities Act or pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act. There will be no public offer of the Offer Securities in the United States. Prospective purchasers are hereby notified that the Bank, the Selling Shareholders and any other sellers of the Offer Securities are relying on an exemption from the registration requirements of Section 5 of the U.S. Securities Act, which may include Rule 144A or Regulation S.

Neither the delivery of this document (the "**Prospectus**") nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Bank since the date hereof or that the information contained herein is correct as of any time subsequent to such date. In the event of any changes to the information in this Prospectus that may affect the valuation of the Offer Securities during the period from the date of announcement to the first day of trading, such changes will be announced in accordance with the provisions of Act No. 108/2007 on Securities Transactions, as amended (the "**Securities Transactions Act**"). This Prospectus has been approved by, and registered with, the Financial Supervisory Authority of Iceland (*Fjármálaeftirlitid*) (the "**FME**") in accordance with the provisions of the Securities Transactions Act, implementing the Directive 2003/71/EC of the European Parliament and the European Council, and amendments thereto (including those resulting from Directive 2010/73/EU) (the "**Prospectus Directive**"). Approval and registration by the FME does not imply that the FME guarantees that the factual information provided herein is correct or complete. The Bank has requested that the FME notify the Financial Supervisory Authority of Sweden (*Finansinspektionen*) (the "**FSA**") by providing a certificate of approval of this Prospectus.

Joint Global Coordinators and Joint Bookrunners

Arion Bank | **Carnegie** | **Citigroup** | **Morgan Stanley**

Joint Bookrunners

Deutsche Bank | **Goldman Sachs International**

Co-Lead Managers

Handelsbanken Capital Markets | **Fossar Markets**
Íslandsbanki | **Landsbankinn**

This Prospectus is dated 31 May 2018

NOTICE TO INVESTORS

The distribution of this Prospectus and the offer, acceptance, delivery, transfer, exercise, purchase of or trade in the Offer Securities may, in certain jurisdictions, including, but not limited to, the United States, be restricted by law. Persons in possession of this Prospectus are required to inform themselves about, and to observe, such restrictions. Any failure to comply with such restrictions may constitute a violation of the securities laws of any such jurisdiction. This Prospectus may not be used for, or in connection with, and does not constitute an offer to sell, or an invitation to purchase, any of the Offer Securities in any jurisdiction in which such offer or invitation is not authorised or would be unlawful. Neither this Prospectus, nor any related materials, may be distributed or transmitted to, or published in, any jurisdiction except under circumstances that will result in compliance with any applicable laws or regulations.

None of the Bank, the members of the board of directors of the Bank (the "**Board of Directors**"), the executive committee of the Bank (the "**Executive Committee**"), the Selling Shareholders, the Managers or any of their respective representatives is making any representation to any offeree or purchaser of the Offer Securities regarding the legality of an investment in the Offer Securities by such offeree or purchaser under the laws applicable to such offeree or purchaser.

All purchasers of the Offer Securities are deemed to acknowledge that (i) they have not relied on the Managers or any person affiliated with them in connection with any investigation of the accuracy of any information contained in this Prospectus or their investment decision and (ii) they have relied only on the information contained in this Prospectus, and that no person has been authorised to give any information or to make any representation concerning Arion Bank, the Selling Shareholders or the Offer Securities (other than as contained in this Prospectus) and that, if given or made, any such other information or representation has not been relied upon as having been authorised by Arion Bank, the Selling Shareholders or any of the Managers.

EXCEPT AS OTHERWISE SET FORTH IN THIS PROSPECTUS, THE OFFERING DESCRIBED IN THIS PROSPECTUS IS NOT BEING MADE TO INVESTORS IN THE UNITED STATES, CANADA, AUSTRALIA OR JAPAN.

This Prospectus does not constitute or form part of any offer or invitation to sell, or any solicitation of any offer to acquire, the Offer Securities in any jurisdiction in which such an offer or solicitation is unlawful or would result in Arion Bank becoming subject to public company reporting obligations outside Iceland or Sweden.

The distribution of this Prospectus, and the offer or sale of the Offer Securities, is restricted by law in certain jurisdictions. This Prospectus may only be used where it is legal to offer, solicit offers to purchase or sell the Offer Securities. Persons who obtain this Prospectus must inform themselves about and observe all such restrictions.

No action has been, or will be, taken to permit a public offer or sale of the Offer Securities or the possession or distribution of this Prospectus or any other material in relation to the Offering in any jurisdiction outside Iceland or Sweden where action may be required for such purpose. Accordingly, neither this Prospectus nor any advertisement or any other related material may be distributed or published in any jurisdiction, except in compliance with any applicable laws and regulations. See "*Plan of Distribution and Transfer Restrictions—Selling and Transfer Restrictions*".

United States

The Offer Securities have not been, and will not be, registered under the U.S. Securities Act or with any securities regulatory authority of any state of the United States and may not be offered or sold within the United States, unless the Offer Securities are registered under the U.S. Securities Act or pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act. In the United States, the Offer Securities will be sold only to persons reasonably believed to be QIBs as defined in, and in reliance on, Rule 144A under the U.S. Securities Act or pursuant to another exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act and applicable state securities laws. All offers and sales of the Offer Securities outside the United States will be made in compliance with Regulation S under the U.S. Securities Act and in accordance with applicable law. See "*Plan of Distribution and Transfer Restrictions—Selling and Transfer Restrictions*". The Offer Securities have not been recommended by any U.S. federal or state securities commission or regulatory authority. Furthermore, the foregoing authorities have not confirmed the accuracy or determined the adequacy of this Prospectus. Any representation to the contrary is a criminal offence in the United States.

European Economic Area

This Prospectus and the Offering are only addressed to, and directed at, persons in member states of the European Economic Area (the "**EEA**"), other than Iceland, Sweden and the United Kingdom, who are "**Qualified Investors**" within the meaning of Article 2(1)(e) of the Prospectus Directive. The Offer Securities are only available to, and any invitation, offer or agreement to purchase or otherwise acquire the Offer Securities will be engaged in only with, Qualified Investors. This Prospectus and its contents should not be acted or relied upon in any member state of the EEA by persons who are not Qualified Investors.

This Prospectus has been prepared on the basis that all offers of the Offer Securities, other than the offers contemplated in Iceland and Sweden, respectively, will be made pursuant to an exemption under the Prospectus Directive, as implemented in member states of the EEA, from the requirement to produce a prospectus for offers of the Offer Securities. Accordingly, any person making or intending to make any offer within the EEA of the Offer Securities that is the subject of the Offering contemplated in this Prospectus should only do so in circumstances in which no obligation arises for the Bank, the Selling Shareholders or any of the Managers to produce a prospectus for such offer. None of the Bank, the Selling Shareholders or the Managers has authorised, nor does the Bank, any of the Selling Shareholders or the Managers authorise, the making of any offer of the Offer Securities through any financial intermediary, other than offers made by the Managers that constitute the final Offering of the Offer Securities contemplated in this Prospectus.

For the purposes of this provision, (a) the expression an "**offer to the public**" in relation to any Offer Securities in any member state of the EEA that has implemented the Prospectus Directive (each, a "**Relevant Member State**") means the communication in any form and by any means of sufficient information on the terms of the Offering and the Offer Securities so as to enable an investor to decide to purchase the Offer Securities, as the same may be varied in such Relevant Member State by any measure implementing the Prospectus Directive in such Relevant Member State, (b) the expression "**Prospectus Directive**" means Directive 2003/71/EC (and amendments thereto, including the 2010 PD Amending Directive) and includes any relevant implementing measure in each Relevant Member State and (c) the expression "**2010 PD Amending Directive**" means Directive 2010/73/EU.

United Kingdom

In the United Kingdom, this Prospectus is being distributed only to, and directed at, Qualified Investors within the meaning of the Prospectus Directive (a) who have professional experience in matters relating to investments who fall within the definition of "investment professionals" in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "**Order**"), (b) who are high net worth entities, as described in Article 49(2)(a) to (d) of the Order or (c) other persons to whom it may lawfully be communicated (all such persons being referred to in (a), (b) and (c) are collectively "**Relevant Persons**"). In the United Kingdom, any investment or investment activity to which this Prospectus relates is only available to, and will be engaged in only with, Relevant Persons. Any other persons who receive this Prospectus should not rely on or act upon it.

If any Offer Securities are offered to a financial intermediary as such term is used in Article 3(2) of the Prospectus Directive, such financial intermediary will be deemed to have represented, acknowledged and agreed that the Offer Securities acquired by it in the Offering have not been acquired on a non-discretionary basis on behalf of, nor have they been acquired with a view to their offer or resale to, persons in circumstances which may give rise to an offer of any Offer Securities to the public other than their offer or resale in a Relevant Member State to a Qualified Investor within the meaning of the Prospectus Directive as so defined or in circumstances in which the prior consent of the Joint Global Coordinators has been obtained to each such proposed offer or resale. The Bank, the Selling Shareholders, the Managers and their respective affiliates, and other persons will rely upon the truth and accuracy of the foregoing representation, acknowledgement and agreement.

Information to Distributors

Solely for the purposes of the product governance requirements contained within: (a) EU Directive 2014/65/EU on markets in financial instruments, as amended ("**MiFID 2**"); (b) Articles 9 and 10 of Commission Delegated Directive (EU) 2017/593 supplementing MiFID 2; and (c) local implementing measures (together, the "**MiFID 2 Product Governance Requirements**"), and disclaiming all and any liability, whether arising in tort, contract or otherwise, which any "manufacturer" (for the purposes of the Product Governance Requirements) may otherwise have with respect thereto, the Shares have been subject to a product approval process, which has determined that such Shares are: (i) compatible with an end target market of retail investors and investors who meet the criteria of professional clients and eligible counterparties, each as defined in MiFID 2; and (ii) eligible for distribution through all distribution channels as are permitted by MiFID 2 (the "**Target Market Assessment**"). Notwithstanding the Target Market Assessment, distributors should note that: the price of the Shares may decline and investors could lose all or part of their investment; the Shares offer no guaranteed income and no capital protection; and an investment in the Shares is compatible only with investors who do not need a guaranteed income or capital protection, who (either alone or in conjunction with an appropriate financial or other adviser) are capable of evaluating the merits and risks of such an investment and who have sufficient resources to be able to bear any losses that may result therefrom. The Target Market Assessment is without prejudice to the requirements of any contractual, legal or regulatory selling restrictions in relation to the Offer. Furthermore, it is noted that, notwithstanding the Target Market Assessment, the Managers will only procure investors who meet the criteria of professional clients and eligible counterparties. For the avoidance of doubt, the Target Market Assessment does not constitute: (a) an assessment of suitability or appropriateness for the purposes of MiFID 2; or (b) a recommendation to any investor or group of investors to invest in, or purchase, or take any other action whatsoever with respect to the Shares. Each distributor is responsible for undertaking its own target market assessment in respect of the Shares and determining appropriate distribution channels.

TABLE OF CONTENTS

SUMMARY

Prospectus summaries consist of information requirements presented in "items". The items are numbered in sections A–E (A.1–E.7).

The summary in this Prospectus includes all of the items required in a summary for the relevant type of security and issuer. However, because certain items are not required to be addressed, there may be gaps in the numbering of the items.

Even if an item is required to be included in the summary for the relevant type of security and issuer, it is possible that no relevant information can be provided regarding the item. In such case, the information is replaced by a brief description of the item together with the indication "not applicable".

Section A—Introductions and warnings		
A.1	*Introduction and warnings*	**This summary should be read as an introduction to the Prospectus.** **Any decision to invest in the Offer Securities (as defined in C.1) should be based on consideration of the Prospectus as a whole by the investor.** **Where a claim relating to the information in the Prospectus is brought before a court, the plaintiff investor might, under the national legislation of the member states of European Economic Area, have to bear the costs of translating the Prospectus before the legal proceedings are initiated.** **Civil liability attaches only to those persons who have tabled the summary, including any translation thereof, but only if the summary is misleading, inaccurate or inconsistent when read together with the other parts of the Prospectus or it does not provide, when read together with the other parts of the Prospectus, key information in order to aid investors when considering whether to invest in such securities.**
A.2	*Consent to use the Prospectus*	Not applicable. Financial intermediaries are not entitled to use the prospectus for subsequent resale or final placement of the Offer Securities.

Section B—Issuer		
B.1, B.31	*Company name and trading name*	The company's name is Arion banki hf., with foreign trading name Arion Bank hf.
B.2, B.31	*Registered office and type of company*	The Bank is a public limited company established on 18 October 2008 under Act No. 2/1995 respecting Public Limited Companies, as amended, with ID number 581008-0150 in the Register of Enterprises of the Republic of Iceland ("**Iceland**"). The Bank was initially named New Kaupthing banki hf. and, on 21 November 2009, its name was changed to Arion banki hf. The registered office of the Bank is located at Borgartún 19, 105 Reykjavík, Iceland. The Bank is a financial institution which operates in accordance with Act No. 161/2002 on Financial Undertakings, as amended (the "**Financial Undertakings Act**").
B.3, B.31	*Main business operations*	Arion Bank is a leading universal relationship bank in Iceland with a differentiated and innovative approach. To ensure it is well-balanced and diversified in its product and services offering and expertise, Arion Bank has organised itself across four dedicated divisions, in addition to certain support divisions, and strategically established and acquired subsidiaries that add valuable products and services to its business.

Section B—Issuer		
		Divisions: ***Retail Banking*** provides a comprehensive range of products and services, including mortgage loans, savings and checking accounts, vehicle and equipment financing, factoring, payment cards, pension services, insurance and funds, to both individuals and small- and medium-sized companies. ***Corporate Banking*** provides customised lending solutions, including term loans, revolving credit facilities and guarantees, to large corporate customers across all industry sectors with an emphasis on top 100 companies in Iceland. ***Investment Banking*** provides a full range of investment banking products and services, including equity and fixed income brokerage, initial public offerings and merger and acquisition advisory and bond and equity trading services, to a broad range of customers, including corporate customers, professional investors, asset management companies and pension funds. ***Asset Management***, comprising the Asset Management division of Arion Bank and its wholly owned independent subsidiary Stefnir hf., provides a full range of asset management products and services to institutional investors, such as pension funds and insurance companies, and high net worth individuals. The above four dedicated divisions, together with Treasury and Other divisions and subsidiaries, comprise the Group's reportable segments. *Subsidiaries:* The main subsidiaries of Arion Bank, in addition to Stefnir hf., are set forth below: • Valitor Holding hf. ("**Valitor**") is Arion Bank's international payments platform, with operations primarily in Iceland, the United Kingdom and the Nordic countries, and comprises both card acquiring services and card issuing services. Valitor provides e-commerce and card-present card acquiring services to merchants and corporate customers and provides card issuing services and payment processing solutions to domestic and international partners. Arion Bank is currently assessing a range of strategic alternatives with respect to its ownership of Valitor. In this regard, the Board of Directors examined the feasibility of a spin-off of Valitor to existing shareholders by means of a dividend in kind. The Board of Directors is of the opinion that, although a disposal of Valitor could be in the strategic interests of Arion Bank, the form of any such disposal requires further evaluation and may take the form of a sale of all or a portion of Valitor to a third party. The Board of Directors has resolved to examine the structural options with a view to disposing of Valitor in the medium term. However, no firm decision has been taken at this point in time with respect to a disposal of all or part of Valitor or with respect to the form or timing of any such transaction; and • Vördur tryggingar hf. is a universal insurance company providing policies for motor vehicles, home protection, property and life and health products.
B.4a, B.31	*Trends*	Iceland's economy has made a strong recovery from the financial crisis in 2008 and has currently one of the highest GDPs per capita in the world, amounting to approximately U.S.$52,000 in 2017 *(source: IMF)*. Iceland is a relatively young and growing economy with an average real GDP growth of 3.2% from 2010 to 2017 and an increasing investment demand

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		(source: Arion Bank Research). Real GDP in Iceland increased in each of 2017, 2016 and 2015 by 3.6%, 7.5% and 4.3%, respectively *(source: Statistics Iceland)*. Since 2011, government gross debt as a percentage of GDP has been decreasing, and the International Monetary Fund forecasts that this figure will decrease even further from 63% in 2017 to 33% in 2020 *(source: Statistics Iceland, IMF)*. Iceland's current account surplus stood at 3.7% of GDP and Iceland had a budget surplus of 1.2% of GDP as of and for the year ended 31 December 2017 *(source: Icelandic Central Bank Monetary Bulletin 2017/2)*. Iceland has a population of approximately 350,000 people who enjoy a generally high standard of living. The unemployment rate in Iceland is decreasing and stood at 2.8%, 3.0% and 4.0% in 2017, 2016 and 2015, respectively, which was significantly lower than Sweden, Ireland and the eurozone average *(source: Statistics Iceland, IMF)*. Iceland's economy is diversified and based on the four export pillars of tourism (*i.e.*, as a source of foreign income), seafood, energy and other industrial goods and services. Exports were responsible for approximately 47% of Iceland's GDP, with the tourism and seafood industry sectors amounting to 42% and 16% of exports, respectively, in 2016. In recent years, there has been a significant growth in the number of tourists by 30% in 2015, 40% in 2016 and 24% in 2017, in each as compared to the prior period *(source: Statistics Iceland, Isavia)*. Iceland's strong economy supports its growing and stable banking sector. The banking sector is comprised of the three main banks (Arion Bank, Landsbankinn hf. and Íslandsbanki hf.), which held a combined market share of 52% of loans to households, 80% of loans to corporates and 98% of deposits from customers as of 31 December 2017 *(source: Ministry of Finance and Economic Affairs, Arion Bank, Landsbankinn and Íslandsbanki annual reports)*. Capital controls introduced by the Parliament of Iceland (*Althingi*) in November 2008 with the intent of stabilising the foreign exchange rate of Icelandic Krona (the "**Capital Controls**"), which were limiting the ability of the Icelandic population and corporates to buy or sell foreign currency, were largely lifted in March 2017. ***Retail Banking*** The Icelandic retail banking market is a relatively stable market in a growing economy and, as such, the overall retail banking market is growing. Iceland has a young population, a high level of education and low unemployment rates. These factors have contributed, and are expected to contribute, to an increasing demand for financing and growth in the mortgage loans market in the medium term. For the years ended 31 December 2017, 2016 and 2015, total loans to households in Iceland amounted to ISK 1,770 billion, ISK 1,626 billion, and ISK 1,585 billion, respectively (*source: Icelandic Central Bank, Statistics Iceland*). Deposits in Iceland for the years ended 31 December 2017, 2016 and 2015 totalled ISK 1,652, ISK 1,628 billion and ISK 1,652 billion, respectively (*source: Icelandic Central Bank, Statistics Iceland*). ***Corporate Banking*** The Icelandic corporate banking market is currently experiencing growing demand for credit, and Arion Bank estimates that the total corporate lending market in Iceland (including corporate bond issuance) amounted to ISK 1,904 billion, ISK 1,771 billion and ISK 1,706 billion for the years ended 31 December 2017, 2016 and 2015, respectively. Nevertheless, the

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		corporate banking market has experienced margin pressures since 2013, mainly driven by competition from local pension funds (through their investment in real estate asset-backed securities, rather than direct corporate lending) and, to a limited extent, foreign banks. In addition, foreign banks have increasingly been entering the Icelandic corporate banking market, targeting corporates with international operations, in particular in the seafood industry sector. ***Investment Banking*** New bond issuances in Iceland increased in the aftermath of the financial crisis in 2008 and stabilised in 2014, with new bond issuances amounting to ISK 228 billion, ISK 206 billion and ISK 150 billion for the years ended 31 December 2017, 2016 and 2015, respectively (*source: Nasdaq Iceland*). Real estate companies and covered bond issuances have been the key drivers of such new bond issuances, with institutional investors driving the demand. Historically, Icelandic companies have relied to a greater extent on credit facilities from financial institutions as a source of funding, but Arion Bank expects that the corporate bond market will continue to grow in the future, in part on the basis of expected growth in mergers and acquisitions ("**M&A**") activity. There are various macroeconomic factors that could encourage increased M&A activity in Iceland, including the lowering of the Icelandic Central Bank's benchmark interest rates, low inflation and strong GDP growth in Iceland. Furthermore, Icelandic companies have experienced several years of strong earnings and cash conversion, resulting in deleveraging which enables them to access the credit markets in order to finance acquisitions. ***Asset Management*** The savings market in Iceland has historically been largely dominated and driven by pension funds, and Arion Bank expects there to be a continued inflow into pension schemes in the coming years. Since the financial crisis in 2008, the market has seen continued growth, greater international investment and a broadening of product offerings. The assets held by pension funds in Iceland are currently approximately 30 times larger than the financial assets managed by insurance companies, and the pension funds' investable assets as a percentage of GDP were over 152% as of 31 December 2017 *(source: Icelandic Central Bank, Statistics Iceland)*. Arion Bank estimates that total assets under management in the domestic investment management industry, excluding pension funds, reached approximately ISK 2,500 billion as of 31 December 2017 (including fund management companies). ***Card and Electronic Payments*** The Icelandic card payments market is growing, with a steady increase in total household payment card turnover since 2014. Foreign card payments have also been growing every month (on a year-on-year basis) since 2014, following a clear seasonal pattern. Trends in the electronic payments market are also driving high growth, as countries worldwide increasingly move towards a cashless society. During the year ended 31 December 2016, card transactions accounted for 56% of all consumer payment transactions in the United Kingdom, 76% of all consumer payment transactions in Norway, Denmark and Sweden and 31% of all consumer payment transactions in Western Europe, and these numbers are expected to increase to 65%, 80% and 39%, respectively, by 2020 *(source: Euromonitor, WW New Media Market Model)*.

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B.5, B.31 *The Group*

Arion Bank is the parent company of the Group, which consists of a number of subsidiaries. The terms “Arion Bank”, the “Bank” and the “Group” refer to Arion Bank and its consolidated subsidiaries, unless the context otherwise requires.

B.6, B.31 *Major shareholders, etc.*

As of the date of this Prospectus, Kaupskil ehf. and Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP), as the Selling Shareholders, hold 68.01% of the issued Shares. After completion of the Offering, the Selling Shareholders will continue to hold 38.60% of the issued and outstanding Shares, assuming that the Over-Allotment Option is not exercised and that the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares.

The table below sets forth certain information with respect to the ownership of the Shares immediately prior to the Offering on an actual basis and immediately after the Offering (i) as adjusted for the Offering assuming that the Over-Allotment Option is not exercised and that the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares and (ii) as adjusted for the Offering assuming that the Over-Allotment Option is exercised in full and that the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares:

	Actual		As adjusted for the Offering if the Over-Allotment Option is not exercised		As adjusted for the Offering if the Over-Allotment Option is exercised in full	
Shareholder	**Number**	**%[(1)]**	**Number**	**%[(1)]**	**Number**	**%[(1)]**
Kaupskil[(2)]	1,111,401,629	55.57	523,151,629	26.16	434,914,129	21.75
Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP)	248,799,999	12.44	248,799,999	12.44	248,799,999	12.44
Taconic Capital Advisors UK LLP (through TCA New Sidecar III s.à r.l.)	199,999,999	9.99	199,999,999	9.99	199,999,999	9.99
Sculptor Investments s.à r.l. (an affiliated entity of Och-Ziff Capital Management Group)	131,522,115	6.58	131,522,115	6.58	131,522,115	6.58
Goldman Sachs International (through ELQ Investors II Limited)	67,400,000	3.37	67,400,000	3.37	67,400,000	3.37
Arion Bank[(3)]	190,000,000	9.50	190,000,000	9.50	190,000,000	9.50
Other shareholders[(4)]	50,876,258	2.54	50,876,258	2.54	50,876,258	2.54
New shareholders[(5)]	—	—	588,250,000	29.41	676,487,500	33.82
Total	**2,000,000,000**	**100.0**	**2,000,000,000**	**100.0**	**2,000,000,000**	**100.0**

(1) Percentages reflect rounding to the nearest hundredth of a percent.

(2) Kaupskil is a wholly owned subsidiary of Kaupthing. Following the Offering, Immediately upon conclusion of the Offering, Kaupthing is permitted, based upon the FME decision regarding Kaupthing’s eligibility as a qualified holder, to determine to hold its interest in the Shares directly rather than through Kaupskil and without the conditions previously imposed by the FME. By virtue of indirect holdings, the shareholders of Arion Bank named above hold the following beneficial interests in the share capital of Arion Bank: Attestor Capital LLP: 4.39%; Taconic Capital Advisors UK LLP: 26.65%; Och-Ziff Capital Management Group: 3.30%; Goldman Sachs International: 1.82%. Consequently, when combined with their direct holding of Shares, the aggregate beneficial ownership of each in the share capital of the Bank is as follows: Attestor Capital LLP: 16.83%; Taconic Capital Advisors UK LLP: 36.64%; Och-Ziff Capital Management Group: 9.88%; Goldman Sachs International: 5.19%.

(3) In February 2018, Arion Bank acquired 9.5% of its own Shares in a buyback transaction with Kaupskil for ISK 17.1 billion. No voting rights are attached to Arion Bank’s own shares while held by Arion Bank. Arion Bank is considering cancelling a portion of the Shares it currently holds and has no intention of selling such Shares into the market; however, the Bank intends to retain a portion of such Shares for a one-time employee incentive bonus, based on authority

		granted at a meeting of shareholders on 9 May 2018, to be awarded to all employees as a bonus, in the form of a restricted grant of Shares (the "**Stock Grant**"). The award remains conditional on successful completion of the Offering and admission to trading on NASDAQ Iceland and NASDAQ Stockholm (to occur no later than 31 December 2018). Arion Bank estimates that the total value of the Stock Grant will be approximately ISK 675 million. (4) Other shareholders comprise established Icelandic investment funds, which acquired such Shares in a private placement transaction in February 2018. (5) New Shareholders include the Cornerstone Investors.
B.7, B.31	*Selected consolidated financial information*	The selected consolidated financial information as of and for the years ended 31 December 2017, 2016 and 2015 has, unless otherwise stated and except for the below, been derived from Arion Bank's audited consolidated financial statements for the financial years ended 31 December 2017, 2016 and 2015, prepared in accordance with International Financial Reporting Standards, as adopted by the European Union ("**IFRS**"), and additional requirements set forth in Act No. 3/2006 on Annual Accounts, as amended (the "**Annual Accounts Act**"), the Financial Undertakings Act and rules on Accounting for Credit Institutions. Due to the following reclassification, certain line items in the selected consolidated information for the years ended 31 December 2016 and 2015 differ from the respective audited Annual Financial Statements included herein: • In the periods prior to the year ended 31 December 2017, net income from non-current assets held for sale was classified as "Discontinued operations, net of tax". In the audited consolidated financial statements as of and for the year ended 31 December, 2017 (the "**2017 Financial Statements**"), net income from non-current assets held for sale was presented among "Other operating income". • In the periods prior to the year ended 31 December 2017, non-current assets and disposal groups held for sale were presented within "Other assets". In the 2017 Financial Statements "Non-current assets and disposal groups held for sale" were presented as a separate line item. • In the periods prior to the year ended 31 December 2017, "Cash and cash equivalents acquired through business combination" was presented as a separate reconciling line item below "Net increase in cash and cash equivalents". In the 2017 Financial Statements "Cash and cash equivalents acquired through business combination" was presented within "Net cash (to) from investing activities". • In the periods prior to the year ended 31 December 2017, the operating segment information has been presented without allocated expense from supporting divisions to business segments. Bank levy has also been excluded from the operating segment information. In the 2017 Financial Statements, allocated expense from supporting divisions to business segments has been added as well as allocation of bank levy. • In the periods prior to the year ended 31 December 2016, the earned premium of subsidiary Okkar líftryggingar hf. was presented as "Other operating income" and claims incurred were presented as "Other operating expense". Since 2016 those amounts are presented in the separate line item "Net insurance income". Accordingly, the selected consolidated financial information as of and for the years ended 31 December 2017, has, unless otherwise stated, been derived from the 2017 Financial Statements. In order to present information on a consistent basis with the presentation adopted in the 2017 Financial Statements, the selected consolidated financial information as of and for the

		year ended 31 December 2016 has, unless otherwise stated, been derived from the unaudited comparative information included in the 2017 Financial Statements that reflects those line item reclassifications, and the selected consolidated financial information as of and for the year ended 31 December 2015 has been derived from the accounting records, in respect of the reclassifications made in the 2017 Financial Statements. In order to present information on a consistent basis with the presentation adopted in the audited consolidated financial statements as of and for the year ended 31 December 2016 (the "**2016 Financial Statements**"), the selected consolidated financial information as of and for the year ended 31 December 2015 has, unless otherwise stated, been derived from the unaudited comparative information included in the 2016 Financial Statements that reflects those line item reclassifications. The selected condensed consolidated interim financial information as of and for the three months ended 31 March 2018 has, unless otherwise stated, been derived from Arion Bank's unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018 prepared in accordance with International Accounting Standard 34, Interim Financial Reporting ("**IAS 34**"). On 1 January 2018, the Group adopted IFRS 9, Financial Instruments ("**IFRS 9**") and, as permitted by the transition provisions of IFRS 9, the comparative period was not restated; accordingly, all comparative period information presented in this Prospectus is presented in accordance with International Accounting Standard 39, Financial Instruments: Recognition and Measurement ("**IAS 39**"). The Group also elected, as a policy choice permitted under IFRS 9, to continue to apply hedge accounting under IAS 39. The impact of the adoption of the new standard of ISK 942 million has been recognised directly in retained earnings on 1 January 2018. In addition, on 1 January 2018 the Group also adopted IFRS 15, Revenue from Contracts with Customers ("**IFRS 15**"). IFRS 15 was applied using the modified retrospective method, with the effect of initial application recognised on the date of initial application and without restatement of the comparative periods. The adoption of IFRS 15 did not, in the Bank's view, have a material impact on the Consolidated Statement of Comprehensive Income. The audited consolidated financial statements as of and for the years ended 31 December 2017, 2016 and 2015 do not reflect the changes from the application of IFRS 9 and IFRS 15. Those audited consolidated financial statements applied International Accounting Standard ("**IAS**") 39, Financial Instruments: Recognition and Measurement ("**IAS 39**") and IAS 18, Revenue ("**IAS 18**"), which were the accounting standards in effect at the time for each period. Therefore, due to the adoption of the new accounting standards, the consolidated financial statements as of and for the years ended 31 December 2017, 2016 and 2015 and the comparative figures as of and for the three months period ended 31 March 2017, are not directly comparable with the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018.

Section B—Issuer

Consolidated Statement of Comprehensive Income

	Three months ended 31 March		Year ended 31 December		
	2018	2017	2017	2016	2015
	(ISK in millions)				
Interest income	14,162	13,723	57,089	61,655	54,546
Interest expense	7,254	(6,563)	(27,254)	(31,755)	(27,554)
Net interest income	**6,908**	**7,160**	**29,835**	**29,900**	**26,992**
Fee and commission income	8,197	6,091	29,777	23,887	21,234
Fee and commission expense	(4,655)	(2,761)	(14,420)	(9,909)	(6,750)
Net fee and commission income	**3,542**	**3,330**	**15,357**	**13,978**	**14,484**
Net financial income	1,340	1,230	4,091	5,162	12,844
Net insurance income	143	447	2,093	1,395	760
Share of profit of associates and net impairment	(18)	(34)	(925)	908	29,466
Other operating income	269	564	2,927	3,203	2,074
Operating income	**12,184**	**12,697**	**53,378**	**54,546**	**86,620**
Salaries and related expense	(4,636)	(4,222)	(17,189)	(16,659)	(14,892)
Other operating expenses	(3,996)	(3,834)	(12,772)	(13,881)	(12,919)
Bank levy	(804)	(797)	(3,172)	(2,872)	(2,818)
Net impairment	(99)	880	186	7,236	(3,087)
Earnings before tax	**2,649**	**4,724**	**20,431**	**28,370**	**52,904**
Income tax expense	(818)	(1,371)	(5,806)	(6,631)	(3,225)
Net earnings from continuing operations	**1,831**	**3,353**	**14,625**	**21,739**	**49,679**
Discontinued operations, net of tax	118	—	(206)	—	—
Net earnings	**1,949**	**3,353**	**14,419**	**21,739**	**49,679**
Other comprehensive income					
Net gain on financial assets carried at fair value through OCI, net of tax	30	—	—	—	—
Realised net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement	(97)	—	—	—	—
Net gain on AFS financial assets, net of tax	—	—	—	(2,903)	2,903
Exchange difference on translating foreign subsidiaries	(59)	44	(5)	182	13
Total comprehensive income	**1,823**	**3,397**	**14,414**	**19,018**	**52,595**
Shareholders of Arion Bank	1,823	3,396	14,395	18,426	44,884
Non-controlling interest	—	1	19	592	7,711

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Consolidated Statement of Financial Position

	As of 31 March 2018	As of 31 December 2017	2016	2015
	(ISK in millions)			
Assets				
Cash and balances with Central Bank	97,934	139,819	87,634	48,102
Loans to credit institutions	94,961	86,609	80,116	87,491
Loans to customers	782,255	765,101	712,422	680,350
Financial instruments	106,415	109,450	117,456	133,191
Investment property	6,749	6,613	5,358	7,542
Investments in associates	743	760	839	27,299
Intangible assets	13,498	13,848	11,057	9,285
Tax assets	611	450	288	205
Non-current assets and disposal groups held for sale	8,496	8,138	4,418	5,082
Other assets	20,107	16,966	16,436	12,496
Total assets	**1,131,769**	**1,147,754**	**1,036,024**	**1,011,043**
Liabilities				
Due to credit institutions and Central Bank	7,880	7,370	7,987	11,387
Deposits	453,059	462,161	412,064	469,347
Financial liabilities at fair value	3,130	3,601	3,726	7,609
Tax liabilities	6,885	6,828	7,293	4,922
Other liabilities	55,715	57,062	54,094	49,461
Borrowings	400,855	384,998	339,476	256,058
Subordinated liabilities	—	—	—	10,365
Total liabilities	**927,524**	**922,020**	**824,640**	**809,149**
Equity				
Share capital and share premium	58,722	75,861	75,861	75,861
Other reserves	14,880	16,774	19,761	4,548
Retained earnings	130,515	132,971	115,590	112,377
Total shareholders' equity	**204,117**	**225,606**	**211,212**	**192,786**
Non-controlling interest	128	128	172	9,108
Total equity	**204,245**	**225,734**	**211,384**	**201,894**
Total liabilities and equity	**1,131,769**	**1,147,754**	**1,036,024**	**1,011,043**

Selected Consolidated Statement of Cash Flows

	Three months ended 31 March		Year ended 31 December		
	2018	2017	2017	2016	2015
	(ISK in millions)				
Net cash from operating activities	(9,658)	94,577	62,663	17,476	36,593
Net cash from (used in) investing activities	(623)	(532)	(5,036)	21,366	16,026
Net cash used in financing activities	(24,254)	—	(63)	(18,171)	(32,810)
Cash and cash equivalents at beginning of the period	181,898	123,933	123,933	110,000	91,715
Effect of exchange rate changes on cash and cash equivalents	(1,047)	439	401	(6,738)	(1,524)
Cash and cash equivalents at the end of the period	**146,316**	**218,417**	**181,898**	**123,933**	**110,000**

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Reconciliation of Consolidated Statement of Financial Position, transition from IAS 39 to IFRS 9 as of 1 January 2018

	IAS 39 as of 31 December 2017	Impact of classification and measurement	Impact of impairment(1)	Total impact	IFRS 9 as of 1 January 2018
			(ISK in millions)		
Assets					
Cash and balances with Central Bank	139,819	—	(7)	(7)	139,812
Loans to credit institutions	86,609	—	(3)	(3)	86,606
Loans to customers	765,101	486	930	1,416	766,517
Financial instruments	109,450	—	—	—	109,450
Investment property	6,613	—	—	—	6,613
Investments in associates	760	—	—	—	760
Intangible assets	13,848	—	—	—	13,848
Tax assets	450	—	—	—	450
Non-current assets and disposal groups held for sale	8,138	—	—	—	8,138
Other assets	16,966	—	—	—	16,966
Total assets	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**
Liabilities					
Due to credit institutions and Central Bank	7,370	—	—	—	7,370
Deposits	462,161	—	—	—	462,161
Financial liabilities at fair value	3,601	—	—	—	3,601
Tax liabilities	6,828	97	138	235	7,063
Other liabilities	57,062	—	229	229	57,291
Borrowings	384,998	—	—	—	384,998
Total liabilities	**922,020**	**97**	**367**	**464**	**922,484**
Equity					
Share capital and share premium	75,861	—	—	—	75,861
Other reserves	16,774	—	3	3	16,777
Retained earnings	132,971	389	550	939	133,910
Total shareholders' equity	**225,606**	**389**	**553**	**942**	**226,548**
Non-controlling interest	128	—	—	—	128
Total equity	**225,734**	**389**	**553**	**942**	**226,676**
Total liabilities and equity	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**

(1) Impact of impairment arises not from a specific asset or assets but rather from the application of the new "expected credit loss" impairment models.

The above reconciliation table presents the measurable impact of IFRS 9 on the Bank's consolidated statement of financial position. In addition:

- IFRS 9 requires debt instruments to be classified based on the business model and cash flow characteristics of the instrument, rather than based on reasons for individual purchases. Based on the new requirements, a portion of the Bank's assets were reclassified from amortised cost to fair value through profit and loss and from fair value through profit and loss to fair value through other comprehensive income. The effect of reclassification from fair value thorough profit and loss to fair value through other comprehensive income had no effects on the carrying value of the Bank's assets.
- IFRS 9 replaces the "incurred credit loss" model used under IAS 39 with an "expected credit loss" ("**ECL**") model. The changes from incurred to expected credit losses requires professional judgement over various factors used in the calculation of ECLs, such as how macroeconomic scenarios affect the ECL calculation. The new "expected credit" impairment models apply to financial assets that are debt instruments (including loans to customers) measured at amortised cost or fair value reported in other comprehensive income ("**FVOCI**"), lease receivables, loan commitments and financial guarantee contracts. Equity instruments are not subject to

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		impairment. The implementation of new models caused a decrease in the overall loss allowance. Excepted loss allowance for loan commitments and financial guarantees are presented under Other liabilities. **Material changes since 31 March 2018** The Group's trading performance since 31 March 2018 has, in the Bank's view, progressed favourably. Net interest income improved in April, partly due to higher inflation, which positively affects the Bank's interest margin as it has more inflation-linked assets than liabilities. Net interest income was also positively affected by a repayment of a bond issue with a relatively high coupon in the first quarter of 2018, reducing interest expense. The Bank's loan book has grown in line with the first quarter, with continued growth in mortgages, SMEs and corporate lending. There has been improvement in the Group's insurance business after a difficult first quarter. The cost base has followed trends observed in the three months ended 31 March 2018, and no significant developments on loan impairments have occurred since the end of the first quarter. The pipeline for new lending and projects in corporate advisory remains healthy. Other than as described above, there has been no significant change in the financial or trading position of the Group since 31 March 2018, the end of the last financial period for which financial information was prepared.
B.8	*Selected pro forma accounts*	Not applicable. The Prospectus contains no pro forma accounts.
B.9, B.31	*Earnings forecast*	Not applicable. The Prospectus contains no earnings forecast or calculation of anticipated earnings.
B.10, B.31	*Qualification of audit report*	Not applicable. There are no qualifications of audit reports.
B.11	*Insufficient working capital*	Not applicable. It is Arion Bank's opinion that its working capital is sufficient for its present requirements.
B.32	*Name/legal form/ domicile of the issuer of the Swedish depository receipts*	The Custodian, as issuer of the Swedish depository receipts, is Skandinaviska Enskilda Banken AB (publ) ("**SEB**" or the "**Custodian**"), a banking association organised under the laws of Sweden. The Custodian is primarily regulated by the Swedish FSA. Its registered office is at Kungsträdgårdsgatan 8, SE-106 40 Stockholm, Sweden. The Custodian was incorporated in 1971.

Section C—Securities		
C.1, C.13, C.14	*Securities offered*	Ordinary shares of the Bank, each with a par value of ISK 1.00 (the "**Existing Offer Shares**") (ISIN code: IS0000028157) Swedish depository receipts, each representing one ordinary share of the Bank, ("**SDRs**") (ISIN code: SE0010413567) (together, the "**Offer Securities**").
C.2, C.13, C.14	*Denomination*	The Shares are denominated in ISK. The SDRs are denominated in Swedish krona ("**Swedish Krona**" or "**SEK**").

Section C—Securities		
		The Shares will be traded in ISK on NASDAQ Iceland and the SDRs will be traded in SEK on NASDAQ Stockholm.
C.3, C.13	*Number of shares in the issuer*	As of 31 March 2018, Arion Bank's articles of association provide for a total share capital in the amount of ISK 2,000,000,000, represented by 2,000,000,000 Shares, each with a par value of ISK 1.00. All Shares are fully paid. In February 2018, the Bank acquired 190,000,000, or 9.5%, of its Shares in a transaction with Kaupskil for a price of ISK 90.203 per Share, the amount for which was deducted from the dividend payment of ISK 25 billion approved by the shareholders' meeting on 12 February 2018. The authority to buy back such Shares arose from a temporary provision in the Bank's Articles of Association, which was approved at the same shareholders' meeting and which expired on 15 April 2018. No voting rights are attached to the Bank's own Shares while held by the Bank.
C.4, C.13, C.14	*Rights associated with the securities*	*Shares* The Annual General Meetings are held before the end of April each year. The supreme authority in the affairs of the Bank is in the hands of legitimate shareholders' meetings. One vote is attached to each Icelandic Krona of share capital, and decisions at shareholders' meetings are generally taken by majority vote. No special rights are attached to the Shares. An increase in the share capital of the Bank may be authorised at a meeting of shareholders. Shareholders have pre-emptive rights to an increase in the Bank's share capital in proportion to their holdings of the Shares and within the time limits specified in the resolution to increase the share capital. However, a meeting of shareholders can, by a two-thirds majority vote, waive pre-emptive rights to increases of share capital, if there is no discrimination. Payment of dividends is proposed by the Board of Directors and must be approved by the shareholders at a general meeting (whether an annual general Meeting or an extraordinary general meeting). Dividends must be paid no later than six months after the date of the general meeting at which such dividends were approved. Any dividends declared are payable to the shareholders of record at the time of the payment of dividends. However, the general meeting may decide that the dividends will be payable to the shareholders of record on a different date, provided that the alternative date is stipulated in the general meeting's resolution on dividend payment and is notified to the market via NASDAQ Iceland. The date for the payment of dividends is decided by the shareholders at the general meeting. Dividends are declared at the general meeting and paid in Icelandic Krona. The Bank withholds Icelandic tax on dividends. Upon liquidation of the Bank, shareholders would be entitled to receive proportionately any assets remaining after the payment of Arion Bank's debt and taxes and the expenses of the liquidation. *SDRs* The Company shall at the latest 21 calendar days before and not earlier than 28 calendar days prior to the shareholders' meeting inform SEB of the shareholders' meeting. As soon as practicable thereafter the Company shall

Section C—Securities		
		notify the Depository Receipt Holders of the shareholders' meeting. The notification shall include i) the Company's name and registration number, ii) the type of shareholders' meeting to be held, iii) the time and location of the shareholders' meeting, iv) information on how to find the convening notice in full and the agenda of the shareholders' meeting on the Company's website, v) the Record Date for the Depository Receipt Holders, and vi) instructions regarding any measures to be taken by the Depository Receipt Holder in order to be able to vote at the shareholders' meeting by attending the meeting in person or to authorise a person to attend and vote for him or by instructing SEB to vote by proxy form. Only Depository Receipt Holders registered in the VPC Register five (5) calendar days before the shareholders' meeting and who have, no later than five (5) calendar days before the meeting, notified SEB or its representative that they shall attend and vote at the meeting or have instructed SEB to vote by proxy form, are entitled to attend the meeting either in person or by an authorised attorney or vote by proxy form. SEB, as registered owner of the Shares, shall appoint as proxies, all those Depository Receipt Holders who have notified SEB or its representative of their intention to be represented at the shareholders' meeting. Such proxies shall be presented to the Company together with a list of the Depository Receipt Holders for whom proxies have been issued. The Company shall upon request from a Depository Receipt Holder, send the material for the shareholders' meeting provided through the Company's website by mail. The payment of dividends for the SDRs shall take place in Swedish kronor ("**SEK**") to those persons who, on the relevant record date, are registered in the VPC Register as Depository Receipt Holders or rights holders in respect of dividends. In conjunction with every distribution, SEB shall, in consultation with the Company, determine the date of the payment of dividends ("**Payment Date**"). Payment of dividends to Depository Receipt Holders or holders of other rights to the dividend, shall take place on the Payment Date through Euroclear and in accordance with the rules and regulations applied by Euroclear from time to time. SEB shall convert dividends in foreign currency into SEK in accordance with the exchange rates applied by SEB from time to time, which shall be set in accordance with public market rates, prior to payment taking place. The conversion of foreign currency into SEK shall take place three (3) banking days before the Payment Date. The dividend amount distributed per SDR will be rounded down to the nearest whole öre. Surplus amounts, which as a consequence of a rounding are not paid, shall be repaid by SEB to the Company. The payment of dividends to Depository Receipt Holders shall be made without any deduction of any costs, fees, or equivalents thereto which are related to the Company, SEB, the Sub-Custodian or any of their respective agents. However, deductions shall be made for Swedish preliminary income tax, withholding tax or other taxes which are to be withheld pursuant to Swedish law or agreements with foreign tax authorities as well as for any taxes which may be imposed pursuant to Swedish, Icelandic or applicable provisions of another country. Under current Swedish law, it is expected that any cash which is held for holders of SDRs by the Custodian as banker under the terms and conditions of the SDRs would constitute an unsecured obligation of the Custodian. Holders of the SDRs would therefore only have an unsecured claim in the event of the Custodian's insolvency for such cash, and such cash would also be available to general creditors of the Custodian. However, the Custodian is obliged under Swedish law to separate the SDRs from securities

Section C—Securities		
		belonging to the Custodian and such SDRs therefore would not form part of the bankruptcy estate of the Custodian. Under the terms and conditions of the SDRs, if the Custodian fails to pay cash or deliver non-cash assets to holders of the SDRs in the circumstances required by the terms and conditions, the Custodian will be in breach of its contractual obligations under such terms and conditions, and holders of the SDRs would have a claim under Swedish law against the Custodian for the Custodian's breach of its contractual obligations under terms and conditions of the SDRs. Under the terms and conditions applicable to the SDRs, the Custodian has the right to terminate the SDR arrangements with the Bank in certain circumstances. In such a case, the Custodian will provide holders of the SDRs with a notice of termination, which shall contain the record date upon which SEB shall de-register all the SDRs and transfer the Shares to a custodian account as instructed by each relevant holder of SDRs or as otherwise agreed with the holder of the SDRs. In the event (i) the holder of the SDRs has not provided a transfer instruction with a designated custodian account, (ii) it is not practically possible to transfer the Shares in accordance with the transfer instruction by the holder of the SDRs or (iii) an agreement has otherwise not been reached, SEB is entitled to sell the underlying Shares. The holder of the SDRs shall be entitled to the proceeds of such sale following deduction for fees, taxes and reasonable costs. The amount shall be paid to the cash account linked to respective VPC Account of the holder of the SDRs concerned or in the absence of such cash account, in the form of a payment notice. No interest shall accrue on the amount.
C.5, C.13, C.14	*Restrictions on transferability*	Neither the Shares nor the SDRs are subject to restrictions on transferability on NASDAQ Iceland or NASDAQ Stockholm. The Bank's articles of association do not contain any limitations on the ability to transfer the Shares, and shareholders may pledge the Shares unless otherwise prohibited by law. Pre-emptive rights to increases in the share capital are transferable according to the Icelandic Public Limited Companies Act. However, special rules apply to qualifying holdings in financial institutions pursuant to Articles 40-49.b of the Financial Undertakings Act. Parties who propose to acquire a qualifying holding in a financial institution must seek in advance the approval of the FME. In addition, the approval of the FME is required when a party, alone or jointly with others, intends to increase its holding to such an extent that the direct or indirect ownership in the share capital, guarantee capital or voting rights reaches or exceeds 20.0%, 33.0% or 50.0% or comprises such a large portion that the financial institution may be regarded as its subsidiary company. A "qualifying holding" is a direct or indirect holding in a financial undertaking which represents 10.0% or more of its share capital, guarantee capital or voting rights or any other holding which enables the exercise of a significant influence on the management of the financial institution. If the owner of a "qualifying holding" intends to reduce its shareholding with the result that such owner will not subsequently own a "qualifying holding", this is required to be reported to the FME in advance together with the shareholding following the reduction. If the shareholding decreases below the specified levels or to such an extent that the financial institution ceases to be a subsidiary of the parent company in question, this is also required to be reported. A person acquiring the Shares cannot exercise its rights as a shareholder until such person's name has been registered in the Bank's share registry or such person has announced and proven the ownership of the Shares.

Section C—Securities		
C.6, C.13	*Admission to trading*	Application has been made to list and admit all of the Shares to trading under the symbol "ARION" on NASDAQ Iceland and to admit up to 2,000,000,000 SDRs to trading under the symbol "ARIONs" on NASDAQ Stockholm.
C.7, C.13	*Dividend policy*	Based on the Bank's expected financial performance over the medium term, the Bank aims to pay an annual dividend, before special distributions, in line with a payout ratio of approximately 50% of net earnings attributable to shareholders.

Section D—Risks		
D.1, B.31	*Main risks associated with the issuer or the industry*	Any investment in the Offer Securities is associated with risks. Prior to any investment decision, it is important to carefully analyse the risk factors considered relevant to the future development of Arion Bank and the Offer Securities. These risks include, among others, the following main industry- and business-related risks, any of which could have a material adverse effect on Arion Bank's business, prospects, financial position and/or results of operations: • Arion Bank may be adversely affected by economic and political events in Iceland that could diminish the ability of Arion Bank's customers to repay their loans. The Icelandic economy and, in turn, Arion Bank may also be adversely affected by economic and political events in Iceland's key trading markets, such as the United Kingdom, the United States and the European Union. The relatively small size of Icelandic economy, reluctance of the private sector to engage in lending activities, limited scope for international operations and relatively high levels of problem loans held by Icelandic banks may restrict Arion Bank's near-term growth prospects; • public sentiment towards the banking sector or changes in Icelandic law could impair Arion Bank's operations and / or restrict its ability to pay dividends; • Arion Bank's operations are funded largely by uninsured demand deposits, exposing Arion Bank to liquidity risk arising from maturity mismatch between its assets and liabilities. Arion Bank's increasing reliance on non-deposit funding also makes it vulnerable to adverse changes in debt and equity markets; • Arion Bank is exposed to interest rate, maturity, inflation, foreign exchange and other risks, which may produce asset-liability mismatches that restrict Arion Bank's liquidity. Arion Bank is also exposed to various risks in its customer loan portfolio, arising from its holdings of problem loans, significant exposure to the real estate and seafood industry sectors and concentrated exposure to Icelandic borrowers; • as an Icelandic financial institution, Arion Bank is subject to a special tax on its indebtedness and to a further special tax on employee remuneration. These and other levies may increase Arion Bank's funding and operating costs and place Arion Bank at a competitive disadvantage to domestic and foreign lenders who are not subject to such additional taxes; • Arion Bank may fail to implement its business strategy successfully, and unforeseen political, economic or market developments or

Section D—Risks		
		developments arising from acquisitions or disposals may adversely affect Arion Bank and hinder it from implementing its business strategy; • Arion Bank may face increased competition from Icelandic banks and other financial institutions, including foreign financial institutions; • Arion Bank may fail to comply with applicable laws or regulations, which could result in enforcement actions, lawsuits, and / or reputational damage. Arion Bank may also be subject to lawsuits and / or other claims and investigations; • Arion Bank's operations may be impaired and it may face increased costs, litigation and / or reputational damage as a result of failure or breach of its information technology systems or disclosure of confidential information, whether or not related to such failure or breach; • Arion Bank may suffer a credit rating downgrade, increasing its funding costs; • Arion Bank is exposed to various operational risks, including the risk of damage to its or any of its subsidiaries' reputation, failure of Arion Bank's risk management systems or other internal controls, employee misconduct or human error, failure to hire or retain key management, failure or disruption of services provided by third parties, failure to maintain adequate insurance coverage and restriction, suspension or termination of operating licences; • full implementation of the capital requirements directive adopted by the European Parliament and the European Council in 2013 for the implementation of the Basel III framework in the European Union or changes thereto may require Arion Bank to raise additional capital through the issuance of new securities to meet its regulatory capital requirements and may also limit Arion Bank's ability to pay dividends; • Arion Bank and its subsidiary Valitor depend on membership in Visa and MasterCard card schemes. Increased costs for participating in these schemes may reduce Arion Bank and Valitor's margins, and changes in Arion Bank's or Valitor's relationship with the card schemes could adversely affect Arion Bank's and Valitor's operations; and • Arion Bank's asset management operations may face increased costs as a result of new regulations as well as experience increased redemptions and withdrawals as a result of poor performance or increased competition, whether domestic or from foreign asset managers as the Capital Controls are eased, reducing the operating income of the asset management operations. There are additional industry- and business-related risks, including legal and financial risks, and there may also be risks that Arion Bank is currently unaware of.
D.3, D.5	*Main risks associated with the securities*	The main risks relating to the Offering and the Offer Securities include, among others: • general risks related to the Offer Securities (risks and risk taking are an unavoidable aspect of owning shares and SDRs and, because an investment in shares or SDRs can both rise and fall in value, it is not certain that an investor will recover the capital invested, whether as a result of general market fluctuations, exchange rate fluctuations or otherwise);

Section D—Risks		
		• future dividends (the size of any future dividends depends on Arion Bank's ability to pay dividends to its shareholders, which in turn depends on its future earnings, financial position, cash flows, capital requirements, results of operations, general public and political sentiment and other factors); • risks relating to an investment in the SDRs (relating to the insolvency or default of the Custodian or Sub-custodian for the SDRs or termination of the SDR arrangements by the Custodian, withholding tax in both Iceland and Sweden); and • the potential for substantial future sales of shares by the Selling Shareholders or Kaupthing.

Section E—Offering		
E.1	*Issue amount and issue expenses*	The gross proceeds from the Offering to be received by the Selling Shareholders will be approximately ISK 43,236 million (assuming the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares and that the Over-Allotment Option is not exercised). The aggregate underwriting commissions, other fees and expenses (including regulatory filing and registration expenses) and amounts to be paid by the Selling Shareholders in connection with the Offering are expected to be up to approximately ISK 1,474 million (assuming the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares and that the Over-Allotment Option is not exercised).
E.2a	*Reasons and use of the issue proceeds*	The Offering and the listing of the Offer Securities on NASDAQ Iceland and NASDAQ Stockholm will expand the shareholder base and enable Arion Bank to access the Icelandic, the Swedish and other international capital markets. The Board of Directors and the Executive Committee consider the Offering and listing of the Offer Securities on NASDAQ Iceland and NASDAQ Stockholm to be a logical step for Arion Bank. The listing is a quality mark and increases the awareness of Arion Bank and its brand, which is expected to increase its ability to attract new customers and to strengthen the franchise value of Arion Bank. The Bank will not receive any proceeds from the sale of the Offer Securities by the Selling Shareholders, all of which will be paid to the Selling Shareholders.
E.3	*Form and terms of the Offering*	The Offering applies to already issued shares in Arion Bank held by the Selling Shareholders (whether sold in the form of Shares or SDRs). The Selling Shareholders and the Bank will agree on the final number of the Offer Securities sold in the Offering in close consultation with the Joint Global Coordinators, and in any case the Offering will comprise Offer Securities representing a minimum of 25.0% of the total issued and outstanding share capital of the Bank and a maximum of 40.0% of the total issued and outstanding share capital. All Offer Securities being sold to investors pursuant to the Offering will be sold at the Offer Price.

Section E—Offering		
		The Offering is being made by way of: • a public offering to Icelandic investors in accordance with Article 43(1) of the Securities Transactions Act; • a public offering to Swedish investors; and • an institutional offer: (i) to certain institutional investors outside the United States in reliance on Regulation S and in accordance with locally applicable laws and regulations, and (ii) in the United States, only to QIBs in reliance on Rule 144A or pursuant to another exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act. The price at which the Offer Shares will be sold (the "**Offer Price**") is expected to be between ISK 68 and ISK 79 per Existing Offer Share and SDR and will be determined through a book-building process. The Offer Price will be set in ISK and, for purposes of sales of SDRs via NASDAQ Stockholm, will be translated to SEK based on the prevailing selling rate of exchange published by the Central Bank of Iceland on 14 June 2018. Allocation of the Offer Securities among the public offerings in Iceland and Sweden and the institutional offering will be at the sole discretion of Kaupskil, in close consultation with the Joint Global Coordinators and the Bank. When allocating the Offer Securities, the objectives of the Offering will be taken into account, i.e., encouraging increased liquidity of the Offer Securities, creating a more diverse shareholder base, selling the Offer Securities at the best price for the Selling Shareholders and enabling a good secondary market in the Offer Securities. Allocation to employees of the Bank, Kaupthing and Kaupskil may be accorded some priority at the sole discretion of the Selling Shareholders and the Bank. The result of the Offering is expected to be published on 15 June 2018, and NASDAQ Iceland and NASDAQ Stockholm will subsequently give an answer to the Bank's application to have the Offer Securities admitted to trading on the regulated markets of NASDAQ Iceland and NASDAQ Stockholm. Subsequently, information on the allocation of the Shares to investors in the Offering will be sent to investors, expected on 15 June 2018 if a positive answer has been received from NASDAQ Iceland and NASDAQ Stockholm on 15 June 2018, the final due date is then set for 19 June 2018 (18 June 2018 for retail investors in Iceland) and paid Offer Securities will be delivered to the buyer at the latest two business days after payment is received. Pursuant to the above information, the first expected day of conditional trading of the Offer Securities (conditional on admission) is 15 June 2018, and the first expected day of unconditional trading of the Offer Securities on the regulated markets of NASDAQ Iceland and NASDAQ Stockholm is 19 June 2018, being also the expected date of admission. The above dates assume that the Selling Shareholders do not change the offer period, the processing of orders does not take a shorter or longer time than the Selling Shareholders expected and the Bank's applications to NASDAQ Iceland and NASDAQ Stockholm are responded to within the timeframe expected by the Selling Shareholders.

Section E—Offering		
		The offer period in respect of the public offerings in Iceland and Sweden will start on 31 May 2018 at 12:00 p.m. GMT in Iceland (2:00 p.m. CEST in Sweden) and end on 13 June 2018 at 3:00 p.m. GMT in Iceland (5:00 p.m. CEST in Sweden). No orders will be accepted after the offer period has finished (unless the Selling Shareholders specifically decide to postpone the Offering or to extend it and in such cases a supplement to this Prospectus or a new prospectus will be published, as applicable). Each of Miton Asset Management Limited and Lansdowne Partners (UK) LLP (the "**Cornerstone Investors**") has committed to acquire at the Offer Price (and at any such price throughout the Offer Price Range set forth above) a number of Offer Securities equivalent to US$ 22.5 million and US$ 38.0 million, respectively, converted into ISK at the mid-rate of the Icelandic Central Bank on, in the case of Miton, the date the Offer Price is set and, in the case of Lansdowne, 30 May 2018. The Cornerstone Investors' commitments are subject to certain conditions. The Cornerstone Investors will not be subject to a lock-up in respect of their allocations.
E.4	*Interested parties of importance for the Offering*	Other than as disclosed in B.6 above, there are no other interests, including conflicting interests, that are material to the Offering.
E.5	*Seller of the securities and lock up agreement*	The Selling Shareholders are Kaupskil ehf. and Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP). Sale of Offer Securities by Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP) will be dependent on market demand. Any such sale would be in addition to the sale of Offer Securities by Kaupskil, and such sales in aggregate would be within the maximum number of Offer Securities to be sold as disclosed in this Prospectus. The terms of any such sale will be notified to investors in the pricing statement expected to be published on or around 15 June 2018. The Selling Shareholders, along with each of the other purchasers in the private placement which occurred in March 2017 (the "**First Private Placement**"), will agree with the Managers not to divest their remaining Shares (in the case of the purchasers in the First Private Placement, only those Shares acquired in the First Private Placement) for a period of 180 days after the first day of trading in the Offer Securities on NASDAQ Iceland or NASDAQ Stockholm, subject to certain exceptions. The Cornerstone Investors will not be subject to a lock-up in respect of their allocations.
E.6	*Dilution effect*	Not applicable. As there will be no issuance of new Shares pursuant to the Offering, there will be no dilution as a result of the Offering.
E.7	*Expenses borne by the investor*	Not applicable. There are no commissions, fees or expenses to be charged to investors by the Bank or the Selling Shareholders in connection with the Offering. As described in the general terms and conditions of the SDRs, the Custodian will be entitled to charge certain fees to the holders of the SDRs.

RISK FACTORS

Any investment in the Offer Securities is subject to a number of risks. Prior to investing in the Offer Securities, prospective investors should carefully consider risk factors associated with any investment in the Offer Securities, Arion Bank's business and the industry in which it operates together with all other information contained in this Prospectus, including, in particular, the risk factors described below.

Prospective investors should note that the risks relating to Arion Bank, its industry and the Offer Securities summarised in "Summary" are the risks that Arion Bank believes to be the most relevant to an assessment by a prospective investor of whether to consider an investment in the Offer Securities. However, as the risks which Arion Bank faces relate to events and depend on circumstances that may or may not occur in the future, prospective investors should consider not only the information on the key risks summarised in "Summary" but also, among other things, the risks and uncertainties described below.

The following is not an exhaustive list or explanation of all risks which investors may face when making an investment in the Offer Securities and should be used as guidance only. Additional risks and uncertainties relating to Arion Bank that are not currently known to it, or that Arion Bank currently deems not to be risks, may individually or cumulatively also have a material adverse effect on Arion Bank's business, prospects, financial position and/or results of operations and, if any such risk should occur, the price of the Offer Securities may decline and investors could lose all or part of their investment. Investors should consider carefully whether an investment in the Offer Securities is suitable for them in light of the information in this Prospectus and their personal circumstances.

Risks Relating to Business and Industry

1. The strength of Iceland's economy remains vulnerable to a range of domestic and international economic and political factors

The Bank currently conducts substantially all of its business in Iceland. Accordingly, its performance is influenced by the level and cyclical nature of business activity in Iceland, and the overall strength of Iceland's economy, which in turn has been and will continue to be affected by both domestic and international economic and political factors.

Following the collapse of the Icelandic banking system in October 2008 resulting in the winding up proceedings of Glitnir Bank hf. ("**Glitnir**"), Landsbanki Islands hf. (later renamed LBI hf.) ("**Landsbanki**") and Kaupthing Bank hf. ("**Kaupthing**") and a severe recession beginning in the fourth quarter of 2008, Iceland's economy has demonstrated a significant recovery since 2011, with gross domestic product ("**GDP**") growth of 1.2% in 2012, 4.4% in 2013, 1.9% in 2014, 4.3% in 2015, 7.5% in 2016 and 3.6% in 2017 *(source: Statistics Iceland)*. However, no assurance can be given that the present health of Iceland's economy will be sustained, particularly in view of the difficulties in resolving the problems arising out of the 2008 financial crisis.

The domestic factors that could affect the strength of Iceland's economy include:

- *Fluctuations in the value of Icelandic Krona:* In 2017, Icelandic Krona appreciated significantly by 8.0% against the U.S. dollar and 4.7% against the euro. The continued appreciation in the value of Icelandic Krona could lead to decreased demand for Icelandic exports or services, including tourism (*i.e.*, as a source of foreign income), and could make Iceland less competitive relative to other economies and currencies. Alternatively, a devaluation of Icelandic Krona and an increase in the cost of imports could diminish consumer confidence and lead to contraction in certain sectors, such as real estate.
- *Inflation:* While inflation currently remains within the target rate of 2.5% per annum set by the Icelandic Central Bank, its current inflation outlook is that the rate of inflation could rise in excess of the target rate in 2018 and again in 2020, while falling below target in 2019 due to proposed changes in VAT *(source: Icelandic Central Bank)*. In the view of the International Monetary Fund (the "**IMF**"), inflation was being contained by falling import prices and appreciation of Icelandic Krona. Wage growth is expected to erode competitiveness over time, and an increase in salary costs as a result of inflation could have a direct impact on the Bank's profitability. In addition, the current account surplus is expected to shrink steadily as a percentage of GDP. In the view of the IMF, these processes, if not sufficiently restrained by macroeconomic policies, could overheat the economy *(source: IMF)*.
- *Lack of foreign direct investment:* No assurance can be given that sufficient levels of foreign direct investment in Iceland will materialise following the easing or complete lifting of the Capital Controls,

which may result in fiscal and balance of payments deficits and a worsening of Iceland's economic and fiscal positions.

- *Other factors:* Other domestic factors also pose significant risks to Iceland's economic and fiscal position, including the high level of corporate and household debt, political factors (particularly in light of public sentiment regarding the financial sector), the remainder of the capital controls enacted in Iceland in November 2008 (the "**Capital Controls**"), any restructuring of the financial sector and winding down of Kaupthing, Glitnir and Landsbanki and as well as levels of consumption.

Iceland's economy also remains vulnerable to external factors, including conditions in Europe and other international economic and political developments, many of which are outside the control of the Icelandic government. In particular, instability or deterioration of the international financial markets, whether as a result of uncertainty surrounding ongoing negotiations over the terms of the United Kingdom's exit from the European Union and the ultimate economic and political effects of such exit or other events, could have a material adverse effect on the recovery of the Icelandic economy, especially given the relatively small size of the Icelandic economy and its dependence on trade with external partners, particularly the European Union. Although the financial sector in Iceland is still nominally subject to the Capital Controls and is mostly funded by domestic deposits, a global recession is likely to affect demand for, and the price of, Iceland's most important products and exports (*i.e.*, tourism, seafood and aluminium).

The occurrence of any of the above factors could adversely affect Iceland's economy , which in turn could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

2. The Bank's operations are exposed to Iceland's key industry sectors, particularly tourism, seafood, aluminium, energy and real estate

Iceland's economy depends in large measure on a select number of industry sectors. In terms of exports, which accounted for 47% of Iceland's GDP in 2017, the largest are tourism (*i.e.*, as a source of foreign income), seafood, aluminium and other industrial goods and services (including energy), which accounted for 42%, 16%, 17% and 25%, respectively, of total exports in 2017 *(source: IMF, Statistics Iceland)*. In addition, growth in the real estate industry sector has recently helped to fuel the domestic economy and, as of 31 December 2017, loans in the real estate industry sector accounted for 16.7% of the Bank's customer loan portfolio (the "**customer loan portfolio**").

Key risks in these industry sectors include:

- *Tourism:* In 2011, the Icelandic government approved a new public strategy for tourism in Iceland in recognition of tourism's potential as a means to diversify and stimulate national, regional and local economic growth as well as to create jobs, attract foreign direct investment and earn foreign currency income. As a result, the tourism industry sector has emerged in recent years as an important contributor to Iceland's GDP, with the number of tourists increasing 30% in 2015, 40% in 2016 and 24% in 2017, in each case, as compared to the previous year, but growth is expected to moderate in the medium term (source: *Statistics Iceland, Isavia, Arion Bank Research*). In view of its contribution to the Icelandic economy, any decline of the Icelandic tourism industry sector, whether as a result of global economic downturn, financial difficulties of key companies in the tourism industry, natural disasters, significant appreciation of Icelandic Krona or otherwise, could have an adverse impact on the Icelandic economy.
- *Seafood:* Although Iceland's exports of other products have increased in relative terms, seafood remains a principal export for Iceland. The principal focus of the Icelandic seafood industry sector is the fishing, farming and processing of seafood species. The seafood industry in Iceland therefore depends on the availability of plentiful stocks of various seafood species and the international demand for seafood, and any decline in stocks, a decrease in quotas for a particular seafood species, a decrease in international demand or a significant appreciation of Icelandic Krona could have a material adverse effect on the seafood industry sector.
- *Aluminium:* Iceland's aluminium industry sector has developed as a result of the availability of extensive, relatively inexpensive renewable energy sources to support energy-intensive aluminium smelting operations. Consequently, aluminium (smelted from imported raw materials) has become a principal component of Iceland's exports. Should the price of aluminium decline, to the point where it is no longer economical for aluminium producers to ship raw materials for smelting in Iceland, or if aluminium producers are able to find equivalent or cheaper sources of energy for their smelting operations, Iceland's aluminium exports could decline.

- *Energy:* According to the National Energy Authority of Iceland (*Orkustofnun*), nearly all stationary energy in Iceland is derived from renewable sources, such as hydro, wind and geothermal sources, and Iceland has become a key exporter of know-how regarding renewable energy sources. If Iceland is not able to keep up with the pace of worldwide developments in energy technology, for example, due to a shortage of skilled technicians or a lack of educational programmes specialising in energy, or if foreign investment in Icelandic energy projects and initiatives is not sufficient for its projected growth, Iceland's advantage in the energy industry sector could be impaired.
- *Real estate:* As tourism and the Icelandic population continue to increase, and assuming continued low levels of unemployment in Iceland, there will be a corresponding need for additional real estate development. For example, the Research subdivision of Arion Bank estimates that 8,000 to 9,000 housing units will be needed in the next three years (an increase of approximately 6-7% from current levels). However, any deterioration of the underlying factors which are driving this increased demand for real estate, such as a decline in tourism or unexpected macroeconomic event increasing unemployment, could have a material adverse effect on the real estate industry sector in Iceland.

As a universal relationship bank with substantially all of its operations in Iceland, a decline in any of these industry sectors as a result of occurrence of any of the above or other factors, including natural disasters or other cataclysmic events outside the control of the Bank, could, for example, result in higher levels of problem loans, defined as loans more than 90 days past due but not impaired and other problem (*i.e.*, individually impaired) loans, and provisions for losses on such problem loans (particularly in the Corporate Banking division), reduced demand for mortgage loans (in the Retail Banking division) and a reduction of transactions executed for customers. In addition, a decline in any of these industry sectors may negatively affect the broader Icelandic economy. Accordingly, a decline in any of the key industry sectors may have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

3. Public sentiment and political activity in Iceland could impair the Bank's operations

Due to the financial crisis in 2008 and the subsequent deep recession in Iceland, public sentiment towards the banking sector has at times been negative. Any such negative sentiment could ultimately be reflected in political and legislative decisions which could have material adverse effects on the Bank. One possibility which has been discussed in Iceland is the potential for a law requiring the separation of commercial banking activities from investment banking activities, which could require the Bank to divest or otherwise restructure some of its most significant operations. Since 2017, the Minister of Finance has established various committees to examine the structure of the banking system in Iceland. In February 2018, the Minister of Finance announced a committee for the preparation of a white paper focusing on a full strategic review of the Icelandic financial system, with results expected to be published later in 2018. Although no changes have yet been proposed or enacted, no assurance can be given that such a law or similar or related measures will not be proposed and ultimately enacted, which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

Also, as the Bank was established in order to assume certain assets and liabilities of Kaupthing, and the Bank employs a number of individuals previously employed by Kaupthing, negative sentiment by certain customers of Kaupthing can be directed at the Bank and its employees, by virtue of perceived connections with Kaupthing, and could cause reputational damage for the Bank. The Bank has received correspondence from an individual who previously had business dealings with Kaupthing, alleging that the Bank has not conducted sufficient internal due diligence to ensure that its management and directors are fit and proper to carry on the operations of a financial institution, on the basis that certain individuals who are employed by the Bank were also employed by its predecessor Kaupthing or the other Icelandic banks at the time of the financial crisis in 2008. In May 2018, the Bank received further correspondence from this individual, which stated that he had filed a criminal complaint with the prosecutor in Iceland concerning Kaupthing's alleged wrongful appropriation of assets during the "winding up" process of Kaupthing. Included in the correspondence described above was information which the individual claimed supports his allegations against the Bank and those employees named in the correspondence. The Bank has considered the allegations in this correspondence, along with the related materials, and has conducted its own review of these allegations and related materials, including with support of external counsel, and it remains of the view that the allegations are without merit and that those employees named in the correspondence are indeed fit and proper. There can be no assurance that this individual will not seek to make his allegations more public or seek to bring further claims against the Bank or its employees or directors, or that the Bank would prevail in any such claims.

In addition, various decision-making processes within the Bank may continue to be affected by perceived public sentiment and reputational risk due to the financial crisis in 2008 and the resulting lack of trust in the banking sector. This could, for example, lead to the Bank deciding to refrain from engaging in activities which it might otherwise consider to be in its interests and the interests of its shareholders, such as whether to divest or otherwise restructure any of its operations, provide credit to a particular borrower or hire the best qualified individual for a job because of their association with or involvement in events leading up to or in the aftermath of the financial crisis.

During the financial crisis, the Icelandic government was not able to provide liquidity and guarantees to the banking sector, mostly due to the size of the banking sector before 2008. It is unclear whether, and in what capacity, the Icelandic government would assist the banking sector during difficult times in the future.

Any negative public sentiment in Iceland relating to the Bank's shareholders and other stakeholders, including professional financial and institutional investors, could also lead to a loss of customers or business opportunities for the Bank.

Moreover, even if the Bank's operations are otherwise successful and it is in a position to declare and pay a dividend in the ordinary course, the Bank's ability and willingness to declare and pay dividends, whether as a requirement of law or otherwise, may be affected if public sentiment opposes the payment of dividends, even in the event the Bank is legally permitted to pay dividends. See "*—Risks Relating to the Offering and the Offer Securities—The Bank's ability to declare a dividend in the future is subject to a variety of factors*".

4. The Bank is exposed to significant liquidity risk

Banking institutions are exposed to liquidity risk, resulting from the fact that the maturity of assets (typically loans) exceeds the maturity of liabilities (the majority of which are demand deposits or otherwise short term) or might not otherwise be adequately matched with the maturity profile of other sources of funding.

The Bank's primary source of funding has historically been deposits from individuals, corporations and financial institutions, although it also accesses international and domestic capital markets for funding through bond issuances under its multicurrency EUR 2.0 billion medium term note programme (the "**EMTN Programme**") and covered bond facilities. For additional information on the Group's deposits, see "*Risk Management—Liquidity Risk*".

The Bank has recently extended the maturity profile of its liabilities, strengthened its liquidity reserve and converted a large portion of its demand deposits to term deposits (with 71.8% of the Bank's deposits being on demand as of 31 December 2017, as compared to over 90% as of 31 December 2009). See "*Operating and Financial Review—Key Factors Affecting the Group's Business, Financial Position and Results of Operations—Management of Funding and Liquidity*" and "*Risk Management—Liquidity Risk*". However, no assurance can be given that the Bank will continue to be successful in converting its demand deposits to term deposits or will otherwise be able to increase the maturity profile of its funding.

The Bank's non-deposit funding primarily consists of notes issued under the EMTN Programme that are denominated, among others, in euro, Norwegian krone ("**NOK**" or "**Norwegian Krone**") and U.S. dollars, as well as bonds issued under the Bank's covered bond facilities (including covered bonds previously issued by Kaupthing and assured by the Bank since January 2012), other loans and equity funding.

The Bank has recently sought to further diversify its funding profile through increased debt issuances and will continue to do so if its deposit base declines or fails to grow relative to any increases in its assets, as there will be a natural limit on the scope for growth in deposits in view of Iceland's relatively small economy and in view of competition for funding with other banks and with pension funds. See "*Industry Overview—Corporate Banking*". The Bank's loan-to-deposit ratio was 165.5% as of 31 December 2017 (129.0% excluding covered bonds (which is Non-IFRS Information)), as compared to 172.9% as of 31 December 2016 (133.8% excluding covered bonds) and 145.0% as of 31 December 2015 (116.0% excluding covered bonds) and, as a result, the Bank continues to rely significantly on non-deposit funding to fund its customer loan portfolio. The ability of the Bank to access the domestic and international capital markets depends on a variety of factors, including market conditions, the general availability of credit, the volume of trading activities and rating agencies' and investors' assessment of the Bank's credit strength and of the state of Iceland's economy. These and other factors could limit the Bank's ability to raise funding in the capital markets, which could in turn result in an increase in its cost of funding or could have other material adverse effects on the Bank's business, prospects, financial position and/or results of operations.

Following the further easing of the Capital Controls in March 2017, the Bank's funding did not experience any significant withdrawal of deposits denominated in Icelandic Krona by customers who were restricted to some extent from doing so due to the Capital Controls. However, no assurance can be given that the Icelandic Central Bank will be able to halt capital flight in the event further Capital Controls are imposed in the future.

To the extent that the Bank fails to match more closely the maturity profiles of its assets and liabilities or otherwise ensure that its funding grows in line with any growth in its customer loan portfolio, the Bank will continue to be exposed to a material risk that it may be unable to repay its obligations under its funding instruments when due, or will only be able to do so at excessive cost, which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

5. The Bank is exposed to a range of other typical financial institution market risks, including interest rate risk and equity price risk, as well as inflation risk in connection with its inflation-linked assets and liabilities

As a financial institution, the Bank is exposed to various market risks, including interest rate risk and equity price risk; in addition, the Bank is exposed to inflation risk in connection with its inflation-linked assets and liabilities. The Bank's exposure to these market risks arises from imbalances on the Bank's balance sheet as well as in market making activities and position taking in certain securities traded by it. The Bank's strategy towards market risk is to seek to limit the risk exposure that arises as a result of imbalances on the Bank's balance sheet but to accept limited market risk in its trading book. The market risk in the trading book arises from market-making activities, whereas market risk in the banking book arises from mismatches in assets and liabilities, primarily in relation to currencies, maturities and interest rates. The Bank's market-making activities are largely in Icelandic treasury notes and listed equity securities. The Bank's own account equity price risk principally arises as a result of the fact that, through the loan restructuring process, it acquired significant shareholdings in a number of companies. See "*Business Overview—History—2010-2012: Restructuring of Arion Bank and its customers*". The Bank has implemented a number of position limits and other controls designed to limit its trading book exposure, but no assurance can be given that these controls will be effective in all circumstances. The Bank is exposed to the risk that these controls do not prove to be effective in all circumstances and that the Bank could therefore experience material losses in its trading book. In addition, to the extent that these securities are marked to market, the Bank could experience significant fluctuations in its consolidated income statement as a result of movements in the market value of these securities. The results of operations of the asset management operations of the Bank are also subject to market risk, as fluctuations in the markets in which the asset management operations of the Bank hold assets under management can have a significant impact on their results of operations.

In relation to its balance sheet, the Bank's operations are subject to interest rate risk associated with mismatches between its interest-earning assets and its interest-bearing liabilities. The principal mismatch arises from the Bank's fixed interest liabilities as against its floating rate assets. The Bank also faces interest rate risk between its interest-earning assets and interest-bearing liabilities due to different floating rate calculations in different currencies.

The current environment of particularly low interest rates has resulted in interest-earning assets (in particular residential mortgage loans) generating lower yields upon origination or refinancing and other loans and securities held also generating lower levels of interest income when compared to historical levels. In addition, the Icelandic government has recently introduced legislation to abolish the stamp fee on collateral and has imposed restrictions on repayment fees which banks can charge, which has increased the ability of customers to refinance their debts. The Bank has seen a consequential increase in refinancings as interest rates have decreased, and there can be no assurance that the Bank can obtain funding at similarly low interest rates in order to maintain net interest income.

In a period of increasing interest rates, the Bank's level of interest expense may increase more rapidly than the interest it earns on its loans and other assets. Unfavourable market movements in interest rates (for example, a prolonged period of flatter than usual interest rate curves, a stronger than expected rise in interest rates, in certain circumstances negative interest rates or an inverse yield curve) could materially adversely affect earnings and current and future cash flows. Changes in interest rates may also negatively affect the value of the Bank's assets and its ability to realise gains or avoid losses from the sale of such assets, all of which would ultimately affect the Bank's net results.

In addition, the Bank is exposed to inflation risk when there is a mismatch between its assets and liabilities linked to the Consumer Price Index (the "**CPI**"). As of 31 December 2017, the total amount of the Bank's CPI-linked assets was ISK 363,791 million and the total amount of its CPI-linked liabilities was ISK 230,851 million. In the event of periods of very low inflation or of deflation, CPI-linked assets would generate diminished levels of net interest income, which could have a material adverse effect on the Bank's net interest margin. Such assets would also decrease in value during periods of very low inflation or of deflation.

The Bank also has significant maturity mismatches in its CPI-linked assets and liabilities, which arise from the fact that a significant proportion of the Bank's CPI-linked mortgages is not match-funded. The Bank is faced with interest rate risk and liquidity risk when CPI-linked mortgages are funded with liabilities which have a shorter interest-fixing period and maturity. Although the Bank has implemented a range of risk management procedures designed to mitigate these risks, no assurance can be given that these controls will be effective in all circumstances, in which case the Bank could experience material losses. Any losses experienced by the Bank as a result of its market risk exposures could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

6. The Bank is exposed to the risk of failure and breaches of its information technology systems

The availability, integrity, reliability and operational performance of the Bank's information technology ("**IT**") systems, including Valitor's international payments platform, are critical to the Bank's operations. The Bank's business relies on the efficient and uninterrupted operation of numerous systems, including computer hardware and software systems, data centres, third party telecommunications networks and the systems of third parties. Although the Bank's IT systems and Valitor's international payments platform have demonstrated a high level of reliability and performance to date, no assurance can be given that the Bank will be able to continue to maintain past levels of performance. In particular, the Bank currently uses a system provided by Reiknistofa Bankanna ("**RB**"), which is a centralised cash settlement system in Iceland, as its core system for deposits and payments, with all payment instructions settled through the RB system. RB is in the process of replacing its legacy deposit and payment system with the Sopra Banking system. One of the other Icelandic banks has already migrated to the new platform, and the other plans to migrate in September 2018. This in turn requires the Bank to replace its core deposit and payment systems, and the Bank is currently in negotiations with RB on the Sopra implementation. The implementation of a new cash settlement system or any other IT operations, outsourced or otherwise, could be subject to unexpected difficulties, implementation costs and delays, and no assurance can be given that such implementations will be delivered on time or within budget.

The Bank's ability to provide products and services to its customers on a timely basis or at all would be impaired by damage, interruption, failure or lack of capacity of its IT systems, core deposit and payment systems, international payments platform, any other systems in its clearing operations or the systems of third parties on which it relies due to malicious increases in usage or cyber-attacks by hackers (including as a result of denial of service or similar attacks which exceed network or gateway capacity), hardware or software defects, human error, unauthorised access, natural hazards, disasters or similarly disruptive events as well as due to planned upgrades and improvements which may be subject to developmental delay or fail to be effective. In addition, the Bank is at risk of breaches of its IT systems for illegal purposes such as cyber fraud or theft. The Bank considers that, with the easing of the Capital Controls in March 2017, Icelandic financial institutions could be subject to a greater risk of cyber-attacks going forward. The insurance policies which the Bank maintains may not be adequate to compensate the Bank for all losses that may occur as a result of any damage, interruption, failure or lack of capacity. A sustained failure of the Bank's IT system centrally or across its branches, or of critical third-party systems, would have a significant impact on its operations and the confidence of its customers in the reliability and safety of its banking systems and Valitor's international payments platform and could, in turn, have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

7. Unauthorised disclosure of confidential information and personal data, whether through cyber security breaches, computer viruses or otherwise, could expose the Bank to fines, liability and protracted and costly litigation and damage its reputation

The secure transmission of confidential information is a critical element of the Bank's operations, with the Bank processing personal customer data (including, in certain instances, customer names, addresses, credit and debit card numbers and bank account details), merchant data (including merchant names, addresses, sales data and bank account details), transaction data (including payment instructions, money transfers, securities trading and various other electronic communications and transfers within Iceland and cross-border) and other confidential information as part of its business. Therefore, the Bank is responsible for safeguarding such confidential information and must comply with strict data protection and privacy laws when dealing with such data in the jurisdictions in which it operates, including through the Bank's subsidiaries Valitor Holding hf. ("**Valitor**"), Stefnir hf. ("**Stefnir**") and Vördur tryggingar hf. ("**Vördur**"). The Bank seeks to ensure that procedures are in place for compliance with the relevant data protection and privacy laws by its employees and any third party service providers. Although the Bank is also taking steps to implement and maintain appropriate security measures to protect confidential information, such measures could prove not to be effective in all cases.

Data protection requirements are evolving in the jurisdictions in which the Group operates. One significant change is the European General Data Protection Regulation (the "**GDPR**") which is expected to become effective in May 2018 and will bring a number of changes to current data protection legislation in the European Union. Notwithstanding steps taken by the Bank in preparation for compliance with the GDPR when it becomes effective, the Bank will be exposed to the enhanced data protection requirements under the GDPR and will need to make additional changes to its operations, and potentially incur additional costs, in order to comply with the GDPR. Failure to comply with the GDPR could subject the Bank to substantial fines.

The Bank could be liable in the event of a breach of applicable law including any loss of control of such confidential information or as a result of unauthorised third party access. Unauthorised disclosure of confidential information could occur in a number of circumstances, including as a result of cyber security breaches, malware infection, malicious or accidental user activity, errors in software development, internal security breaches or as a result of human error as well as physical security breaches due to unauthorised personnel gaining physical access to confidential information.

The loss, destruction or unauthorised modification of confidential information by the Bank or third parties could result in significant reputational damage, additional costs relating to customer and/or merchant compensation or other charges, fines, loss of relationships with financial institutions, sanctions and legal proceedings or adverse regulatory actions against the Bank by the governmental authorities, customers, merchants or other third parties. Although the Bank generally requires that its agreements with third party partners or service providers who may have access to confidential information include confidentiality obligations that restrict such third parties from using or disclosing any such confidential information, these contractual measures may not prevent the unauthorised use, modification, destruction or disclosure of confidential information or allow the Bank to seek reimbursement from such third party in case of a breach of confidentiality or data security obligations. In addition, certain of the small- to medium-sized enterprise customers of the Bank and/or its subsidiaries, defined as corporates with loans up to ISK 2.0 billion ("**SME**"), may have limited data security capability and experience loss of confidential information when using the Group's business-to-business services. Any unauthorised use, modification, destruction or disclosure of confidential information could also result in protracted and costly litigation. Any of these or other factors could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

8. The Bank is subject to additional taxes beyond corporate income tax, which impose costs and competitive disadvantages

In addition to the basic corporate income tax rate of 22% in Iceland, the Bank is subject to certain other taxes which are specific to financial institutions in Iceland and increase its effective tax rate and its effective cost of funding, which in turn can inhibit its ability to compete effectively with domestic and foreign lenders who are not subject to such additional taxes.

In particular, in December 2010, the Parliament of Iceland passed Act No. 155/2010 on Special Tax on Financial Institutions, pursuant to which certain types of financial institutions, including the Bank, are required to pay an annual levy (the "**Bank Levy**"), which, since the year ended 31 December 2013, has been calculated at 0.376% on the total debt of the Bank in excess of ISK 50.0 billion as of the end of the applicable period. Non-financial subsidiaries are exempt from the Bank Levy. Whereas the Bank Levy was originally introduced as a temporary measure, there is currently no fixed date for its removal and no assurance can be given as to whether the Bank Levy will be reduced, eliminated or increased further in the future. In addition, in December 2011, the Parliament of Iceland enacted Act No. 165/2011 on Financial Activities Tax, pursuant to which certain types of financial institutions, including the Bank, are currently required to pay a special additional 5.5% tax levied on all remuneration paid to employees (the "**Financial Activity Tax**"). Under Income Tax Act No. 90/2003, as amended (the "**Income Tax Act**"), the Bank is subject to an additional tax of 6.0% as a financial institution in respect of taxable profit exceeding ISK 1.0 billion irrespective of joint taxation or carry-forward losses (the "**Special Financial Activity Tax**"). The Bank Levy, the Financial Activity Tax and the Special Financial Activity Tax place an increased cost burden on the Bank and subject it to a competitive disadvantage relative to other lenders not subject to such taxes, including international banks, domestic pension funds and the Housing Financing Fund. The Bank (on a standalone basis) was the highest corporate tax payer in Iceland in respect of operations in 2016, with total tax amounting to ISK 10.5 billion (*source: Icelandic Directorate of Internal Revenue*).

In addition, the Bank's results of operations could be harmed by changes in tax laws and tax treaties or the interpretation thereof, changes in corporate tax rates and the refusal of tax authorities to issue or extend advanced tax rulings, any of which could result in the Bank being subject to a higher effective tax rate. The unavailability of tax rulings could also diminish the range of structured transactions the Bank can enter into with its customers.

Moreover, the Bank may be subject to additional taxes or levies in the future. For example, the governor of the Central Bank of Iceland has suggested the possible imposition of a levy on banks to help fund the negative carry costs of the significant foreign currency reserves which the Central Bank of Iceland maintains, which, if enacted, could impose significant additional costs on financial institutions in Iceland, including the Bank.

Any additional tax or levy could increase the Bank's cost of funding and operating costs generally, impair the ability of the Bank to compete effectively with other lenders and/or decrease the Bank's lending volumes and margins, any of which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

9. The Bank could face tax liabilities or competitive disadvantages in respect of VAT on some of its services

The services of banks, savings banks and other credit institutions are currently exempt from value added tax ("**VAT**") under the Value Added Tax Act no. 50/1988. The tax authorities in Iceland have historically construed the exemption to be limited to the services that banks and other credit institutions provide according to the Financial Undertakings Act. For certain of the services provided by the Bank to customers and under the terms of its intra-Group arrangements with subsidiaries, the Bank has not historically collected VAT, and there is uncertainty whether VAT should be collected for some of such services. While the Bank believes that its practices with respect to collection of VAT are common among financial institutions in Iceland, there can be no assurance that Icelandic tax authorities will not reassess VAT on services provided by the Bank and conclude that the Bank has failed to collect VAT properly on certain services in the past. Should this occur, the Bank could be liable retroactively for six years' unpaid amounts, plus penalties and interest. To the extent that, going forward, the Bank decided, or was obliged, to start claiming VAT in respect of such services but its competitors did not, it would be at a competitive disadvantage and could be priced out of competing effectively for provision of certain services. Any of the foregoing could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

10. The Bank is exposed to credit risk and its customer loan portfolio contains certain problem and impaired loans

As a financial institution engaged in lending to individuals and companies, the Bank faces credit risk which arises from the possible failure of repayment by the borrower and/or the loans not being secured sufficiently. Although the Bank attempts to manage this risk through its credit risk management policies by monitoring the extension of credit to customers and taking of collateral, there is no guarantee that such precautions will be effective, and the Bank could be exposed to more credit risk than it finds acceptable. For example, non-compliance by employees with the Bank's credit risk management policies can result in riskier loans being extended than permitted. In addition, the Bank may fail to assess the inherent risk in each loan application correctly, the credit quality of borrowers or the value of collateral could decline, and deviations from the rules by committees allowed to make such deviations could become more frequent, especially in response to increased competition amongst lenders due to any deterioration in the economic situation in Iceland. Any of the foregoing could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

At 31 December 2016, the Bank held a loan of ISK 6,277 million against Sameinad silicon hf. ("**United Silicon**"), collateralised with shares in the company and other assets. The Bank also had a 6% equity interest in United Silicon and an unsecured bond in the total amount of ISK 877 million. In the second quarter of 2017, Arion Bank invested ISK 907 million in United Silicon, obtaining an interest ownership of 16.3%, with voting rights of 23.9% and thus United Silicon became an associate of Arion Bank, accounted for according to the equity method, less impairment. The purpose of the investment was to support the company in a time of operating difficulties. Due to these operating difficulties the Bank made full provision for the value of the equity holdings in United Silicon of ISK 1,164 million at the end of the second quarter of 2017, recognising ISK 907 million through Share of profit of associates and ISK 257 million through Net financial income in the consolidated statement of comprehensive income.

In September 2017 the Bank foreclosed on its collateral and took possession of the shares in United Silicon and became the largest shareholder of the company, with an interest ownership of 66.58% and voting rights of 66.68%, while remaining United Silicon's primary lender as well. With this transaction the Bank acquired the control of United Silicon and thus the company became a subsidiary of the Bank. The fair value calculation of the underlying assets at the time of the foreclosure resulted in a provision on loans of ISK 2,962 million recognised in Net impairment as well as fair value loss of unsecured bond of ISK 708 million recognised in Net financial income of the consolidated statement of comprehensive income. Including the impact of the calculated income tax effect, the total impact of United Silicon on the Group's results of operations for 2017 amounted to a reduction of the Group's net earnings in the amount of ISK 4,068 million.

The book value of assets of United Silicon held by the Group was ISK 5,219 million as at 31 December 2017. As the company was acquired exclusively with a view to resale, it has been classified as an asset held for sale and as a discontinued operations as of 31 December 2017 in accordance with IFRS 5. Although the Bank does not anticipate further impairments at this time, there can be no assurance that further impairments or losses relating to United Silicon will not occur, or that a sale of United Silicon will be achieved. The Bank is also involved in litigation concerning United Silicon; see "*—The Bank is involved in a number of ongoing legal proceedings and is subject to investigations by governmental authorities*".

As demonstrated by the impairments the Bank incurred in respect of United Silicon, no assurance can be given that any currently performing loans will not become problem loans in the future, whether as a result of a general impairment of conditions in a particular customer or class of customers, a deterioration of the Icelandic economy or otherwise, or that impairments or losses relating to problem loans will not occur. Actions the Bank may take with respect to problem loans, such as enforcing collateral or forcing a bankruptcy in respect of problem loans, may have an adverse impact on customers in the Bank's other divisions, for example if such customers had invested in equity of the relevant problem borrowers or had other exposure to such borrowers through products and services provided by other divisions of the Bank, such as Investment Banking or Asset Management, and experienced losses as a result.

In particular:

- as of 31 December 2017, 1.0% of the Bank's customer loan portfolio was classified as problem loans, which are defined as (i) the book value of loans more than 90 days past due but not impaired, plus (ii) the book value of other problem (*i.e.*, individually impaired) loans. As of 31 December 2017, the Bank's provisions on its customer loan portfolio amounted to 1.7% of the total gross amount of the customer loan portfolio and 1.6% of the gross amount of loans to customers outstanding had been wholly or partially impaired. As of 31 December 2017, the value of collateral that the Bank holds relating to loans to customers determined to be individually impaired amounted to ISK 3,795 million. When discounts and other adjustments have been applied, the book value of those loans amounted to ISK 2,491 million or 19.5% of the aggregate carrying amount of such loans to customers;
- the Bank has significant lending exposure to the real estate and construction and fishing industry sectors, with exposure amounting to 16.7% and 10.3%, respectively, of the total net carrying value of the Bank's customer loan portfolio as of 31 December 2017;
- as of 31 December 2017, the aggregate amount of the Bank's 10 largest loans to customers equalled 12.1% of the total gross amount of the Bank's customer loan portfolio as of such date;
- the Bank's customer loan portfolio is also highly concentrated among Icelandic borrowers and
- On 1 January 2018, the Bank implemented IFRS 9. IFRS 9 replaced the "incurred credit loss" model used under IAS 39 with an "expected credit loss" model. The changes from incurred to expected credit losses requires professional judgement over various factors used in the calculation of expected credit losses, such as how macroeconomic scenarios affect the calculation. The application of the IFRS 9 impairment requirements could increase volatility in profit and loss of the Group.

Should any customers or an industry sector to which the Bank is exposed default or experience a significant deterioration in their business or prospects, as the case may be, this could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

11. Iceland's banking system has been subject to restructuring and is relatively small given the small size of the Icelandic economy, which could limit opportunities for growth in the near term

Early in October 2008, the Icelandic banking system faced a serious banking crisis, as a consequence of which Kaupthing, Glitnir and Landsbanki were placed first into restructuring and later into winding up proceedings. As part of the restructuring of the banking sector, the FME transferred certain of their assets and liabilities, including their domestic deposits, into three newly established banks, Íslandsbanki hf. ("**Íslandsbanki**"), Landsbankinn hf. ("**Landsbankinn**") and the Bank, respectively, which held a combined market share of 52% of loans to households, 80% of loans to corporates and 98% of deposits from customers as of 31 December

2017 *(source: Ministry of Finance and Economic Affairs, Arion Bank, Landsbankinn and Íslandsbanki annual reports)*. The small size of the Icelandic economy and any changes to the Icelandic banking sector have affected and could continue to affect the Icelandic banks.

Uncertainty about the quality of the loan assets held by the Bank, Íslandsbanki and Landsbankinn and the relatively high levels of problem loans on their balance sheets have been a risk to the business, prospects, financial position and/or results of operations of the Icelandic banks. Although the levels of problem loans on the balance sheets of the Bank, Íslandsbanki and Landsbankinn have declined from 42% of total loans as of 31 December 2009 to 2.2% as of 31 December 2017 *(source: Icelandic Central Bank)*, no assurance can be given that the rate of problem loans will not increase in the future. Levels of problem loans, determination of loan values and the levels of write-offs will depend, in the medium term, on general economic developments and on the operating and financial condition of the particular borrowers as well as decisions by the Supreme Court of Iceland affecting the value of loans linked to foreign currencies. Worldwide financial and economic developments, in particular financial and economic developments in the United Kingdom and the other European countries that constitute Iceland's main trading partners, may also have an effect.

Given the relatively small size of the Icelandic economy and the short period of time since the financial crisis in 2008, Icelandic households and businesses may be reluctant to engage in new borrowing activities and, as a result, the Icelandic banks are not expected to grow significantly through domestic lending in the near term and may experience increased competition and consequently pressures on net interest income. In addition, the Bank has limited funding opportunities in Icelandic krona, namely its ISK-denominated deposits and its covered bond facilities, neither of which is capable of fully funding the Bank's ISK corporate lending volumes. Consequently, the Bank's ability to increase its corporate lending is limited and will continue to be limited unless the Bank is able to find additional sources of funding in Icelandic krona. It is also unlikely that the Bank, Íslandsbanki or Landsbankinn will grow significantly through international operations in the near future. Iceland's economy remains vulnerable to renewed disruptions, cessation or reversal of growth and a return to recession. Moreover, the Icelandic banks could also be adversely affected if other developments in the Icelandic economy or internationally result in slowing of growth in Iceland's economy or trigger a recession, any of which could in turn have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

12. The Bank may be unable to successfully implement its strategy or its strategy may not yield the anticipated benefits

The Bank's strategy is based on assumptions and expectations, including in respect of macroeconomic developments, competition, interest rates, revenue, expenses and cost of risk and future demand for Bank's services, which may prove to be incorrect. Also, the benefits and impact of the Bank's strategy could fall short of what the Bank anticipates. For example, the Bank might not be able to realise the full benefits of its lean banking or digitalisation initiatives, which could result in less than expected customer satisfaction improvements and cost reductions and negatively impact revenues and operating results, respectively. In addition, the expansion of Valitor's operations and the integration of Vördur might take longer or cost more than expected and not realise the currently expected benefits. For additional information on the Bank's strategy, see "*Business Overview—Strategy*".

Since the global financial crisis in 2008, macroeconomic volatility has made it more difficult to predict GDP development in many economies, resulting in frequent modifications to growth expectations published by economic research institutions as well as in adjustments by market research specialists, sometimes giving rise to significant revisions to growth expectations for specific markets. As a result, many financial institutions, including the Bank, may find it difficult to accurately model and predict the prospects for their businesses and set viable financial targets, and it may be difficult for investors to use historical financial results as an indicator for future results. Any failure by the Bank to accurately predict macroeconomic developments, interest rates, revenue, expenses and cost of risk and/or future demand for Bank's services could lead to misjudgements with respect to its strategy and increase the risk of failed implementation. If the Bank's strategy is not implemented successfully or if the Bank's strategy does not yield the anticipated benefits, this could have a material adverse effect on the Group's business, prospects, financial position and/or results of operations.

13. The Bank is exposed to competition and expects competition will increase

The Icelandic banking sector is dominated by Arion Bank, Íslandsbanki and Landsbankinn (the latter two being wholly owned by the Icelandic government, and each of which is classified as a systemically important financial institution), but also includes other commercial banks and savings banks, the Housing Financing Fund (a provider of financing for residential housing in Iceland and also a systemically important financial institution) and pension funds, which have increased their mortgage lending to individuals at aggressive interest rates, partially as a result of the fact that they are not subject to the Bank Levy. Pension funds in Iceland also provide competition for the Bank's deposits, as a vast proportion of individuals' savings in Iceland are held in pensions rather than in bank deposits, and a significant portion of payments to pension funds, representing a proportion of salary and a contribution by employers, are required by law. Pension funds also represent a significant source of the Bank's funding in Icelandic Krona as purchasers of the Bank's covered bonds. In addition, the Icelandic government has recently introduced legislation in order to facilitate customers switching banks in an effort to promote competition, for example, by abolishing the stamp fee on collateral, which has had the effect of increasing the rate of refinancings, and there can be no assurance that the Bank will be able to obtain funding at similarly low interest rates in order to maintain net interest margin.

In addition, in respect of Valitor's operations, the market for card and electronic payments is highly competitive and has many players, including dedicated payment processing companies, financial institutions and non-traditional payment processors, such as PayPal. Valitor is currently subject to a high degree of customer concentration, particularly in its partner channel. Loss of a significant customer would be expected to have a material adverse impact on Valitor's acquiring volumes and consequently on its business and results of operations. The partner channel provides high volumes at lower margins than in the direct channel, balancing risk and contributing to operational economies of scale. The largest partner in the partner channel has informed Valitor that it intends to become its own acquirer in 2018 and effectively compete with Valitor. It is expected that the relationship will be gradually reduced, resulting in lower levels of revenue for Valitor. For a summary of the results of operations of Valitor, see "*Operating and Financial Review—Financial Position and Results of Operations—Segmental Analysis—Other Divisions and Subsidiaries*". Should Valitor be unable to replace this customer, its results of operations would be substantially affected. Valitor's main competitor in the Icelandic card and electronic payments market is Borgun, a card issuing and acquiring subsidiary of Íslandsbanki. As Valitor expands outside of Iceland, it also faces increasing competition from global card issuing and acquiring companies, such as Worldpay which has an established presence in many markets where Valitor seeks to expand.

The Bank is subject to considerable regulatory scrutiny that can hinder its competitiveness. At the same time, fintech companies and initiatives, which are not subject to the same regulatory burden, also pose an emerging source of competition for the Bank. The implementation of Directive (2015/2366/EU) on payment services in the internal market (the "**Payment Services Directive 2**") in Iceland is likely to increase this regulatory burden for the Bank, as well as competitive pressure, when it comes into force (expected to be in 2019). Furthermore, the fact that the Bank is currently classified as a systemically important financial institution in Iceland adds to its regulatory burden. For example, the Bank, Íslandsbanki and Landsbankinn were for some time under investigation by the Icelandic Competition Authority (*Samkeppniseftirlitid*) (the "**ICA**") in relation to alleged abuse of the alleged collective dominant position of these three banks relating to their mortgage loan arrangements. That investigation was concluded with a settlement with the ICA in which the Bank agreed to take certain measures which have the objective of stimulating competition in retail banking services for individuals and small businesses. The measures have the objective of reducing switching costs in financial services, promoting active competition among banks toward individuals and small businesses and negating circumstances that could enforce tacit co-ordination in the market for retail banking services in Iceland. According to the Icelandic Competition Act, a failure to implement or comply with measures agreed to in a settlement can lead to administrative fines being administered pending an investigation by the ICA.

As Iceland's economy continues to recover and demand for new lending and other banking products increases, the Bank expects to face increased competition from the other large Icelandic banks, pension funds and smaller specialised institutions. In addition, if there is sufficient credit demand, the Bank could potentially face increased competition from foreign banks seeking to establish operations in Iceland, in particular with respect to the customers of the Corporate Banking division. The Bank may have to comply with regulatory requirements that may not apply to such foreign competitors, creating an unequal playing field and resulting in higher costs of regulatory compliance for the Bank. Foreign competitors may also have substantially more resources and financial means available to them than the Bank does (particularly given the Bank's relatively smaller size and lack of scale advantage in light of its regulatory obligations as a systemically important financial institution in Iceland), permitting them to invest more in business development and expansion or being able to increase lending volumes or endure a greater reduction in margins.

The Bank expects to compete on the basis of a number of factors, including transaction execution, its products and services, its local know-how, its ability to innovate, reputation and price. If the Bank is unable to compete effectively in the future in any market in which it has a significant presence, this could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

14. There are regulatory, compliance and legal risks inherent in the Bank's businesses

The Bank's operations entail considerable regulatory, compliance and legal risks, including litigation and liability risk. The Bank and certain of its subsidiaries are subject to government regulation and supervision as financial institutions in Iceland, and regulations may be extensive and may change piecemeal, rapidly, at times unexpectedly and with only a very short period of notice and consultation, as they have done since the global financial crisis in 2008. The regulatory and compliance risks faced by the Bank and its subsidiaries arise not only from regulation within Iceland or specific to financial services firms but also from other, more broadly applicable regulations and from risks relating to the ability of Icelandic authorities to adopt, implement and administer applicable regulations and to supervise Icelandic banks. The implementation of new European directives and regulations into Icelandic legislation will be subject to the ability of the Icelandic ministries, legislature and regulators to apply additional, more stringent requirements where they are permitted or required to do so, for example with respect to capital requirements. The Bank and its subsidiaries are also subject to regulatory scrutiny from certain other supervisory bodies, such as the ICA and the Data Protection Authority. In addition, the Bank's ability to conduct certain of its and its subsidiaries' operations is contingent upon licences issued by financial authorities. Compliance with the requirements of these licences, or with an administrative decision or supervisory guidance or any new or revised law, regulation or licensing requirement, may require significant resources and manpower, impose significant costs on the Bank and require changes in the Bank's operations and management. Failure to comply with any of the above could potentially expose the Bank to civil or criminal liability, reputational damage and sanctions including fines, the loss or limitation of licences, authorisations or permits necessary for the Bank's business and stricter regulatory scrutiny or supervision by Icelandic authorities. Such failures may arise despite the Bank's risk management system.

Leading up to the financial crisis in 2008, there was a significant imbalance between the resources of the FME and those of Icelandic banks, which may have limited the ability of the FME to adequately supervise such banks. Although these resource constraints have since been addressed through measures such as the appointment of more staff at the FME and revision and expansion of the regulatory framework surrounding the banking industry, there can be no assurance that the FME or other regulatory authorities will be able to successfully identify and remedy weaknesses in Iceland's financial services sector. Prior to the financial crisis, Icelandic banks engaged in activities of which the FME was aware and on which it did not offer negative comment, but which have since been found unlawful by the Icelandic courts. Despite the increased FME resources and expanded regulatory framework, the possibility exists that employees of the Bank could, in good faith, engage in activities, which may be widespread and might later be found to conflict with regulations. Pursuant to the introduction of the act on the European Surveillance System in the Financial Markets on 9 May 2017, Iceland has adopted the European framework for bank surveillance which aims to enhance stability and the health of the financial system.

In addition, as a result of a lack of a formally defined procedural protocol for correspondence, discussions and meetings between the FME and the Bank, at times the FME has sought to communicate with management in preference to the Board of Directors, or to individual Icelandic members of the Board of Directors as opposed to the Board of Directors as an entity. These circumstances create a risk that the Bank might be unable to have a complete overview of all the correspondence with the FME or that information relevant to the Bank could be lost in translation, delayed or not relayed to the Board of Directors. Inaccurate or insufficient information can prevent the Board of Directors from carrying out its supervisory function and could lead to failure by the Bank to comply with corporate governance requirements.

Violations of rules and regulations, whether intentional or unintentional, or failure to comply with licensing or other requirements, may adversely affect the Bank's reputation or financial condition, results of operations and prospects. In addition, existing laws and regulations could be amended, the manner in which laws and regulations are enforced or interpreted could change and new laws or regulations could be adopted in ways unfavourable to the Bank's operations, which could adversely affect the way the Bank operates its business and its market reputation. See "*—Public sentiment and political activity in Iceland could impair the Bank's operations*" and "*Business Overview—Legal Proceedings*".

Occurrence of any of the foregoing could have a material adverse effect on the Bank's reputation, business, prospects, financial position and/or results of operations.

15. The Bank is involved in a number of ongoing legal proceedings and is subject to investigations by governmental authorities

The Bank is involved in, or could be affected by, a number of ongoing legal proceedings and is subject to investigations by governmental authorities, including, but not limited to:

- *legal proceedings on disclosure requirements for borrowers*: In October 2017, the Supreme Court of Iceland ruled against Íslandsbanki in a case concerning disclosure requirements vis-à-vis borrowers, which lenders must fulfil when a loan agreement allows adjustable interest rates. The disclosure requirement calls on lenders to inform consumers of the condition under which the annual rate of interest may be amended. The proceedings were initiated by Íslandsbanki which submitted that an earlier ruling by the Consumer Rights Appeal Committee, where it was concluded that said disclosure requirements as set out in the Consumer Credit Act (No 121/1994) had not been fulfilled and as a result Íslandsbanki could not unilaterally raise the applicable rate, should be annulled. According to the Supreme Court, the terms and conditions of the loan agreement did not meet the aforementioned disclosure requirements. In accordance with a statutory obligation, a lender was obliged to specify in the loan agreement what conditions would allow for unilateral changes to the annual rate. Whereas Íslandsbanki had merely stipulated that the rate might be amended every five years, the Supreme Court rejected Íslandsbanki's submission. The Bank has reviewed the potential impact on its own loan portfolio. In 2012 and 2013, the Bank amended the applicable terms and conditions vis-à-vis interest rates for mortgage credit. As a result, no agreements concluded post-2013 are viewed as purportedly lacking. In the Bank's view, uncertainty remains concerning the legality of potential reimburse claims, with issues of indifference on behalf of claimants and statutory time limitations still unresolved;
- *legal proceedings on legacy mortgage collateral*: The Bank is involved in court cases which question claims to property pledged as collateral in mortgage loan agreements. Under dispute are questions as to whether part owners unequivocally granted the property as collateral. Case law from the Supreme Court of Iceland, in cases which did not involve the Bank, has so far yielded conflicting results but in the majority of cases the Supreme Court has invalidated the collateral, and the Bank is awaiting further rulings to assess the borderline cases. In judicial decisions to date, invalidation of 50% of the collateral for a given pledge has not affected the remaining 50% of the collateral or the borrower's obligation to repay the debt in full. Therefore, the Bank has not recorded any provision in respect of the matter;
- *claim for alleged violations of the Competition Act*: With a writ issued in June 2013, Kortathjonustan claimed damages in the amount of up to ISK 1.2 billion plus interest in aggregate from the Bank, Íslandsbanki, Landsbankinn, Borgun hf. and Valitor as a result of losses that Kortathjonustan contends the five parties caused by violations of the Competition Act. The case was dismissed on procedural grounds rather than the merits by the District Court of Reykjavík in March 2017 and confirmed by the Supreme Court on 2 June 2017, citing in particular that the plaintiff had not met with requirements related to standing. In September 2017, Kortathjonustan brought proceedings against the Bank and the other defendants on the same grounds, this time claiming damages in the amount of ISK 922 million plus interest. The case was again dismissed on procedural grounds by the District Court of Reykjavík by a ruling in March 2018, which was confirmed by the Court of Appeal in May 2018. Kortathjonustan has appealed the Court of Appeal's ruling to the Supreme Court. If the defendants would be ordered to pay damages, they would be jointly responsible for the payment of damages. The Bank has not recorded any provision in respect of this matter;
- *legal proceedings regarding recognition of liability for damages claimed by Lindarflot ehf. ("**Lindarflot**") and the former chairman of the board of directors of BM Valla hf. ("**BM Valla**") from the Bank*: Lindarflot and the former chairman contend that the Bank caused them losses by its conduct in relation to the bankruptcy of BM Valla and Artun ehf. ("**Artun**") in 2010. Lindarflot and the chairman claim that the Bank, at the time a lender to BM Valla and Artun, rejected their proposal for the financial restructuring of BM Valla and Artun on illegitimate grounds, forcing the companies into insolvency proceedings and therefore causing them losses. The dispute is currently over recognition of liability and not the amount of damages, which will follow in the event that the Bank is found liable. Lindarflot and the former chairman had earlier claimed losses of approximately ISK 4 billion. In April 2018, the District Court of Reykjavík dismissed the case. The plaintiffs have appealed the judgement to the Court of Appeal. The Bank believes that it will be acquitted of the plaintiffs' claims in both cases and has therefore not recorded any provision in respect of this matter;
- *legal proceedings against Valitor hf.*: Datacell ehf. ("**Datacell**") and Sunshine Press Productions ehf. ("**Sunshine Press Productions**") have claimed compensatory damages in the amount of approximately

ISK 8.1 billion, plus accrued interest, in relation to Valitor hf.'s rescission of a vendor agreement with Datacell in 2011. The Supreme Court of Iceland had ruled in an earlier case that the rescission by Valitor hf. was unlawful, as a result of which the companies have now commenced proceedings seeking damages from Valitor hf. for the losses allegedly incurred by Datacell and Sunshine Press Productions due to the unlawful rescission. A court-appointed evaluators' report assessing damages was presented in March 2016. Valitor hf. disagreed with the assessment stated in the report and filed a motion to appoint three court evaluators to re-evaluate the plaintiffs' alleged losses. The District Court of Reykjanes granted this motion. The reassessment has been completed, but it was not filed with the District Court. Valitor hf. requested a new assessment, which would have examined particular aspects which had not yet been assessed, but the District Court has rejected the request. Valitor hf. has appealed the decision to the Court of Appeal. Recently Datacell and Sunshine Press Production claimed a freezing of Valitor hf.'s assets on the basis of the aforementioned claim of compensatory damages but the district magistrate declined the claim. Datacell and Sunshine Press Productions have submitted that decision to the District Court, which has not yet ruled on this claim;

- *disputes relating to United Silicon*: United Silicon was granted a moratorium on payments on 14 August 2017 and filed for bankruptcy on 22 January 2018. The Bank had collateral in United Silicon's assets and the estate conveyed the assets to the Bank. The bankruptcy trustee has approved the Bank's collateral claims but two unsecured creditors have contested that approval and the dispute has been referred to the District Court. The Bank has examined these challenges and believes they are without merit. However, the Bank and the estate have agreed that if the Bank's collateral claims are judged invalid by the District Court, the Bank will refund the estate the amount of the invalidated bond;
- *possible criminal complaint and related correspondence*: In 2017 and 2018, the Bank received a series of correspondence from a former customer of the Bank's predecessor Kaupthing. The correspondence alleged that the Bank had not conducted sufficient internal due diligence to ensure that its management and directors are fit and proper to carry on the operations of a financial institution, on the basis that certain individuals who are employed by the Bank were employed by its predecessor Kaupthing or the other Icelandic banks at the time of the financial crisis in 2008. In May 2018, the Bank received further correspondence from this individual, which stated that he had filed a criminal complaint with the prosecutor in Iceland concerning Kaupthing's alleged wrongful appropriation of assets during the "winding up" process of Kaupthing. The individual alleges that the complaint involves both the Bank and certain of its employees. To date, there has been no indication from authorities in Iceland that any criminal proceedings will be brought against Kaupthing, the Bank or any of its employees in connection with this allegation. Included in the correspondence described above was information which the individual claimed supports his allegations against the Bank and those employees named in the correspondence. The Bank has considered the allegations in this correspondence, along with the related materials, and has conducted its own review of these allegations and related materials, including with support of external counsel, and it remains of the view that the allegations are without merit and that those employees named in the correspondence are indeed fit and proper; and
- *penalty interest during extension of payments*: In March 2018, the Supreme Court of Iceland issued a judgement in case no. 159/2017, which concluded that the Bank was not permitted to calculate penalty interest on customers' debts during the period in which the customer was granted an extension of payments under the law on debt mitigation. The Bank is examining how many customers have paid penalty interest on their debts to the Bank during such extension period. A more detailed examination of these cases will reveal whether any customers may be able to claim repayment from the Bank or be entitled to have their debts reduced, particularly in cases where the debt has been paid in full. An evaluation is currently being made of what the impact will be on the Bank.

For additional information on legal proceedings, see "*Business Overview—Legal Proceedings*".

The Bank and Valitor hf., as relevant, have made objections to and are defending the complaints regarding damages by Lindarflot, BM Valla's former chairman, Datacell and Sunshine Press Productions and the United Silicon claimants as described above. The extent and outcome of the legal proceedings or investigations, as the case may be, as well as any effect on the Bank, remain uncertain.

The Bank is also exposed to risks of lawsuits or other claims inherent in its role as a financial intermediary and consultant to third-party businesses through its Investment Banking division. These risks include potential liability for the Bank's role in determining the price of a company and for advice the Bank provides to participants in corporate transactions and in disputes over the terms and conditions of trading arrangements.

The Bank also faces the possibility that counterparties in the above-mentioned activities, as well as trading transactions will claim that the Bank failed to properly inform them of the associated risks.

The Bank may also be subject to claims arising from disputes with employees for, among other things, alleged illegal dismissal, discrimination or harassment, and it may also be subject to losses or reputational damage as a result of illegal behaviour by its employees or third party service providers. These risks may often be difficult to assess or quantify and their existence and magnitude often remain unknown for substantial periods of time.

Should any legal proceedings or investigations be determined adversely to the Bank, the Bank could be required to pay damages and/or fines and be subject to future restrictions on its business activities, either of which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

16. Iceland's national implementation of the EEA rules may not be comprehensive in all circumstances

As a member state of the EEA, Iceland is obligated to implement certain European Union legislation with EEA relevance, including legislation relating to financial markets. Where Iceland has failed to amend national law to conform to EEA rules, citizens may be unable to rely on them and the Icelandic courts barred from applying them, unless Icelandic legislation may be interpreted in conformity with the relevant EEA rules. In this respect, the Icelandic legislation on financial undertakings, securities transactions and other relevant fields are mostly implemented from EU law. There can be errors in such implementations which can result in a lack of uniformity between EU law and the corresponding Icelandic legislation. In such cases, Icelandic law will be deemed to prevail in the Icelandic courts. Such errors can cause confusion and debate as to precisely which rules the Bank is required to follow and can result in time-consuming and resource intensive discourse with regulators.

Delays in the full implementation of European directives and regulations into Icelandic legislation may also give rise to uncertainty as to the applicable requirements. Icelandic government authorities, as well as the Bank's counterparties, may seek to mitigate delays in formal implementation into national law by seeking to apply in practice requirements equivalent to those under EEA rules. As a result, the Bank may be unable to rely on the precise wording of statutes or draw guidance from legislative preparatory works. Complying with regulation that is in flux can be resource intensive and exposes the Bank to a risk of non-compliance.

17. The Capital Controls restrict to some extent the manner in which the Bank conducts its business and may result in abnormal pricing and financial bubbles in Iceland

In response to the financial crisis, the Parliament of Iceland approved certain amendments to Act No. 87/1992 on Foreign Exchange, as amended (the "**Foreign Exchange Act**") that introduced the Capital Controls in 2008. See "*Regulatory Overview—Principal Legislation and Regulations—Foreign Exchange Act*".

The Icelandic Central Bank has largely removed the Capital Controls, though has done so subject to continued satisfaction of three conditions: macroeconomic stability, an adequate level of foreign reserves and a sound financial system. Even since the most recent reforms in March 2017, certain transactions continue to be restricted, and as a result, there continues to be a certain degree of risk of abnormal pricing and financial bubbles. The reforms announced by the Icelandic Central Bank in March 2017 provide for general exemptions to most of the restrictions pursuant to the Foreign Exchange Act, with restrictions remaining on (i) derivatives trading for purposes other than hedging; (ii) foreign exchange transactions carried out between residents and non-residents without the intermediation of a financial undertaking; (iii) in certain instances, lending by residents to non-residents; and (iv) certain other restrictions in relation to special reserve requirements due to new inflows of foreign currency in further specified cases.

It is uncertain when and if the remaining restrictions of the Capital Controls will be lifted in full, and if economic circumstances in Iceland were to change, there can be no assurance that the Icelandic Central Bank would not re-impose elements of the Capital Controls which have already been lifted. Moreover, even if the Capital Controls were to be successfully lifted in full (*i.e.*, with no direct, unintended negative consequences, such as a significant devaluation of Icelandic Krona, a consequential rise in inflation and flight of capital) and on a permanent basis, levels of foreign direct investment in Iceland may be affected by a market perception that capital restrictions could be reintroduced in the future, which could limit growth prospects for the Icelandic economy and ultimately for the Bank, any of which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

18. The Bank may be unable to successfully maintain salary levels, and overrunning salaries and related expense may give rise to reputational risk while heavy cost-cutting measures may have adverse effects on operations

Measures introduced by the Bank from time to time to cut or contain salaries and related expense may not produce anticipated results. For example, total salary expenditure may increase, notwithstanding cost-cutting measures in the form of redundancies, in response to external factors such as general salary increases. When the general labour market is in a state of flux, including when significant wage increases have been introduced for specific groups such as Members of Parliament and government officials or the market is experiencing wage inflation more generally, the Bank may come under pressure to increase the salaries of its employees. Steep salary increases not only increase the Bank's expenditure but may also have reputational consequences in light of public sentiment. See "*—Public sentiment and political activity in Iceland could impair the Bank's operations*". In addition, failure to properly staff the various divisions of the Bank and to remunerate and incentivise employees adequately could lead to, among other things, an impairment in the level of service which the Bank provides to its customers or in regulatory and compliance functions and, consequently, impair its business operations. Any of the above could have a material adverse effect on the Group's business, prospects, financial position and/or results of operations.

19. The Bank may be unable to recruit or retain experienced and qualified personnel

The Bank's future success depends, in part, on its ability to attract, retain and motivate qualified and experienced banking and management personnel. Competition for personnel with relevant expertise can be significant, particularly given the limited pool of potential candidates in Iceland, as the Bank competes for talented people with both financial and non-financial services companies. In addition, the Bank may not have sufficient scale, or may be subject to additional limitations on compensation imposed by Icelandic law or public sentiment, which make it unable to offer employees rates of compensation comparable to its larger international competitors (or smaller domestic competitors which might be able to offer more flexible compensation structures), particularly at more senior levels. The loss of the services of any key employees with institutional and customer knowledge may significantly delay the Bank's achievement of its business objectives and could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

20. The Bank could experience credit rating downgrades

Rating agencies assess the creditworthiness of the Bank and its operating environment and they assign a rating to it and certain of the financial instruments it has issued for funding and capital management purposes. The Bank has been rated BBB+ by Standard & Poor's Credit Market Services Europe Limited ("**Standard & Poor's**").[1]

A rating agency assessment is based on various factors. While most of the factors are specific to the Bank and the relevant financial instruments it issues, some relate to general economic conditions and other circumstances outside the Bank's control, such as changes in the macroeconomic environment, sovereign credit rating of Iceland and prospective level of systemic support a government can provide. No assurance can be given that a rating agency will not revise downward a credit rating or change the outlook on any such credit rating. In addition, rating agencies have and may in the future change their methodology from time to time, which may also result in a downgrade or a change in the outlook on any credit rating of the Bank or the relevant financial instruments it issues, for example by reducing or removing the effect of systemic support.

Any downgrade or potential downgrade in the ratings of the Bank or of the relevant financial instruments it issues may limit the Bank's access to the capital markets and certain types of instruments (for example, in terms of seniority and maturity), reduce its prospective investor base, increase borrowing costs, require the Bank to replace funding lost due to the downgrade or potential downgrade (for example, customer deposits), limit the Bank's access to capital, funding and money markets and trigger requirements to post additional collateral in derivatives contracts and other secured funding arrangements. In addition, a rating downgrade or potential downgrade of the Bank could, among other things, limit its opportunities to operate in certain business lines and materially adversely affect certain other business activities, which in turn could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

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1 Standard&Poor's is established in the European Union and is registered under Regulation (EC) No. 1060/2009 (as amended) (the "CRA Regulation"). As such, Standard&Poor's is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with the CRA Regulation. A security rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.

21. The Bank is exposed to operational risks

The operational risks that the Bank faces include the possibility of inadequate or failed internal or external processes or systems failures, human error, regulatory breaches, employee misconduct or external events, such as fraud. The Bank's business inherently generates operational risks. The business depends on processing numerous complex transactions. The recording and processing of these transactions are potentially exposed to the risk of human and technological errors, including miscalculations, or a breakdown in internal controls relating to the due authorisation of transactions. Given the volume of transactions processed by the Bank, errors may be repeated or compounded before they are discovered and rectified, and no assurance can be given that risk assessments made in advance will adequately estimate the costs of these errors. Errors or misconduct can have a particularly significant impact with respect to funds and portfolios managed by the Bank or its wholly owned independent subsidiary Stefnir given the volume of assets under management in any particular fund or portfolio and the consequent magnitude of any errors or misconduct.

The Bank has implemented controls designed to detect, monitor and mitigate operational risks. However, these controls cannot completely eliminate such risks as some can be difficult to detect, recommendations and suggestions of surveillance units of the Bank (such as the compliance and internal audit functions) could be ignored, misunderstood or misapplied, and mitigation may fail to be effective. With respect to 2016 and 2017, the internal auditor's overall conclusion on the effectiveness of the Bank's internal controls and the Bank's risk and control culture was that they were unsatisfactory (Is. *ófullnægjandi*) and should be improved, particularly relating to controls and risk awareness in the Corporate Banking division (as evidenced by the matters relating to United Silicon) and anti-money laundering processes at the Bank generally. Although the Bank has been making improvements to its systems and controls in response to these conclusions, there is no assurance that these improvements will be successful. Failures in internal controls could subject the Bank to regulatory scrutiny and could ultimately lead to losses or impairments, as in the case of United Silicon. See "*—The Bank is exposed to credit risk and its customer loan portfolio contains certain problem and impaired loans*" and "*Board of Directors, Executive Committee, Auditor and Corporate Governance—Internal Control, Risk Management, Auditing and Accounting—Internal Audit*". Such events could harm the Bank's reputation and have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

22. The Bank relies on its reputation and brands and those of its subsidiaries

The success of the Bank's business depends significantly on the Bank's reputation with customers as well as the strength and appeal of the brand of the Bank. The Bank's reputation is one of its most important assets and its ability to attract and retain customers and staff and conduct business with its counterparties could be materially adversely affected to the extent that its reputation or the reputation of its brand is damaged. Failure to address, or perception that the Bank has failed to address, various issues that could give rise to reputational risk could cause harm to the Bank and its business prospects. Reputational issues could include:

- poor customer service or IT failures or interruptions that impact customer services and accounts (see "*—The Bank is exposed to the risk of failure and breaches of its information technology systems*");
- failure, or allegations of having failed, to maintain appropriate standards of customer privacy, customer service and record keeping and disclosure of confidential information (see "*—Unauthorised disclosure of confidential information, whether through cyber security breaches, computer viruses or otherwise, could expose the Bank to liability, protracted and costly litigation and damage its reputation*");
- failure to appropriately address potential conflicts of interest and acting, or allegations of having acted, unethically in the conduct of its business;
- breaching, or allegations of having breached, legal and regulatory requirements, including anti-money laundering and anti-terrorism financing requirements (see "*—There are regulatory and legal risks inherent in the Bank's businesses*", "*—The Bank is involved in a number of ongoing legal proceedings and is subject to investigations by governmental authorities*" and "*—The Bank must comply with anti-money laundering and anti-bribery regulations, and the violation of such regulations may have severe consequences*");
- failure to properly identify legal, regulatory, compliance, reputational, credit, operational, liquidity and market risks inherent in the Bank's products and services (see "*—The Bank is exposed to a range of other typical financial institution market risks, including interest rate risk, equity price risk and inflation risk*" and "*—The Bank is exposed to operational risks*");
- third parties on whom the Bank relies for information, products and services failing to provide the required information, products and services;

- adverse impacts on customers of the Bank which had invested in or had exposures to companies whose loans are determined by the Bank to be problem loans, and experienced losses as a result;
- the fact that the Bank is privately owned, while its principal competitors Íslandsbanki and Landsbankinn are government owned; and
- generally poor business performance.

Failure to address these or any other relevant issues appropriately could damage the Bank's reputation and make customers, depositors and investors less willing to do business with the Bank, which may have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

In addition, the Bank believes that its brand and the brands of its subsidiaries Valitor, Stefnir and Vördur are one of the key differentiators from competitors and provide a key competitive advantage. However, no assurance can be given that the Bank and its subsidiaries will be successful in further developing their respective brands and leveraging them into market share growth over competitors. Any circumstance that causes real or perceived damage to the Bank's brand or the brands of its subsidiaries, including the occurrence of any of the risks or events described in these "*Risk Factors*", could have a material adverse effect on the Bank's ability to retain existing customers and attract new customers. An inability by the Bank or its subsidiaries to manage the risks to their brands could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

23. The Bank's risk management methods may leave it exposed to unidentified, unanticipated or incorrectly quantified risks, which could lead to material losses or material increases in liabilities

The Bank's risk management strategies may fail under certain circumstances, particularly when confronted with risks that have not been identified or anticipated. Risk methodologies and techniques that the Bank adopts to assess credit risk, market risk, liquidity risk and operational risk may be flawed or may not take all risks into account, and it is possible that the methods for assessing these risks are not sound or are based on faulty information. They can also be misunderstood, not communicated properly to front-line staff, not implemented correctly or misapplied by the Bank's personnel, and supervision by management could also be insufficient. In addition, the Bank's risk management policies are constantly being re-evaluated and there may be a lag in implementation. Furthermore, some of the Bank's qualitative tools and metrics for managing risk are based upon the use of observed historical market behaviour. The Bank may apply statistical and other tools to these observations to arrive at quantifications of risk exposures. These tools and metrics may fail to predict future risk exposures.

The Bank's losses thus could be significantly greater than its risk management measures would indicate. In addition, the Bank's quantified modelling does not take all risks into account. Unanticipated or incorrectly quantified risk exposures could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

24. The Group relies on third party service providers

The Bank relies on the services, products and knowledge of third party service providers in the operation of its business. For example, the Bank relies on RB for deposit account and payment infrastructure. The Bank also relies on third party service providers in connection with its IT systems, including an outsourcing arrangement for elements of operations of the Bank's IT systems with Origo hf. ("**Origo**"), and it is considering other opportunities for IT outsourcing, and is currently in the process of outsourcing its cash centre operations, in order to benefit from scale synergies with the other Icelandic banks. In addition, the Bank's subsidiary Valitor is subject to chargeback risk if Valitor or its bank sponsors are unable to collect the chargeback from its merchant's account or if the merchant refuses or is financially unable due to bankruptcy or other reasons to reimburse the merchant's bank for the chargeback. Accordingly, the Bank faces the risk that such third party service providers become insolvent, enter into default or fail to perform their contractual obligations in a timely manner or at all or fail to perform at an adequate and acceptable level. Any such failure could lead to interruptions in the Bank's operations or result in vulnerability of its IT systems, exposing the Bank to operational failures, additional costs or cyber-attacks. The Bank may need to replace a third party service provider on short notice to resolve any potential problems, and the search for and payment to a new third party service provider on short notice or any other measures to remedy such potential problems could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

In addition, no assurance can be given that the third party service providers selected by the Bank will be able to provide the products and services for which they have been contracted, for example, as a result of failing to have the relevant capabilities, products or services or due to changed regulatory requirements. Any failure of third party service providers to deliver the contracted products and services in a timely manner or at all or to deliver products and services in compliance with applicable laws and regulations and at an adequate and acceptable level could result in reputational damage, claims, losses and damages and have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

25. The Bank must comply with anti-money laundering and anti-bribery regulations, and the violation of such regulations may have severe consequences

The Bank is subject to laws regarding money laundering and the financing of terrorism as well as laws that prohibit the Bank or its employees or intermediaries from making improper payments or offers of payment to foreign governments and their officials and political parties for the purpose of obtaining or retaining business. Compliance with anti-money laundering and anti-bribery regulations can place a significant financial burden on banks and other financial institutions and requires significant technical capabilities. The Icelandic government is currently in the process of implementing the Fourth Money Laundering Directive (2015/849/EU), which is expected to come into force in Iceland later in 2018 and for which the Bank is currently making preparations. However, the Bank cannot predict the nature, scope or effect of future regulatory requirements to which it might be subject or the manner in which existing laws might be administered or interpreted. Although the Bank believes that its current policies and procedures are sufficient to comply with applicable anti-money laundering, anti-bribery and sanctions rules and regulations, it cannot guarantee that such policies completely prevent situations of money laundering or bribery, including actions by the Bank's employees, for which the Bank might be held responsible. Any such events may have severe consequences, including sanctions, fines and reputational consequences, which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

26. Application of the Capital Requirements Directives could adversely affect the Bank's results

In 2013, the European Parliament and the European Council adopted a legislative package ("**CRD IV**") for the implementation of the Basel III framework in the European Union, the implementation of which in Iceland has now been largely completed. See "*Regulatory Overview—Principal Legislation and Regulations—Capital Requirements Directive*". Any failure by the Bank to maintain any increased regulatory capital requirements or to comply with any other requirements introduced by regulators could result in intervention by regulators or the imposition of sanctions, which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations, could have other effects on the Bank's financial performance, both with or without the intervention by regulators or the imposition of sanctions, and could also require raising additional capital through issuing Shares or SDRs, which in turn could have a dilutive effect on the value of Shares or SDRs held by the Bank's shareholders.

27. The Bank and Valitor depend on both direct and sponsored membership in card schemes and compliance with card scheme rules

Valitor processes a significant majority of transactions through international credit and debit card schemes run by the two key card scheme operators, Visa and MasterCard. To access the international card schemes' networks to provide acquiring and processing services, merchant acquirers, including Valitor, and card issuers, including the Bank, must have the relevant geographically based operating licences or memberships. As part of its agreement and membership with card schemes, the Bank, Valitor and their customers are subject to, amongst other things, the card scheme membership fees and operating rules, including mandatory technology requirements promulgated by the card schemes, which could change, necessitating potentially significant capital expenditures to remain compliant, or could subject the Bank, Valitor and their customers to a variety of fines and penalties, as well as suspension and termination of membership or access. The Bank and Valitor may not be able to pass through the impact of any fees or fines to their customers, which could lead to lower margins in the future.

If a violation of any card scheme rules is sufficiently material, there is a risk of damaging the relationships the Bank and Valitor have with the card schemes to such an extent that any willingness the card schemes had to expand their business relationships in markets and sectors with the Bank or Valitor is restricted. Furthermore, failure to comply with the card scheme rules could also result in the restriction, suspension or termination of Valitor's licences to acquire payment transactions in various jurisdictions or the Bank's licences as issuer under the card schemes. If this were to occur, Valitor would be unable to process transactions using the relevant card scheme in the relevant jurisdiction and/or the Bank would be unable to issue cards under the relevant card scheme, which could have a material adverse effect on Valitor's and the Bank's business, prospects, financial position and/or results of operations.

28. The asset management operations of the Bank may fail to sustain or increase their level of assets under management and is subject to pressure on fee margins

For the year ended 31 December 2017, the Bank generated ISK 4,011 million, or 7.5% of its operating income, from net fee and commission income of the Asset Management segment, comprising the Asset Management division of the Bank and its wholly owned independent subsidiary Stefnir. Stefnir manages open-ended funds, which allow investors to reduce the aggregate amount of their investment in open-ended funds, or to withdraw altogether from such funds, without notice. Similarly, portfolio management mandates and fiduciary mandates as well as discretionary and advisory mandates can typically be reduced or cancelled on short notice. Fee margins for asset management are generally under pressure as a result of competition in the market. If markets are declining, the investment performance of Stefnir's products and third party products provided by the Bank are seen as unsatisfactory and/or if customers are dissatisfied with the quality of the Bank's services or Stefnir's products (for instance, in respect of performance, reporting or compliance with customer instructions), this could lead to significant redemptions and withdrawals of assets under management. Funds provided by the Bank or managed by Stefnir could underperform the market or otherwise generate poor performance, undermining growth in assets under management, negatively affecting net fee and commission income as well as contributing to redemptions and withdrawals. In addition, reputational risk or potential conflicts of interest may result in a loss of key clients. Redemptions or withdrawals of assets under management would have an immediate impact on net fee and commission income and, therefore, operating income and, depending on the extent of such redemptions or withdrawals, could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations. Historical investment performance is not an indicator of the level of the Bank's future performance, and it may not be able to sustain successful performance over time. Results and performance levels in later periods may differ significantly from prior results and performance for various reasons, such as macroeconomic factors, performance of new funds compared with old funds, the departure of fund managers or other key staff members, loss of key clients, market conditions and a lack of investment opportunities.

Some of the pension funds that are fully managed by the Bank invested in the equity of United Silicon and consequently lost their investment following the bankruptcy of the company. There has been media coverage regarding the investment in light of the link between the pension funds and the Bank. The FME has investigated this investment and recommended some operational changes which the Bank and the relevant funds have complied with. The key changes are (i) to adjust the fund's investment processes in order to improve the assessment of potential conflicts of interest and reputational risk and (ii) to maintain more detailed documentation of the meetings and decisions of the fund's board of directors. This has also caused members of certain pension funds managed by the Bank to challenge the Bank's role in management of these funds, for example in terms of board representation by the Bank on the pension funds. The Bank believes that the potential for reputational risk involving possible or perceived conflicts of interest in respect of the operations of its Asset Management segment is increasing, and may have a negative impact on the Bank's relationships with its pension fund customers and their members or other clients and possibly result in loss of pension fund customers.

The Bank and Stefnir manage assets for retail and institutional investors, corporations and high net worth individuals in a broad range of asset classes. Certain of these asset classes may be viewed more or less favourably by potential customers at different times and in different markets with different regulatory and fiscal frameworks. Moreover, the overall proportion of customer assets across the asset management industry sector that is dedicated to actively managed funds of the type managed by the Bank and Stefnir is decreasing in favour of passively managed funds such as index funds, trackers and other similar low-fee alternatives, such as robo-advisers. In addition, new asset classes and categories of actively managed funds may be developed by competitors, some of which might not be among the principal products and services offered by the Bank and Stefnir. The entry into new products and services with potentially higher margins could also subject the Bank and Stefnir to potential losses, as a result of lack of experience with such products and services, greater inherent risk in the products and services or otherwise.

The reduction in the number of pension funds in Iceland, and the recent trend on the part of certain Icelandic pension funds to bring asset management responsibilities back in-house rather than relying on third-party asset managers like the Bank, has had an impact on the fund management market in Iceland and is expected to have a negative effect on the fund management industry, especially in traditional funds, for the foreseeable future. Other imminent changes in the asset management industry include the arrival of new competition in the form of fintech companies, leading to more intense competition and putting pressure on commissions in various financial services. Responding to these changes will require the Bank to incur additional costs, hire employees with new expertise and change its business processes and services.

In addition, regulatory changes, in particular the adoption in Iceland of MiFID 2 and Regulation (600/2014) on Markets in Financial Instruments ("**MiFIR**"), which are intended to replace, extend and improve existing European rules on markets in financial instruments and strengthen investor protection by introducing additional organisational and conduct requirements, will give more extensive powers to regulators and introduce the possibility of imposing higher fines in case of infringement of the requirements of such regulations. As MiFID 2 and MiFIR will significantly extend not only the scope but also the detail of existing regulations, the Bank and Stefnir will have to review existing activities and, where necessary, may need to adjust the manner in which they operate. The Bank and Stefnir are also likely to have to provide more information to their customers, such as about the costs and charges involved in providing investment services and, as a result, could face significantly higher compliance costs and become subject to increasingly complex requirements, which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

29. The Bank could incur unforeseen liabilities from prior and future acquisitions and disposals

During the last few years, the Bank has made various acquisitions (in particular, the acquisition of the insurance subsidiary Vördur and Valitor's acquisitions of AltaPay A/S for its e-commerce platform, IPS-International Payment Services Limited and Chip and PIN Solutions Ltd for its operations in the United Kingdom) and it has divested a number of assets, primarily non-core assets, which consist of legacy equity holdings of non-core subsidiaries and other assets, such as investment property, which it had acquired through restructuring processes following the financial crisis in 2008. See "*Business—History—2010-2012: Restructuring of Arion Bank and its customers*". The Bank also acquired a majority interest in United Silicon as a result of its default. See "*Operating and Financial Review—Key Factors Affecting the Group's Business, Financial Position and Results of Operations—Acquisitions and Disposals—United Silicon*". In the future, the Bank may make additional acquisitions and may decide to divest certain parts of its current businesses. The Bank may encounter difficulties integrating entities it has acquired into its operations or the combination of the businesses may not perform as well as anticipated. Failure to complete announced business combinations or failure to successfully integrate acquired businesses could lead to departures of key employees and have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

Acquisitions expose the Bank to the risk of unforeseen expenses, losses, tax liabilities or obligations with respect to employees, clients and business partners of acquired businesses, governmental authorities and other parties. Before making an investment in a company or business, the Bank assesses the value or potential value of such company or business and the potential return on such an investment. In making the assessment and otherwise conducting due diligence, the Bank relies on the resources available and, in some cases, an investigation by third parties. However, no assurance can be given that due diligence examinations carried out by the Bank or by third parties in connection with equity interests in companies or businesses that the Group has acquired or will acquire are sufficient or will reveal all of the risks associated with such companies and businesses or the full extent of such risks. In addition, acquired companies or businesses may have hidden liabilities that are not apparent at the time of acquisition. Although the Bank normally obtains certain warranties and indemnities from the seller, these warranties and indemnities may not cover all of the liabilities that may arise following the acquisition, and any indemnification may not fully compensate the Bank for any diminution in the value of its interest in such companies or businesses. The Bank may also encounter difficulties enforcing warranties or indemnities against a seller for various reasons, including the insolvency of the seller, legal technicalities, such as the relevant jurisdiction or evidence requirements, or expiry of claim periods for such warranties or indemnities.

When divesting businesses or assets, the Bank may not always be able to pass on the entire risk relating to the divested business or assets to the purchaser, which may lead to additional risks, such as liability related to legacy obligations. The Bank could also face reputational issues or negative public sentiment upon a disposal, whether as a result of a sale at a discount to perceived value or for other reasons.

30. The Bank's insurance coverage may not adequately cover all losses

The Bank maintains customary insurance policies for its operations, including insurance for its liquid assets, money transport and directors' and officers' liability, as well as insurance against computer crimes and for employee dishonesty and mistakes. Due to the nature of the Bank's operations and the nature of the risks that it faces, no assurance can be given that the coverage that the Bank maintains is adequate to cover the losses for which it believes it is insured and, in the event the Bank's insurance is not adequate, this could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

Risks Relating to the Offering and the Offer Securities

1. The market price of the Offer Securities may fluctuate and may decline below the Offer Price

Prior to the Offering, there has been no public market for the Shares or the SDRs. No assurance can be given that an active trading market for the Shares or SDRs will develop or, if developed, will be sustained following the completion of the Offering. The Offer Price may not be indicative of the market price for the Shares or SDRs following listing of the Shares on NASDAQ Iceland and the SDRs on NASDAQ Stockholm. Furthermore, following the listing of the Shares and SDRs, the liquidity and trading price of the Shares and SDRs may be highly volatile in response to many factors, including those referred to in this section, as well as to the Bank's financial performance, large purchases or sales of the Shares or SDRs, legislative or regulatory changes, macroeconomic conditions and the financial markets generally that may adversely affect the liquidity and price of the Shares and the SDRs. In addition, the trading price of the Shares and the SDRs may be affected as a result of the possible privatisation in the future of Landsbankinn and Íslandsbanki, which are currently wholly owned by the Icelandic government. Such fluctuations may occur regardless of the Bank's actual performance or conditions in its key markets and could adversely affect the market price of the Shares and SDRs resulting in losses to investors. The Offer Price, which may bear no relationship to the price at which the Shares and SDRs will trade upon the completion of the Offering, will be agreed between the Selling Shareholders and the Bank, based on close consultation with the Joint Global Coordinators.

2. Substantial future sales of Shares or SDRs could adversely affect the market price of the Shares and SDRs

Upon completion of the Offering, the Selling Shareholders will hold approximately 38.6% of the Shares, assuming that the number of Existing Offer Shares and SDRs sold is the mid-point between 22.6% and 36.2% of the total number of issued Shares and that the Over-Allotment Option is not exercised (34.2% if the Over-Allotment Option is exercised in full). The Bank cannot predict what effect, if any, future sales of the Shares or the SDRs, or the availability of the Shares or the SDRs for future sale, will have on the market price of the Shares or the SDRs. Sales of substantial amounts of the Shares by the Selling Shareholder, or the perception or any announcement that such sales could occur, following the expiration of the applicable lock-up period could adversely affect the prevailing market price of the Shares and the SDRs.

During the periods immediately prior to and following the end of the periods of sales restriction provided for by these lock-up arrangements, the market price of the Shares or the SDRs may fall in anticipation of a sale of the Shares or the SDRs. Following the expiry of these arrangements, there will be no contractual restriction on the sale of the Shares owned the Selling Shareholder who was previously subject to them. The Bank cannot predict whether a substantial number of the Shares or the SDRs in addition to the Offer Securities will be sold in the open market following the expiry or waiver of these restrictions. In particular, no assurance can be given that, after the restrictions expire or prior to such time if any such restrictions are waived, the Selling Shareholder will not reduce its holdings of the Shares.

3. Depending on its level of shareholding, Kaupthing may be able to exercise influence on the Group, and its interests may conflict with those of the Bank's other shareholders

Kaupskil is a wholly owned subsidiary of Kaupthing. If Kaupthing (either directly or via Kaupskil) continues to retain a significant proportion of the Shares following the Offering and, consequently, an interest in the Group, Kaupthing could have an influence on the Bank's management and affairs and on the outcome of most matters submitted to its shareholders for approval. If Kaupthing remained a significant shareholder following the Offering and in accordance with Icelandic law, such matters could include the election of the Board of Directors, the issuance of additional shares and other equity securities, which may dilute existing holders of the Shares and the SDRs, and the payment of any dividends. The interests of Kaupthing may differ from or compete with those of the Bank's other shareholders.

Accordingly, this concentration of ownership could have a material adverse effect on the market price of the Offer Securities by, among other things, delaying, deferring or preventing a change in control, impeding a merger or discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of the Bank.

4. The Bank's ability to declare a dividend in the future is subject to a variety of factors

The declaration and payment of future dividends will be determined by the Bank's shareholders. The Bank's ability to pay dividends in the future depends on numerous factors, including, among other things, its business, future profits, financial condition, results of operations, distributable reserves, cash flows, prospects, capital requirements (see "*—Risks relating to Business and Industry—Changes to the Capital Requirements Directives could adversely affect the Bank's results*"), the ability of its subsidiaries to pay dividends to the Bank, credit terms, general economic and statutory restrictions, general political and public sentiment regarding the payment of dividends (which in Iceland has in the past caused some companies to abandon or adjust their plans for paying dividends) and other factors that members of the Board of Directors deem significant from time to time. The Bank would also need to consider the potential for any dividend payment to create a large exposure for the Bank, defined as exposure to a group of financially related borrowers which exceeds 10.0% of the Bank's eligible capital. The legal maximum for individual large exposures is 25.0% of the Bank's eligible capital, net of eligible collateral. As of 31 March 2018, the Bank had one large exposure to a foreign credit institution. The exposure was 12.9% of the Group's eligible capital before taking account of eligible credit risk mitigation, or 6.6% after credit risk mitigation effects.

Additionally, the Bank operates under strict guidelines from the Icelandic Central Bank regarding currency imbalance, and it would need to ensure that it held sufficient funding sources in Icelandic Krona in order to pay any dividends. In particular, the necessary rebalancing for payment of dividends from a release of the Bank's excess capital is therefore expected to take place over a number of years.

No assurance can be given that dividends will be payable or paid in the future. See "*Shares and Share Capital—Dividends and Dividend Policy*".

5. Future offerings of debt or equity securities by the Bank may adversely affect the market price of the Shares

In the future, the Bank may attempt to increase its capital resources by offering Shares, SDRs, series of preference shares, other share-related securities and debt securities, including commercial paper, medium-term notes, senior or subordinated notes. Upon liquidation, holders of any such preference shares and debt securities, and lenders with respect to other borrowings, would receive a distribution of the Bank's available assets prior to the holders of the Shares. Additional equity offerings may dilute the economic and voting rights of the Bank's existing shareholders or reduce the market price of the Shares and the SDRs, or both. Preference shares, if issued, could have a preference with respect to dividend payments that could limit the Bank's ability to pay dividends to the holders of the Shares and the SDRs. The holders of the Shares and the SDRs bear the risk of any future offerings reducing the market price of the Shares and the SDRs, limiting dividend payments in respect of the Shares and the SDRs by the Bank and diluting their shareholdings in the Bank.

6. Holders of SDRs are subject to the risk of insolvency and default of the SDR Custodian and Sub-custodian

Under the terms of a custody agreement, the Bank has appointed Skandinaviska Enskilda Banken AB (publ) ("**SEB**") as Custodian, to hold Shares and to issue one SDR for each deposited Share, in accordance with the terms and conditions of the SDRs, which are governed by Swedish law. Correspondingly, SEB has entered into a sub-custodian agreement with Íslandsbanki, under which SEB deposits the Shares into a custody account on behalf of holders of the SDRs, and which is governed by Icelandic law. Although SEB is treated as the registered owner of the Shares, the beneficial ownership of such Shares rests with the holders of the corresponding SDRs in accordance with the terms and conditions of the SDRs. See "*General Terms and Conditions of the Swedish Depository Receipts*".

In the event of an insolvency of either the Custodian or the Sub-custodian, holders of the SDRs will be subject to the insolvency regimes applicable in Sweden and Iceland, respectively.

Under current Swedish law, it is expected that any cash which is held for holders of SDRs by the Custodian as banker under the terms and conditions of the SDRs would constitute an unsecured obligation of the Custodian. Holders of the SDRs would therefore only have an unsecured claim in the event of the Custodian's insolvency for such cash, and such cash would also be available to general creditors of the Custodian. However, the Custodian is obliged under Swedish law to separate the SDRs from securities belonging to the Custodian and such SDRs therefore would not form part of the bankruptcy estate of the Custodian. Under the terms and conditions of the SDRs, if the Custodian fails to pay cash or deliver non-cash assets to holders of the SDRs in the circumstances required by the terms and conditions, the Custodian will be in breach of its contractual obligations under such terms and conditions, and holders of the SDRs would have a claim under Swedish law against the Custodian for the Custodian's breach of its contractual obligations under terms and conditions of the SDRs.

Under Icelandic law, cash held by the Custodian on deposit with the Sub-custodian may be reimbursed to the Custodian in the event of the Sub-custodian's insolvency if it is allocated in a separate account in the Custodian's name and provided that such reimbursement is approved in the insolvency proceedings. Any remaining cash would form part of the Sub-custodian's insolvent estate and would be available to satisfy the claims of the Sub-custodian's creditors. Generally, there can be no assurance that, in the event of such insolvency, cash will be available for distribution to the Custodian or holders of SDRs. The holders of SDRs do not have any contractual relationship with, or rights enforceable against, the Sub-custodian. The Custodian has no obligation to pursue a claim in the Sub-custodian's insolvency on behalf of the holders of the SDRs.

For more information, see "*Description of Arrangements to Safeguard the Rights of Holders of the Swedish Depository Receipts*".

7. The Custodian has rights under the terms and conditions of the SDRs to terminate its arrangements with the Bank and, in certain circumstances, can sell the Shares underlying the SDRs

Under the terms and conditions applicable to the SDRs, the Custodian has the right to terminate the SDR arrangements with the Bank in certain circumstances. In such a case, the Custodian will provide holders of the SDRs with a notice of termination, which shall contain the record date upon which SEB shall de-register all the SDRs and transfer the Shares to a custodian account as instructed by each relevant holder of SDRs or as otherwise agreed with the holder of the SDRs. In the event (i) the holder of the SDRs has not provided a transfer instruction with a designated custodian account, (ii) it is not practically possible to transfer the Shares in accordance with the transfer instruction by the holder of the SDRs or (iii) an agreement has otherwise not been reached, SEB is entitled to sell the underlying Shares. The holder of the SDRs shall be entitled to the proceeds of such sale following deduction for fees, taxes and reasonable costs. The amount shall be paid to the cash account linked to respective VPC Account of the holder of the SDRs concerned or in the absence of such cash account, in the form of a payment notice. No interest shall accrue on the amount. For more information, see Condition 18 (*Termination, etc.*) in "*General Terms and Conditions of the Swedish Depository Receipts*".

8. Holders of SDRs may be subject to withholding tax in both Iceland and Sweden

Icelandic tax law does not specifically address the tax treatment of holders of SDRs. Icelandic tax authorities have, in an advance ruling, concluded that an issuer of the SDRs is not classified as the beneficial owner of dividend income of Shares in the Bank. As a result, dividend payments on Shares corresponding to SDRs will be subject to Icelandic withholding tax in the amount of (i) 22% for individuals and (ii) 20% for legal entities, regardless of residency of the holders of the SDRs. In addition, for holders of the SDRs who are tax resident in Sweden, dividends on the underlying Shares will be taxed as income from capital at a rate of 30% for individuals and 22% for limited liability companies. Therefore, holders of the SDRs who are tax resident in Sweden could be subject to double taxation. With the application of the Nordic Tax Treaty, it is possible for withholding on dividends in Sweden to be reduced to 15.0% for individuals and legal entities and to 0.0% for legal entities only, if the shareholding of such legal entities amounts to at least 10.0% of the issued share capital. In this case, holders of the SDRs who are tax resident in Sweden would still be subject to withholding of up to an additional 7.0% tax on dividends, which they would need to seek to reclaim from the tax authorities in Iceland. However, it must be noted again that such a scenario is not explicitly addressed by Icelandic laws and, therefore, individual holders may need to be addressed on a case by case basis by Icelandic tax authorities when determining if relief is available to holders of SDRs, and such relief may not be available. For more information, see "*Taxation*".

9. Preferential rights for U.S. and other non-Icelandic holders of the Shares may not be available

Should there be increases in the Bank's share capital, existing holders of the Shares and the SDRs are generally entitled to preferential rights to subscribe for new Shares and SDRs, unless shareholders waive such rights by a resolution at a general meeting of shareholders. U.S. Holders (as defined in "*Taxation—Certain U.S. Federal Income Tax Considerations*") of the Shares and the SDRs are customarily excluded from exercising any such preferential right they may have, unless the rights and the Shares and the SDRs are registered under the U.S. Securities Act or an exemption from the registration requirements thereunder is available. The Bank is unlikely to file any such registration statement and it cannot assure prospective investors that any exemption from the registration requirements would be available to enable U.S. or other non-Icelandic holders of the Shares and the SDRs to exercise such preferential rights or, if available, that the Bank would utilise any such exemption.

10. There is doubt as to the enforceability in Iceland of claims based on the United States federal securities laws

The Bank is a public limited company established under the laws of Iceland. The majority of the members of the Board of Directors, the Executive Committee and the Selling Shareholders reside outside the United States. In addition, a substantial portion of the Bank's assets and the assets of the members of the Board of Directors, the Executive Committee and the Selling Shareholders are located outside the United States. It may not be possible, therefore, for investors to effect service of process within the United States upon the Bank or members of the Board of Directors, the Executive Committee or the Selling Shareholders or to enforce in U.S. courts judgements against them obtained in those courts based upon the civil liability provisions of the United States federal securities laws. Furthermore, there is substantial doubt as to the enforceability in Iceland of claims based on the United States federal securities laws, whether by original actions or by seeking to enforce a judgement of a U.S. court.

11. U.S. Foreign Account Tax Compliance Act Withholding may affect payments on the Offer Securities

Sections 1471 through 1474 of the U.S. Internal Revenue Code of 1986, as amended (such provisions commonly known as "**FATCA**") impose a reporting regime and potentially a 30.0% withholding tax with respect to certain payments to any non-U.S. financial institution (a "**foreign financial institution**" or "**FFI**" (as defined by FATCA)) that (i) does not become a "Participating FFI" by entering into an agreement with the U.S. Treasury Department to provide certain information in respect of its account holders and (ii) is not otherwise exempt from or in deemed compliance with FATCA. This withholding regime generally applies to payments received from sources within the United States and will apply to "foreign passthru payments" (a term not yet defined) no earlier than 2019.

The United States and a number of potential partner countries have entered into intergovernmental agreements to facilitate the implementation of FATCA (each, an "**IGA**"), and the United States is in negotiations with several other countries to enter into an IGA. Iceland and the United States have entered into a Model 1 IGA, the most widely used IGA, as of 26 May 2015. Pursuant to FATCA and the Model 1 IGA, an FFI in an IGA signatory country may be treated as a "Reporting FI" not subject to FATCA withholding on any payments it receives. Such a Reporting FI also would not be required to withhold under FATCA or an IGA (or any law implementing or complying with, or introduced to conform to, an IGA) (any withholding under any of the foregoing, the "**FATCA Withholding**") from payments it makes, but the model IGA leaves open the possibility that such a Reporting FI might in the future be required to withhold on foreign passthru payments that it makes. A Reporting FI would be required to report certain information in respect of its account holders to its home government.

FATCA is particularly complex, and its application is uncertain at this time. The above description is based in part on regulations, official guidance and the model IGA, all of which are subject to change or may be implemented in a materially different form. Prospective investors should consult their tax advisors regarding the application of FATCA to the Bank and to payments they may receive in connection with the Offer Securities.

12. Exchange rate fluctuations could have an adverse impact on the value of a non-Icelandic holder's Offer Securities and dividends

An investment in the Offer Securities by an investor whose principal currency is not Icelandic Krona exposes the investor to foreign currency exchange rate risk. Any depreciation of Icelandic Krona in relation to such foreign currency will reduce the value of the investment in the Offer Securities or any dividends in foreign currency terms.

Dividends are declared at the Annual General Meeting and paid in Icelandic Krona; however, payment of dividends on the SDRs registered with Euroclear Sweden is made in Swedish Krona. The date for the payment of dividends in Iceland is decided by the shareholders at a general meeting (whether an annual general meeting or an extraordinary general meeting), and the date for the payment of dividends in Sweden is the date after payment of dividends in Iceland. The exchange rate is fixed two days before the payment of dividends in Iceland and three days before the payment of dividends in Sweden. As a result, the exchange rate between Icelandic Krona and Swedish Krona may fluctuate from the date of the Annual General Meeting to the date of exchange, which may consequently affect the amount of dividends paid in Sweden.

13. The ability of shareholders to remit any proceeds denominated in Icelandic Krona from a sale of the Shares is subject to compliance and notification requirements under the Capital Controls

The Capital Controls, as currently implemented, permit non-resident investors to invest in the Shares and to remit ISK proceeds from their sale outside of Iceland. Upon purchase of Shares, non-resident investors must provide a notification to the Icelandic Central Bank of their investment in the Shares in Icelandic Krona. Upon a sale by non-resident investors of the Shares in Icelandic Krona, investors must again notify the Icelandic Central Bank of the sale.

The SDRs are to be traded in Swedish Krona on NASDAQ Stockholm and, as a result, no notifications are required to the Icelandic Central Bank in respect of transactions in the SDRs conducted in Swedish Krona on NASDAQ Stockholm; however, conversion of a holding of the SDRs in Swedish Krona to Shares in Icelandic Krona, whether by residents or non-residents, must be notified to the Icelandic Central Bank as a foreign investment and exportation of securities.

14. Recovery and resolution regimes may affect the rights and remedies of holders of the Offer Securities

On 2 July 2014, Directive 2014/59/EU providing for the establishment of the European Union-wide framework for the recovery and resolution of credit institutions and investment firms (the "**BRRD**") entered into force. The BRRD sets out a set of tools available to competent authorities to intervene sufficiently early and quickly in an unsound or failing bank so as to ensure the continuity of the bank's critical financial and economic functions, while minimising the impact of the bank's failure on the economy and financial system. The BRRD provides that it will be applied by the member states of the EEA from 1 January 2015, except for the general bail-in resolution tool which has applied from 1 January 2016. Iceland has not yet implemented the BRRD.

The powers currently set out in the BRRD will impact how credit institutions and investment firms are managed as well as, in certain circumstances, the rights of creditors. Recovery measures under the BRRD could include the strengthening of the Bank's capital by issuing Shares in a situation of financial distress and/or write down or conversion into equity of the Bank's indebtedness, either of which could result in dilution of the purchasers of the Offer Securities. The exercise of any power under the BRRD, or any suggestion of such exercise, could materially adversely affect the price or value of the Offer Securities.

15. The undertakings to purchase Offer Securities made by the Cornerstone Investors are subject to certain conditions, and the Cornerstone Investors are not subject to any formal lock-up arrangement

Miton Asset Management Limited and Lansdowne Partners (UK) LLP, as Cornerstone Investors, have each agreed to acquire at the Offer Price (and at any such price throughout the Offer Price Range) a number of Offer Securities equivalent to US$ 22.5 million and US$ 38.0 million, respectively, converted into ISK at the mid-rate of the Icelandic Central Bank on, in the case of Miton, the date the Offer Price is set and, in the case of Lansdowne, 30 May 2018. The Cornerstone Investors' undertakings are conditional on, among other things, commencement of unconditional trading of the Offer Securities occurring no later than 29 June 2018. If such conditions are not satisfied, the Cornerstone Investors will not be required to acquire any Offer Securities. In addition, the Cornerstone Investors' undertakings have not been secured through a bank guarantee, blocked funds, pledge of collateral or similar arrangement. Accordingly, there is a risk that payment of the purchase price and settlement of the Offer Securities for the Cornerstone Investors may not occur in connection with the closing of the Offering as anticipated, which could have an adverse effect on the completion of the Offering.

In addition, the Cornerstone Investors' Shares (or SDRs, as the case may be) will not be subject to any formal lock-up arrangement, implying that it is possible that the Cornerstone Investors may divest part or all of their shareholdings at any time. Any sales of substantial amount of the Shares or SDRs could cause the market price of the Shares or SDRs to decline.

PRESENTATION OF FINANCIAL AND OTHER INFORMATION

General

The content of this Prospectus is not to be considered or interpreted as legal, financial or tax advice. It is not intended to provide the basis for any credit or other evaluation and should not be considered as a recommendation by any of Arion Bank, the members of the Board of Directors, the Executive Committee, the Selling Shareholders, any of the Managers or any of their respective representatives that any recipient of this Prospectus should purchase any Offer Securities. The Managers are party to various agreements pertaining to the Offering and have entered or may enter into financing arrangements with Arion Bank, but this should not be considered as a recommendation by them to invest in the Offer Securities. Each prospective investor should consult his own stockbroker, bank manager, lawyer, auditor or other financial, legal or tax advisors before making any investment decision with respect to the Offer Securities to, among other things, consider such investment decision in light of his or her personal circumstances and to determine whether or not such prospective investor is eligible to purchase the Offer Securities.

Potential investors should rely only on the information contained in this Prospectus and any prospectus supplements announced in accordance with the provisions of the Securities Transactions Act. Arion Bank does not undertake to update this Prospectus, unless required pursuant to the provisions of the Securities Transactions Act, and therefore potential investors should not assume that the information in this Prospectus is accurate as of any date other than the date of this Prospectus. No person is or has been authorised to give any information or to make any representation in connection with the Offering, other than as contained in this Prospectus and, if given or made, any such other information or representation must not be relied upon as having been authorised by Arion Bank, the members of the Board of Directors, the Executive Committee, the Selling Shareholders, any of the Managers or any of their respective representatives. The delivery of this Prospectus at any time after the date hereof will not, under any circumstances, create any implication that there has been no change in the affairs of Arion Bank since the date hereof or that the information contained herein is correct as of any time subsequent to such date.

No representation or warranty, express or implied, is made or given by or on behalf of the Managers or any of their affiliates or any of their respective directors, officers or employees or any other person, as to the accuracy, completeness or fairness of the information or opinions contained in this Prospectus, and nothing in this Prospectus shall be relied upon as a promise or representation by the Managers or any of their respective affiliates as to the past or future. None of the Managers accepts any responsibility whatsoever for the content of this Prospectus or for any other statements made or purported to be made by either itself or on its behalf in connection with Arion Bank, the Selling Shareholders, the Offering or the Offer Securities. Accordingly, the Managers disclaim, to the fullest extent permitted by applicable law, all and any liability whether arising in tort, contract or otherwise, which they might otherwise have in respect of this Prospectus and/or any such statement.

The Managers are acting exclusively for Arion Bank and the Selling Shareholders and no one else in connection with the Offering. They will not regard any other person (whether or not a recipient of this Prospectus) as their clients in relation to the Offering and will not be responsible to anyone other than Arion Bank and the Selling Shareholders for providing the protections afforded to their clients or for giving advice in relation to the Offering and the listing or any transaction, matter or arrangement referred to herein.

In connection with the Offering, the Managers and any of their respective affiliates, acting as investors for their own accounts, may acquire the Offer Securities and in that capacity may retain, purchase, sell, offer to sell or otherwise deal for their own accounts in such Offer Securities and other securities of Arion Bank or related investments in connection with the Offering or otherwise.

Goldman Sachs International, which is acting as a Joint Bookrunner in connection with the Offering, also holds Shares through ELQ Investors II Limited. Goldman Sachs International also holds positions in convertible bonds of Kaupthing and in loans to an affiliate of Kaupthing.

Accordingly, references in this Prospectus to the Offer Securities being offered, acquired, placed or otherwise dealt in should be read as including any offer to, or acquisition, dealing or placing by, the Managers and any of their affiliates acting as investors for their own accounts. None of the Managers intends to disclose the extent of any such investment or transactions otherwise than in accordance with any legal or regulatory obligations to do so.

The Offer Price Range is indicative only and the Offer Price may be set within, above or below the Offer Price Range. The Offer Price and the number of the Offer Securities to be included in the Offering will be determined upon the finalisation of the book-building period (expected to occur on or about 14 June 2018) and will be announced through the publication of an announcement. In the event that the Offer Price is set above or below the Offer Price Range, the Bank will publish a supplement to this Prospectus in accordance with the provisions of the Securities Transaction Act.

Supplements

If a significant new factor, material mistake or inaccuracy relating to the information included in this Prospectus that is capable of affecting the assessment of the Offer Securities arises or is noted between the date of this Prospectus being approved by the FME and the end of the Offering Period or, if applicable, the start of trading on NASDAQ Iceland or NASDAQ Stockholm, or if the Offer Price is determined above or below the Offer Price Range, then a prospectus supplement must be announced in accordance with the provisions of the Securities Transactions Act. Such a supplement will be subject to approval by the FME.

Investors who have already agreed to purchase the Offer Securities before the supplement is published shall have the right, exercisable within two business days following the publication of a supplement, to withdraw their acceptances.

Statements contained in any such supplement (or contained in any document incorporated by reference therein) shall, to the extent applicable, whether expressly, by implication or otherwise, be deemed to modify or supersede statements contained in this Prospectus. Any statement so modified or superseded shall, except as so modified or superseded, no longer constitute a part of this Prospectus. For the avoidance of doubt, references in this paragraph to any supplement being published by the Bank do not include the pricing statement.

Stabilisation

IN CONNECTION WITH THE OFFERING, CITIGROUP GLOBAL MARKETS LIMITED, AS STABILISING MANAGER, OR ANY OF ITS AGENTS MAY (BUT WILL BE UNDER NO OBLIGATION TO), TO THE EXTENT PERMITTED BY APPLICABLE LAW, OVER-ALLOT SHARES AND/OR SDRS OR EFFECT OTHER TRANSACTIONS WITH A VIEW TO SUPPORTING THE MARKET PRICE OF THE SHARES AND/OR SDRS AT A HIGHER LEVEL THAN THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. THE STABILISING MANAGER IS NOT REQUIRED TO ENTER INTO SUCH TRANSACTIONS, AND SUCH TRANSACTIONS MAY BE EFFECTED ON ANY SECURITIES MARKET, OVER-THE-COUNTER MARKET, STOCK EXCHANGE OR OTHERWISE AND MAY BE UNDERTAKEN AT ANY TIME DURING THE PERIOD COMMENCING ON THE FIRST DAY OF TRADING IN THE SHARES AND SDRS ON NASDAQ ICELAND OR NASDAQ STOCKHOLM AND ENDING NO LATER THAN 30 CALENDAR DAYS THEREAFTER. HOWEVER, THERE WILL BE NO OBLIGATION ON THE STABILISING MANAGER OR ANY OF ITS AGENTS TO EFFECT STABILISING TRANSACTIONS, AND NO ASSURANCE CAN BE GIVEN THAT STABILISING TRANSACTIONS WILL BE UNDERTAKEN. SUCH STABILISATION, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME WITHOUT PRIOR NOTICE. IN NO EVENT WILL MEASURES BE TAKEN TO STABILISE THE MARKET PRICE OF THE SHARES AND/OR SDRS ABOVE THE OFFERING PRICE. EXCEPT AS REQUIRED BY LAW OR REGULATION, NEITHER THE STABILISING MANAGER NOR ANY OF ITS AGENTS INTEND TO DISCLOSE THE EXTENT OF ANY OVER-ALLOTMENTS MADE AND/OR STABILISATION TRANSACTIONS CONDUCTED IN RELATION TO THE OFFERING.

Potential Conflict of Interest

The Managers and/or their respective affiliates have from time to time engaged, and may in the future engage, in commercial banking, investment banking and financial advisory and ancillary transactions in the ordinary course of their business with the Group (or any parties related to the Group) for which they have received or may receive customary compensation, fees and/or commissions. These services may include issuing or creating and trading in the Group's securities and financial products, acting with the Group in debt or equity syndicates, providing investment banking, corporate banking or lending services with and to the Group, credit and rate flows with the Group, securities financing set-ups, acting as payments provider for the Group, holding cash management accounts for the Group, providing treasury services, such as repo, securities finance and portfolio management for liquidity management purposes and providing trading services, such as credits, rates and foreign exchange, commercial paper and certificate of deposit services and fixed income and treasury sales. In addition, the Managers and/or their respective affiliates, in the ordinary course of their business, hold, have held and/or may in the future hold a broad array of investments and actively trade the Group's debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers, including securities in relation to which the Managers may be exercising voting power over the Group's securities on behalf of third parties. The Managers and/or their respective affiliates may also make investment recommendations and/or publish or express independent research views in respect of securities and/or financial instruments of the Group, its affiliates and/or affiliates of the Selling Shareholders and may hold or recommend to clients that they acquire, long and/or short positions in such securities and instruments.

In connection with the Offering, each of the Managers and/or any of their respective affiliates, acting as an investor for its own account, may take up the Offer Securities and, in that capacity may retain, purchase or sell for its own account such Offer Securities or related investments and may offer or sell such Offer Securities or related investments otherwise than in connection with the Offering. Accordingly, references in this Prospectus to the Offer Securities being offered or placed should be read as including any offering or placement of the Offer Securities to any of the Managers and/or any of their respective affiliates acting in such capacity. In addition, certain of the Managers and/or their respective affiliates may enter into financing arrangements (including swaps) with investors in connection with which the Managers and/or their respective affiliates may from time to time acquire, hold or dispose of the Offer Securities. The Managers do not intend to disclose the extent of any such investment or transactions otherwise than in accordance with any legal or regulatory obligation to do so. As a result of acting in the capacities described above, the Managers may have interests that may not be aligned, or could potentially conflict, with interests of the investors in the Offer Securities and the Group.

Presentation of Financial Information

The consolidated financial information as of and for the years ended 31 December 2017, 2016 and 2015 has, unless otherwise stated and except for the below, been derived from Arion Bank's audited consolidated financial statements for the financial years ended 31 December 2017, 2016 and 2015 included in "*Consolidated Financial Statements*" (the "**Annual Financial Statements**"), prepared in accordance with International Financial Reporting Standards, as adopted by the European Union ("**IFRS**"), and additional requirements set forth in Act No. 3/2006 on Annual Accounts, as amended (the "**Annual Accounts Act**"), Act No. 161/2002 on Financial Undertakings, as amended (the "**Financial Undertakings Act**") and rules No. 532/2003 on Accounting for Credit Institutions. Financial information in this Prospectus is presented on a consolidated basis unless otherwise indicated.

Due to the following reclassification, certain line items in the selected consolidated information for the years ended 31 December 2016 and 2015 differ from the respective audited Annual Financial Statements included herein:

- In the periods prior to the year ended 31 December 2017, net income from non-current assets held for sale was classified as "Discontinued operations, net of tax". In the audited consolidated financial statements as of and for the year ended 31 December, 2017 (the "**2017 Financial Statements**"), net income from non-current assets held for sale was presented among "Other operating income".
- In the periods prior to the year ended 31 December 2017, non-current assets and disposal groups held for sale were presented within "Other assets". In the 2017 Financial Statements "Non-current assets and disposal groups held for sale" were presented as a separate line item.
- In the periods prior to the year ended 31 December 2017, "Cash and cash equivalents acquired through business combination" was presented as a separate reconciling line item below "Net increase in cash and cash equivalents". In the 2017 Financial Statements "Cash and cash equivalents acquired through business combination" was presented within "Net cash (to) from investing activities".
- In the periods prior to the year ended 31 December 2017, the operating segment information has been presented without allocated expense from supporting divisions to business segments. Bank levy has also been excluded from the operating segment information. In the 2017 Financial Statements, allocated expense from supporting divisions to business segments has been added as well as allocation of bank levy.
- In the periods prior to the year ended 31 December 2016, the earned premium of subsidiary Okkar líftryggingar hf. was presented as "Other operating income" and claims incurred were presented as "Other operating expense". Since 2016 those amounts are presented in the separate line item "Net insurance income".

Accordingly, the selected consolidated financial information as of and for the years ended 31 December 2017, has, unless otherwise stated, been derived from the 2017 Financial Statements. In order to present information on a consistent basis with the presentation adopted in the 2017 Financial Statements, the selected consolidated financial information as of and for the year ended 31 December 2016 has, unless otherwise stated, been derived from the unaudited comparative information included in the 2017 Financial Statements that reflects those line item reclassifications, and the selected consolidated financial information as of and for the year ended

31 December 2015 has been derived from the accounting records, in respect of the reclassifications made in the 2017 Financial Statements.

In order to present information on a consistent basis with the presentation adopted in the audited consolidated financial statements as of and for the year ended 31 December 2016 (the "**2016 Financial Statements**"), the selected consolidated financial information as of and for the year ended 31 December 2015 has, unless otherwise stated, been derived from the unaudited comparative information included in the 2016 Financial Statements that reflects those line item reclassifications.

The selected condensed consolidated interim financial information as of and for the three months ended 31 March 2018 has, unless otherwise stated, been derived from Arion Bank's unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018 prepared in accordance with International Accounting Standard 34, Interim Financial Reporting ("**IAS 34**"), as adopted by the European Union, and additional requirements set forth in the Annual Accounts Act, the Financial Undertakings Act and rules on Accounting for Credit Institutions.

On 1 January 2018, the Group adopted IFRS 9, Financial Instruments ("**IFRS 9**") and, as permitted by the transition provisions of IFRS 9, the comparative period was not restated; accordingly, all comparative period information presented in this Prospectus is presented in accordance with International Accounting Standard 39, Financial Instruments: Recognition and Measurement ("**IAS 39**"). The Group also elected, as a policy choice permitted under IFRS 9, to continue to apply hedge accounting under IAS 39. The impact of the adoption of the new standard of ISK 942 million has been recognised directly in retained earnings on 1 January 2018.

In addition, on 1 January 2018 the Group also adopted IFRS 15, Revenue from Contracts with Customers ("**IFRS 15**"). IFRS 15 was applied using the modified retrospective method, with the effect of initial application recognised on the date of initial application and without restatement of the comparative periods. The adoption of IFRS 15 did not, in the Bank's view, have a material impact on the Consolidated Statement of Comprehensive Income.

The audited consolidated financial statements as of and for the years ended 31 December 2017, 2016 and 2015 do not reflect the changes from the application of IFRS 9 and IFRS 15. Those audited consolidated financial statements applied International Accounting Standard ("**IAS**") 39, Financial Instruments: Recognition and Measurement ("**IAS 39**") and IAS 18, Revenue ("**IAS 18**"), which were the accounting standards in effect at the time for each period. Therefore, due to the adoption of the new accounting standards, the consolidated financial statements as of and for the years ended 31 December 2017, 2016 and 2015 and the comparative figures as of and for the three months period ended 31 March 2017, are not directly comparable with the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018.

The financial information included in this Prospectus was not prepared in accordance with generally accepted accounting principles in the United States ("**U.S. GAAP**"). In certain respects, IFRS differs from U.S. GAAP. Investors should seek their own advice regarding the differences between IFRS and U.S. GAAP. In making an investment decision, prospective investors must rely on their own examination of the information regarding the Group, the terms of the Offering and the financial and other information in this Prospectus.

The audited consolidated financial statements for the financial years ended 31 December 2017, 2016 and 2015 have been audited by Deloitte ehf. ("**Deloitte**"), and the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018 have been reviewed by Deloitte. The respective audit reports and review report are included in this Prospectus.

Operating Segment Reporting

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. In presenting geographic information, segment revenue has been based on the geographic location of customers. Inter segment pricing is determined on an arm's length basis. Operating segments pay and receive interest to and from Treasury on an arm's length basis to reflect the allocation of capital, funding costs and relevant risk premium, which intragroup metrics disappear upon consolidation.

The Bank has the following operating segments: (1) Corporate Banking; (2) Retail Banking; (3) Asset Management; (4) Investment Banking; (5) Treasury; and (6) Other Divisions and Subsidiaries, consisting of Valitor, Vördur, Landey and other smaller entities. See "*Business Overview—Business*".

KPIs and Non-IFRS Information

This Prospectus contains certain financial measures that are not defined or recognised under IFRS, exclude amounts that are included in, or include amounts that are excluded from, the most directly comparable measure calculated and presented in accordance with IFRS, or are calculated using financial measures that are not calculated in accordance with IFRS.

The Bank's financial key performance indicators ("**KPIs**") in this prospectus comprise return on equity, return on assets, return on risk-weighted assets, net interest margin on interest-earning assets, net interest margin on total assets, cost-to-income ratio, cost-to-total assets ratio, cost of risk, coverage ratio and loan-to-deposit ratio.

The Bank's non-IFRS measures comprise adjusted return on equity, adjusted net interest margin on interest-earning assets, adjusted net interest margin on total assets, adjusted cost-to-income ratio, adjusted cost of risk, return on equity excluding Valitor, return on equity excluding the effects of the Bank Levy and additional income taxes, cost-to-income ratio excluding Valitor, loan-to-deposit ratio excluding covered bonds, average tangible equity and the adjusted income statement information and metrics derived therefrom, representing events which the Directors consider to be non-recurring items (collectively, the "**Non-IFRS Information**").

Arion Bank uses these indicators in its business operations, among other things, to evaluate the performance of its operations, to develop budgets and to measure Arion Bank's performance against those budgets. Arion Bank believes the Non-IFRS Information and the KPIs to be useful supplemental tools to assist in evaluating operating performance because it considers the Non-IFRS Information and KPIs to reflect its underlying business performance and believes that these measures provide additional useful information for prospective investors on its performance, enhance comparability from period to period and with other companies and are consistent with how business performance is measured internally.

The Non-IFRS Information and related measures are not measurements of performance or liquidity under IFRS and should not be considered by investors in isolation or as a substitute for measures of earnings, as an indicator of the Arion Bank's operating performance or cash flows from operating activities as determined in accordance with IFRS or otherwise as a substitute for analysis of the Bank's operating results reported under IFRS. Arion Bank has presented these supplemental measures because they are used by the Bank to monitor the underlying performance of its business and operations. The Non-IFRS Information and related measures may not be comparable to similarly titled measures disclosed by other banks and have limitations as analytical tools. The Bank does not regard the Non-IFRS Information as a substitute for, or superior to, the equivalent measures calculated and presented in accordance with IFRS or those calculated using financial measures that are calculated in accordance with IFRS. The Non-IFRS Information described in this Prospectus is unaudited and has not been prepared in accordance with IFRS or any other generally accepted accounting principles. In addition, the presentation of the Non-IFRS Information is not intended to and does not comply with the reporting requirements of the U.S. Securities and Exchange Commission.

For definitions of the non-IFRS measures included in the Non-IFRS Information and KPIs, along with quantitative reconciliations to the most directly comparable amounts reported in accordance with IFRS, see "*Selected Consolidated Financial, Operating and Other Information—Certain Other Financial Information*".

Rounding

Certain figures in this Prospectus, including financial information, have been subject to rounding adjustments. Accordingly, in certain instances (a) the sum or percentage change of such numbers may not conform exactly to the total figure given and (b) the sum of the numbers in a column or row in certain tables may not conform exactly to the total figure given for that column or row.

Currency Presentation

The tables below set forth U.S. dollar versus ISK and euro versus ISK exchange rates as certified by the Icelandic Central Bank and U.S. dollar versus Swedish krona ("**Swedish Krona**" or "**SEK**") and euro versus SEK exchange rates as certified by Sveriges Riksbank (the "**Swedish Central Bank**"). Arion Bank does not represent that the ISK or the SEK amounts referred to below could have been or could be converted into U.S. dollars or euro at any particular rate indicated or at any other rate. The rates below may differ from the rates used in "*Consolidated Financial Statements*" and other financial information appearing in this Prospectus.

The table below sets forth the high and low Icelandic Central Bank daily closing mid-rates for U.S. dollar versus ISK for each respective year and the rate at the end of the year. The average amounts set forth below under "Average" are calculated as the average of the Icelandic Central Bank rates for U.S. dollar versus ISK on the last business day of each month for each respective year.

	Low	High	Average	End of Year
	(ISK per U.S. dollar)			
2013	115.03	130.04	121.29	115.03
2014	111.61	127.16	117.05	126.90
2015	124.09	139.80	131.85	129.59
2016	109.97	131.66	120.10	112.82
2017	97.79	116.64	105.95	104.42

The table below sets forth the high and low Icelandic Central Bank rates for U.S. dollar versus ISK for each month during the six full months prior to the date of this Prospectus.

	Low	High
	(ISK per U.S. dollar)	
November 2017	102.82	106.38
December 2017	103.20	106.02
January 2018	100.34	104.91
February 2018	100.08	102.30
March 2018	98.02	101.46
April 2018	98.21	101.40

The U.S. dollar versus ISK Icelandic Central Bank exchange rate on 29 May 2018 was ISK 106.47 per U.S.$ 1.00.

The table below sets forth the high and low Icelandic Central Bank daily closing mid-rates for euro versus ISK for each respective year and the rate at the end of the year. The average amounts set forth below "Average" are calculated as the average of the Icelandic Central Bank rates for euro versus ISK on the last business day of each month for each respective year.

	Low	High	Average	End of Year
	(ISK per euro)			
2013	152.12	174.17	161.29	158.50
2014	152.18	159.70	154.40	154.27
2015	140.30	154.27	145.61	141.32
2016	118.25	143.08	132.66	119.13
2017	110.00	128.38	120.27	120.05

The table below sets forth the high and low Icelandic Central Bank rates for euro versus ISK for each month during the six full months prior to the date of this Prospectus.

	Low	High
	(ISK per euro)	
November 2017	120.80	123.65
December 2017	122.60	125.65
January 2018	124.25	126.08
February 2018	123.70	125.40
March 2018	121.50	123.90
April 2018	121.30	123.23

The euro versus ISK Icelandic Central Bank exchange rate on 29 May 2018 was ISK 122.93 per EUR 1.00.

The table below sets forth the high and low Swedish Central Bank daily closing mid-rates for U.S. dollar versus SEK for each respective year and the rate at the end of the year. The average amounts set forth below under "Average" are calculated as the average of the Swedish Central Bank rates for U.S. dollar versus SEK on the last business day of each month for each respective year.

	Low	High	Average	End of Year
	(SEK per U.S. dollar)			
2013	6.2940	6.8360	6.5140	6.5084
2014	6.3392	7.8117	6.8577	7.8117
2015	7.8239	8.8390	8.4350	8.3524
2016	7.9202	9.3856	8.5907	9.0971
2017	7.9236	9.1510	8.4978	8.2322

The table below sets forth the high and low Swedish Central Bank rates for U.S. dollar versus SEK for each month during the six full months prior to the date of this Prospectus.

	Low	High
	(SEK per U.S. dollar)	
November 2017	8.2859	8.5222
December 2017	8.2322	8.5010
January 2018	7.8434	8.2178
February 2018	7.8550	8.2560
March 2018	8.1697	8.3596
April 2018	8.2988	8.6911

The U.S. dollar versus SEK Swedish Central Bank exchange rate on 29 May 2018 was SEK 8.86 per U.S.$ 1.00.

The table below sets forth the high and low Swedish Central Bank daily closing mid-rates for euro versus SEK for each respective year and the rate at the end of the year. The average amounts set forth below under "Average" are calculated as the average of the Swedish Central Bank rates for euro versus SEK on the last business day of each month for each respective year.

	Low	High	Average	End of Year
	(SEK per euro)			
2013	8.2876	9.097	8.6494	8.943
2014	8.7704	9.5263	9.0968	9.5155
2015	9.0732	9.6418	9.3562	9.135
2016	9.1467	9.9826	9.4654	9.5669
2017	9.4146	10.012	9.6414	9.8497

The table below sets forth the high and low Swedish Central Bank rates for euro versus SEK for each month during the six full months prior to the date of this Prospectus.

	Low	High
	(SEK per euro)	
November 2017	9.7223	10.012
December 2017	9.8397	9.9942
January 2018	9.7570	9.8459
February 2018	9.7936	10.0752
March 2018	10.0806	10.2931
April 2018	10.2759	10.5117

The euro versus SEK Swedish Central Bank exchange rate on 29 May 2018 was SEK 10.26 per EUR 1.00.

Market Data

Certain information contained in this Prospectus relating to the financial services industry in which the Group operates as well as certain economic and industry data and forecasts used, and statements regarding the Group's market position made, in this Prospectus were extracted or derived from other third party reports, market research, government and other publicly available information and independent industry publications, as the case may be, including the Research department of Arion Bank ("**Arion Bank Research**"), Statistics Iceland, IMF, FME, Ministry of Finance and Economic Affairs, Icelandic Central Bank, Isavia, Icelandic Tourist Board, NASDAQ Iceland, Euromonitor, WW NewMedia Market Model, Registers Iceland, Capacent, Capacent Gallup, IP&E Reference Hub and annual reports of Landsbankinn and Íslandsbanki. See "*Industry Overview*" and "*Business Overview*".

While Arion Bank believes the third party information included herein to be reliable, Arion Bank has not independently verified such third party information, and none of Arion Bank, the Managers or the Selling Shareholders make any representation or warranty as to the accuracy or completeness of such information as set forth in this Prospectus. Arion Bank confirms that such third party information has been accurately reproduced and, as far as Arion Bank is aware and able to ascertain from information available from those publications, no facts have been omitted which would render the reproduced information inaccurate or misleading. However, the accuracy of such third party information is subject to availability and reliability of the data supporting such information and neither the information nor the underlying data has been independently verified. Additionally, the industry publications and other reports referred to above generally state that the information contained therein has been obtained from sources believed to be reliable, but that the accuracy and completeness of such information is not guaranteed and, in some instances, these reports and publications state expressly that they do not assume liability for such information. Arion Bank cannot therefore make any assurances regarding the accuracy and completeness of such information as it has not independently verified such information.

Enforcement of Civil Liabilities

The ability of shareholders in certain countries other than Iceland, in particular in the United States, to bring an action against the Bank may be limited by relevant law. The Bank is a public limited company established under Act No. 2/1995 respecting Public Limited Companies, as amended (the "**Public Limited Companies Act**"), with ID number 581008-0150 in the Register of Enterprises of Iceland and has its registered office in Reykjavík, Iceland.

The Lugano Convention on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters (the "**Lugano Convention**") is in force between the European Union and Iceland. The Lugano Convention and protocols 1, 2 and 3 are incorporated into Icelandic law with Act No. 7/2011. Subject to the conditions set forth in the Lugano Convention, it forms the basis on which international jurisdiction of the courts is determined, facilitates recognition of foreign judgements and sets out an expeditious procedure for securing the enforcement of judgements in Iceland.

Iceland, Denmark, Finland, Norway and Sweden have been parties to a convention on the recognition and enforcement of judgements since 1932 and to a convention on the recognition and enforcement of judgements in civil matters since 1977 (the "**Nordic Judgements Conventions**"). The Lugano Convention supersedes the Nordic Judgements Convention, subject to certain exceptions set forth in the Lugano Convention.

The majority of the members of the Board of Directors, the Executive Committee and other officers named herein are residents of countries other than the United States. All or a substantial portion of the assets of these persons are located outside the United States. The assets of Arion Bank are predominantly located outside the United States. As a result, it may be impossible or difficult for investors to effect service of process within the United States upon such persons or Arion Bank or to enforce in U.S. courts a judgement obtained in courts of other jurisdictions against them or Arion Bank.

The United States and Iceland do not currently have a treaty providing for reciprocal recognition and enforcement of judgements, other than arbitration awards according to the New York Convention 1958, in civil and commercial matters. Accordingly, a judgement rendered by a court in the United States will not be recognised and enforced by the Icelandic courts. It is a general principle of Icelandic law that foreign judgements do not have legal effect in Iceland unless such effect is provided for in legislation. Because Icelandic law does not provide that judgements rendered by a court in the United State will have specific legal effects in Iceland, such judgements will have limited relevance to the resolution of claims in Icelandic courts. Judgements rendered by a court in the United States can provide guidance on the interpretation of U.S. law to the extent that it governs the subject of the dispute and have probative value as to disputed facts, if the jurisdiction of the U.S. court has been based on grounds which are internationally acceptable, the defendant has been given a reasonable opportunity to defend the claims made and proper legal procedures have been observed and except to the extent that the foreign judgement contravenes Icelandic public policy.

No Incorporation of Website Information

Neither the contents of Arion Bank's website, nor any other website, form a part of, nor are to be considered incorporated into, this Prospectus.

Forward-Looking Statements

This Prospectus contains forward-looking statements that reflect Arion Bank's intentions, beliefs or current expectations and projections about its future business, results of operations, financial condition, liquidity, performance, prospects, anticipated growth, strategies and opportunities and the markets in which it operates. Forward-looking statements involve all matters that are not historical facts. Arion Bank has tried to identify forward-looking statements by using words such as "may", "will", "would", "could", "should", "expects", "intends", "estimates", "anticipates", "projects", "believes", "could", "hopes", "seeks", "plans", "aims", "objective", "potential", "goal", "strategy", "target", "continue", "annualised" and similar expressions or negatives thereof or other variations thereof or comparable terminology or by discussions of strategy that involve risks and uncertainties. Forward-looking statements may be found principally in sections of this Prospectus titled "*Risk Factors*", "*Industry Overview*", "*Business Overview*", "*Operating and Financial Review*" and "*Shares and Share Capital—Dividends and Dividend Policy*" as well as elsewhere.

Forward-looking statements are based on Arion Bank's beliefs, assumptions and expectations regarding future events and trends that affect Arion Bank's future performance, taking into account all information currently available to Arion Bank, and are not guarantees of future performance. These beliefs, assumptions and expectations can change as a result of possible events or factors, not all of which are known to Arion Bank or are within its control. If a change occurs, Arion Bank's business, results of operations, financial condition, liquidity, performance, prospects, anticipated growth, strategies or opportunities may vary materially from those expressed in, or suggested by, these forward-looking statements. In addition, forward-looking estimates and forecasts reproduced in this Prospectus from third party reports could prove to be inaccurate. A number of important factors could cause actual results or outcomes to differ materially from those expressed in any forward-looking statement as a result of risks and uncertainties facing Arion Bank. Such risks, uncertainties and other important factors include, but are not limited to, those listed in the section of this Prospectus titled "*Risk Factors*".

The following include some but not all of the factors that could cause actual results or events to differ materially from the anticipated results or events:

- deterioration of the economic conditions or the banking system in Iceland, either as a result of political and economic factors, either domestic or international;
- exposure to Iceland's key industry sectors, in particular tourism, seafood, aluminium, energy and real estate;
- an adverse shift in public sentiment and potential political or legislative action;
- exposure to liquidity, maturity, foreign exchange, and market funding risks, and various other typical financial institution market risks relating to interest rates, equity pricing and inflation;
- existing customer loan portfolio exposure to problem and impaired loans;
- costs and competitive disadvantages resulting from the Bank Levy and other taxes;
- domestic economic constraints on near-term growth;
- failure to implement the Bank's strategy or failure to achieve the anticipated benefits of this strategy;
- exposure to existing and increasing competition in Iceland as Iceland's economy recovers and the Capital Controls are eased;
- regulatory and legal risks inherent in the Bank's businesses;
- ongoing legal proceedings and investigations by government authorities;
- failure or breach of the Bank's information technology systems;
- unauthorised disclosure of confidential information and any resulting liability, litigation, and reputational damage;
- restrictions under the Capital Controls on the Bank's operations and abnormal pricing and financial bubbles that may result from the Capital Controls;
- potential inability to recruit or retain experienced personnel or key members of the Executive Committee;
- a credit rating downgrade or change in outlook;

- various operational risks, including risk of systems failures, human error, regulatory breaches, and employee misconduct;
- damage to the reputation of the Bank, its subsidiaries or its shareholders;
- exposure to unidentified, unanticipated or incorrectly quantified risks as a result of risk management methods;
- reliance on third party service providers;
- violation of anti-money laundering or anti-bribery regulations;
- adverse changes to the Capital Requirements Directives;
- restriction, suspension or termination of relationships with key card scheme operators;
- failure of the Asset Management division to sustain or increase its level of assets under management and is subject to pressure on fee margins;
- incurrence of unforeseen liabilities from prior and future acquisitions and disposals;
- inadequate insurance coverage; and
- inadequate implementation by Iceland of the EEA rules.

Should one or more of these risks or uncertainties materialise or should any of the assumptions underlying the above or other factors prove to be incorrect, Arion Bank's future business, results of operations, financial condition, liquidity, performance, prospects, anticipated growth, strategies or opportunities could differ materially from those described herein as currently anticipated, believed, estimated or expected.

Investors or potential investors should not place undue reliance on the forward-looking statements in this Prospectus. Arion Bank urges investors to read the sections of this Prospectus titled "*Risk Factors*", "*Industry Overview*", "*Business Overview*" and "*Operating and Financial Review*" for a more complete discussion of the factors that could affect Arion Bank's future performance and the markets in which it operates. In light of the possible changes to Arion Bank's beliefs, assumptions and expectations, the forward-looking events described in this Prospectus may not occur. Additional risks currently not known to Arion Bank or that Arion Bank has not considered material as of the date of this Prospectus could also cause the forward-looking events discussed in this Prospectus not to occur. Forward-looking statements involve inherent risks and uncertainties and speak only as of the date they are made. Arion Bank undertakes no duty to and will not necessarily update any of the forward-looking statements in light of new information or future events, except to the extent required by applicable law.

BACKGROUND AND REASONS AND USE OF PROCEEDS

Background and Reasons

Arion Bank was established in October 2008 as the entity to which certain assets and liabilities of Kaupthing were transferred following the assumption of control of Kaupthing by the FME. Arion Bank faced a number of challenges arising from assets and liabilities which it acquired from its predecessor. In March 2010, a new Board of Directors was appointed at Arion Bank's annual general meeting of shareholders (the "**Annual General Meeting**") and, in June 2010, the Board of Directors appointed a new chief executive officer (the "**CEO**"). Under this new leadership, Arion Bank adopted a strategic plan, including ongoing attention to the restructuring and reduction of Arion Bank's risk and liabilities and the positioning of Arion Bank as the leading universal relationship bank in Iceland with a balanced and wide range of products and services. Arion Bank continues to implement this strategy and has made significant progress on reducing problem loans, expanding its sources of funding and building trust with its customers, Icelandic society as a whole and international financial institutions and investors. Today, Arion Bank is a well-balanced and diversified universal relationship bank, the revenue streams of which broadly reflect the Icelandic economy, and it continues to improve its business to meet the changing needs of its customers and the Icelandic society.

As such, the Board of Directors and the Executive Committee are of the opinion that the time is appropriate for a listing of Arion Bank on NASDAQ Iceland and NASDAQ Stockholm. The Offering and the listing of the Offer Securities on NASDAQ Iceland and NASDAQ Stockholm will expand the shareholder base and enable Arion Bank to access the Icelandic, the Swedish and other international capital markets. The Board of Directors and the Executive Committee consider the Offering and listing of the Offer Securities on NASDAQ Iceland and NASDAQ Stockholm to be a logical step for Arion Bank. The listing is a quality mark and increases the awareness of Arion Bank and its brand, which is expected to increase its ability to attract new customers and to strengthen the franchise value of Arion Bank.

Use of Proceeds

Arion Bank will not receive any proceeds from any sale of the Offer Securities by the Selling Shareholders, all of which will be paid to the Selling Shareholders. The gross proceeds from the Offering to be received by the Selling Shareholders will be approximately ISK 43,236 million (assuming that the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares and that the Over-Allotment Option is not exercised). The aggregate underwriting commissions, other fees and expenses (including regulatory filing and registration expenses) and amounts to be paid by the Selling Shareholders in connection with the Offering are expected to be up to approximately ISK 1,474 million (assuming that the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares and that the Over-Allotment Option is not exercised). See "*Plan of Distribution and Transfer Restrictions*".

Responsibility Statements

Arion Bank and the Board of Directors are responsible for the content of this Prospectus. Arion Bank and the Board of Directors hereby declare that, having taken all reasonable care to ensure that such is the case, the information in this Prospectus is, to the best of Arion Bank's and the Board of Directors' knowledge, in accordance with the facts and contains no omission likely to affect its import.

Reykjavík, 31 May 2018

For and on behalf of Arion Bank

/s/ Höskuldur H. Ólafsson

Höskuldur H. Ólafsson, CEO of Arion Bank

For and on behalf of the Board of Directors

/s/ Eva Cederbalk

Eva Cederbalk, Chairman of the Board of Directors

The board of directors of each of Kaupskil ehf. and Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP) declares that, having taken all reasonable care to ensure that such is the case, the information in this Prospectus regarding the Offer Price Range, the Offer Price, the timing of the Offering, including payment and delivery of the Offer Securities, the description of the lock-up applicable to its Shares and the fees payable by it in relation to the Offering is, to the best of its knowledge, in accordance with the facts and contains no omission likely to affect its import. Neither Kaupskil ehf. nor Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP) accepts any responsibility for any other information contained in this Prospectus, nor has it separately verified any such other information.

Reykjavík, 31 May 2018

For and on behalf of the board of directors of Kaupskil ehf.

/s/ Reynir Karlsson

Reynir Karlsson, Chairman of the board of directors of Kaupskil ehf.

Dublin, 31 May 2018

For and on behalf of the board of directors of Trinity Investments Designated Activity Company

/s/ Roger McGreal

Roger McGreal, Director of Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP)

Statement by the Auditor

Deloitte ehf., identification number 521098-2449, Smáratorgi 3, 201 Kópavogi, Iceland, has audited the consolidated financial statements of Arion Bank for the years ended 31 December 2017, 2016 and 2015. Deloitte ehf. hereby confirms that the consolidated financial statements of Arion Bank for the years ended 31 December 2017, 2016 and 2015 give a true and fair view of the financial position of Arion Bank for the respective years ended 31 December and of its financial performance and its cash flows for years then ended in accordance with International Financial Reporting Standards ("IFRS") as adopted by the European Union. Deloitte ehf. confirms that the information reproduced in this Prospectus from the above-mentioned consolidated financial statements for Arion Bank is consistent with their respective originals.

Reykjavík, 31 May 2018

On behalf of Deloitte ehf.

/s/ Páll Grétar Steingrímsson

Páll Grétar Steingrímsson

Certified public accountant and member of the Icelandic Institute of State Authorised Public Accountants

OFFER STATISTICS

Offer Price Range (per Share / SDR)(1)	ISK 68 to ISK 79
Number of the Shares issued	2,000,000,000
Number of the Shares outstanding(2)	1,810,000,000
Number of the Existing Offer Shares and SDRs to be sold in the Offering(3)	Up to 724,000,000
Percentage of the issued share capital expected to be sold in the Offering(3)	Up to 36.2%
Maximum number of the Over-Allotment Shares	108,600,000
Estimated gross proceeds of the Offering(4)	ISK 43,236 million
Estimated net proceeds of the Offering(4)(5)	ISK 41,762 million
Expected market capitalisation of Arion Bank at the Offer Price(6)	ISK 133,035 million

(1) The Offer Price may be set within, above or below the Offer Price Range. To the fullest extent permitted by law, applications received under the Offer are irrevocable and are based on the amount the applicant wishes to invest and not the number of the Shares or the Offer Price. The Offer Price will be set in ISK and, for purposes of sales of SDRs via NASDAQ Stockholm, will be translated to SEK based on the prevailing selling rate of exchange published by the Central Bank of Iceland on 14 June 2018. It is expected that the Pricing Statement containing the Offer Price and the number of the Shares which are the subject of the Offer will be published on or about 15 June 2018.

(2) Shares outstanding excludes the Shares held by Arion Bank.

(3) Assumes that the Over-Allotment Option is not exercised.

(4) Assumes that the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares and that the Over-Allotment Option is not exercised.

(5) After deduction of commissions and expenses and VAT payable by the Selling Shareholders of ISK 1,474 million. Arion Bank will not receive any portion of the proceeds from the Offering.

(6) Calculated based on the number of Shares outstanding and assumes that the Offer Price is set at the mid-point of the Offer Price Range.

EXPECTED TIMETABLE OF PRINCIPAL EVENTS

Prospectus published, announcement of the Offer Price Range	31 May 2018
Opening of the Offering to retail investors in Iceland	12:00 p.m. (GMT) on 31 May 2018
Opening of the Offering to retail investors in Sweden	2:00 p.m. (CEST) on 31 May 2018
Closing of the Offering to retail investors in Iceland	3:00 p.m. (GMT) on 13 June 2018
Closing of the Offering to retail investors in Sweden	5:00 p.m. (CEST) on 13 June 2018
Expected determination of the Offer Price and number of the Offer Securities	14 June 2018
Announcement of the Offer Price and number of the Offer Securities	15 June 2018
Results of allocations under the Offer notified to investors	15 June 2018
Final date for payment by retail investors in Iceland	18 June 2018
Final date for delivery of the Offer Securities to investors	19 June 2018
Commencement of conditional trading in the Shares on NASDAQ Iceland expected from(1)	9:30 a.m. (GMT) on 15 June 2018
Commencement of conditional trading in the SDRs on NASDAQ Stockholm expected from(1)(2)	11:30 a.m. (CEST) on 15 June 2018
Admission to trading and commencement of unconditional trading in the Shares on NASDAQ Iceland expected from	9:30 a.m. (GMT) on 19 June 2018
Admission to trading and commencement of unconditional trading in the SDRs on NASDAQ Stockholm expected from	9:00 a.m. (CEST) on 19 June 2018
End of stabilisation period	13 July 2018

(1) Prior to commencement of conditional trading, there will be publication of order book information in respect of the Shares from 8:00 a.m. to 9:30 a.m. GMT and order book information in respect of the SDRs from 11:20 a.m. to 11:30 a.m. CEST in respect of the SDRs. The difference in time periods is to permit conditional trading to occur simultaneously.

(2) Due to the time difference between Iceland and Sweden, conditional trading in the SDRs on NASDAQ Stockholm will be temporarily suspended (from 8:00 a.m. to 11:20 a.m. CEST) in order to permit conditional trading in the Shares on NASDAQ Iceland and in the SDRs on NASDAQ Stockholm to occur simultaneously.

Condtional trading represents trading on an "as if and when delivered" basis—that is, it is conditional on the occurrence of admission to trading of the Offer Securities. In this respect, it should be noted that, if admission of the Offer Securities to trading on either NASDAQ Iceland or NASDAQ Stockholm does not occur for any reason, all conditional trading on the respective market will be of no effect and any such dealings will be at the sole risk of the parties concerned. Temporary documents of title will not be issued.

INDUSTRY OVERVIEW

This Prospectus contains statistics, data and other information relating to the banking industry in which Arion Bank operates. Where indicated, Arion Bank has extracted or derived certain economic and industry data from third party reports, market research, government reports and other publicly available information. Although the information has been accurately reproduced and although Arion Bank believes the sources are reliable, none of Arion Bank, the Managers or the Selling Shareholders has independently verified and cannot give any assurance with respect to the accuracy and completeness of such information. As far as Arion Bank is aware and able to ascertain from other information published by such sources, no fact has been omitted which would render the reproduced information inaccurate or misleading.

Overview

Iceland currently has one of the highest GDPs per capita in the world, amounting to approximately U.S.$52,000 in 2017 *(source: IMF)*. Iceland is a relatively young and growing economy with an average real GDP growth of 3.2% from 2010 to 2017 and an increasing investment demand *(source: Arion Bank Research)*. Real GDP in Iceland increased in each of 2017, 2016 and 2015 by 3.6%, 7.5% and 4.3%, respectively *(source: Statistics Iceland)*. Iceland's economy has made a strong recovery from the financial crisis in 2008, and since 2011, government gross debt as a percentage of GDP has been decreasing, and the IMF forecasts that this figure will decrease even further from 63% in 2017 to 33% in 2020 *(source: Statistics Iceland, IMF)*. Iceland's current account surplus stood at 3.7% of GDP and Iceland had a budget surplus of 1.2% of GDP as of and for the year ended 31 December 2017 *(source: Statistics Iceland)*.

Iceland has a population of approximately 350,000 people who enjoy a generally high standard of living. The unemployment rate in Iceland is decreasing and stood at 2.8%, 3.0% and 4.0% in 2017, 2016 and 2015, respectively, which was significantly lower than Sweden, Ireland and the eurozone average *(source: Statistics Iceland, IMF)*.

Iceland's economy is becoming increasingly diversified and is based, among other things, on the four export pillars of tourism (*i.e.*, as a source of foreign income), seafood, energy and other industrial goods and services. Exports were responsible for approximately 47% of Iceland's GDP, with the tourism and seafood industry sectors amounting to 42% and 16% of exports, respectively, in 2017. In recent years, there has been a significant growth in the number of tourists by 30% in 2015, 40% in 2016 and 24% in 2017, in each case, as compared to the previous year, but growth is expected to moderate in the medium term *(source: Statistics Iceland, Isavia, Arion Bank Research)*.

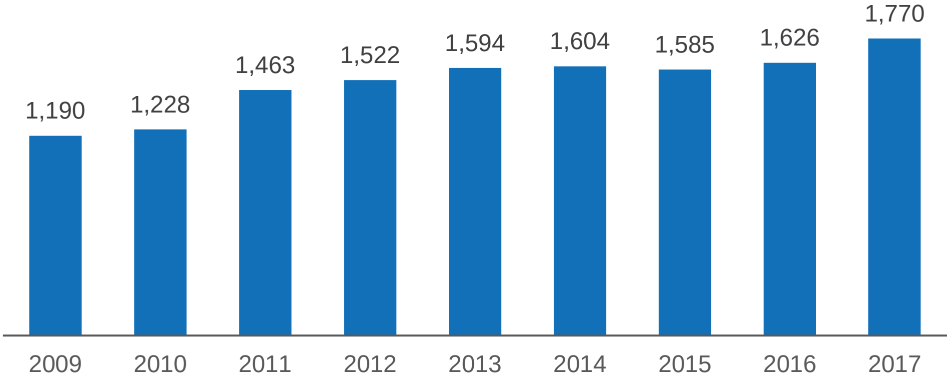
Iceland's strong economy supports its growing and stable banking sector. The banking sector is comprised of the three main banks (Arion Bank, Landsbankinn and Íslandsbanki), which held a combined market share of 52% of loans to households, 80% of loans to corporates and 98% of deposits from customers as of 31 December 2017 *(source: Ministry of Finance and Economic Affairs, Arion Bank, Landsbankinn and Íslandsbanki annual reports)*. The Capital Controls, which were limiting the ability of the Icelandic population and corporates to buy or sell foreign currency, were largely lifted in March 2017, but certain limited elements remain, such as restrictions on (i) derivatives trading for purposes other than hedging; (ii) foreign exchange transactions carried out between residents and non-residents without the intermediation of a financial undertaking; (iii) in certain instances, lending by residents to non-residents; and (iv) certain other restrictions in relation to special reserve requirements due to new inflows of foreign currency in further specified cases.

Retail Banking

The Icelandic retail banking market is a relatively stable market in a growing economy and, as such, the overall retail banking market is growing. Iceland has a young and growing population, a high level of education and low unemployment rates. These factors have contributed, and are expected to contribute, to an increasing demand for financing and growth in the mortgage loans market in the medium term. For the years ended

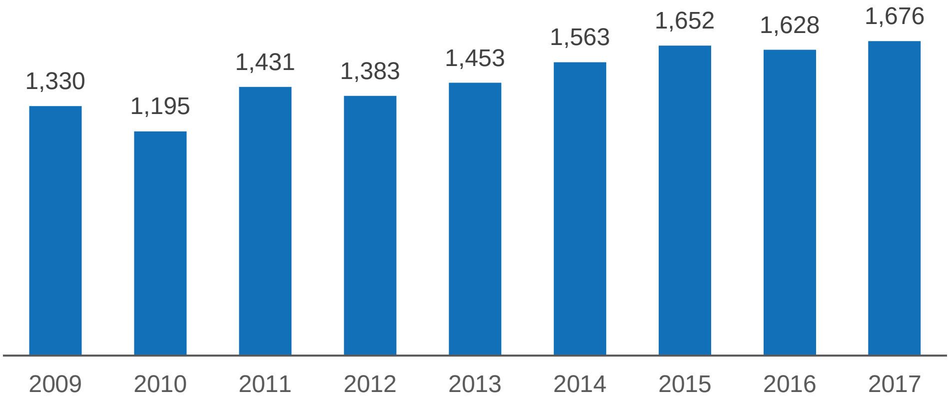
31 December 2017, 2016 and 2015, total loans to households in Iceland amounted to ISK 1,770 billion, ISK 1,626 billion, and ISK 1,585 billion, respectively (*source: Icelandic Central Bank, Statistics Iceland*).

Total loans to Households in Iceland (ISK bn)



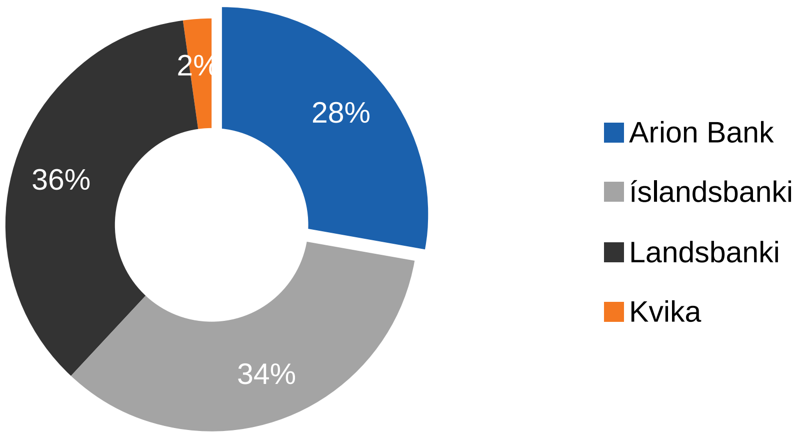
Deposits in Iceland for the years ended 31 December 2017, 2016 and 2015 totalled ISK 1,676, ISK 1,628 billion and ISK 1,652 billion, respectively (*source: Icelandic Central Bank, Statistics Iceland*).

Deposits in Iceland (ISK bn)



The graph below presents Arion's share of deposits relative to the three other commercial banks in Iceland as of 31 December 2017 *(source: Arion Bank, Landsbankinn, Íslandsbanki and Kvika annual reports)*.

Deposits from customers

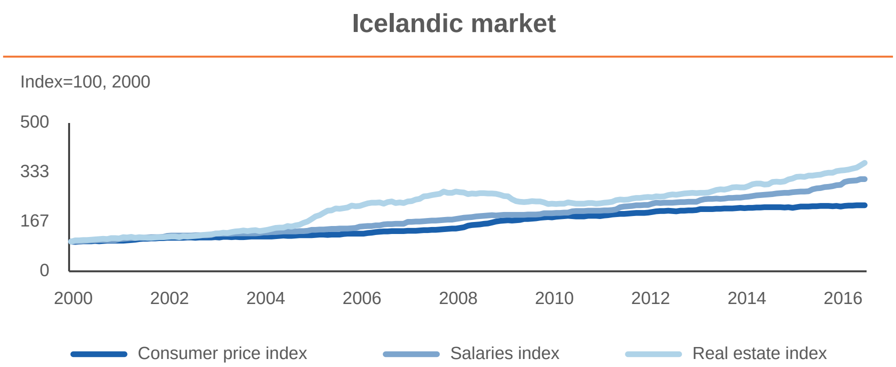


Arion Bank's main competitors in the retail banking market are Landsbankinn and Íslandsbanki, both of which are government owned, with Arion Bank's market share of individual customers amounting to 27.9% as of 31 December 2017 *(source: Capacent monthly survey of individuals, based on the question, "What is your main retail bank?")*. There are limited opportunities for consolidation in the market, as savings banks, which represent a smaller share of the banking system than the commercial banks, have largely disappeared following the financial crisis in 2008. Accordingly, the total assets of the savings bank system amounted to ISK 21 billion as of 31 December 2016, as compared to ISK 627 billion as of 31 December 2007. The biggest factor in this decline was the collapse of Reykjavík Savings Bank ("**SPRON**"), the largest of the savings banks, which was taken over by the FME in March 2009. SPRON's deposits and card transactions of over 20,000 customers were subsequently transferred to Arion Bank, and the operations of the six SPRON branches and its internet banking were discontinued following the acquisition. Some smaller savings banks continue to operate in certain regions. In addition, there is currently no meaningful foreign bank interest in the Icelandic retail banking market.

The retail banking market for individuals is relatively stable, with Arion Bank's strongest competition appearing in the retail banking market for mortgage loans. The easing of the Capital Controls has not had a significant effect on the retail banking market.

Mortgage Loans Market

Iceland is, and is expected to remain in the foreseeable future, a market that is favourable to homeownership, as rising rent prices have driven demand for homes and mortgage loans. Housing prices have also been rising, and are expected to continue to do so, until 2018 *(source: Arion Bank Research)*, with the real estate index currently above CPI.



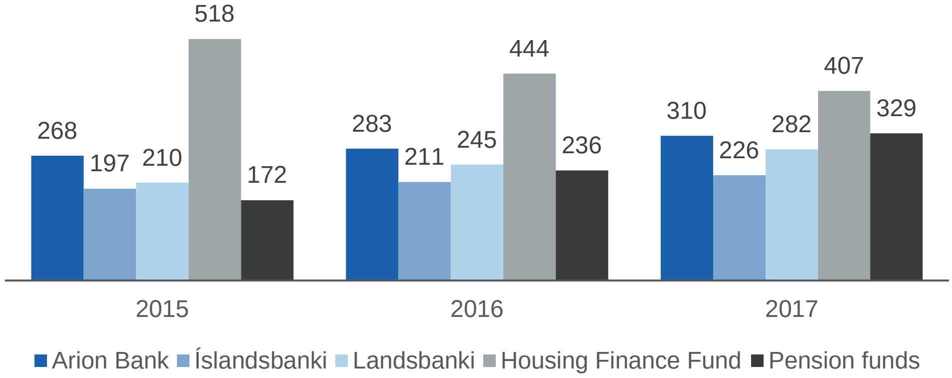
Source: Icelandic Central Bank, Statistics Iceland

The CPI measures changes in the price of private consumption and is measured monthly by Statistics Iceland, after surveying the price of all goods and services in a defined consumption basket. The consumption basket is based on the results of regularly conducted expenditure surveys, which determine which goods and services consumers purchase, and in what amounts. The survey findings determine the weight assigned to individual goods and services in the CPI.

Typically, CPI-linked mortgages link monthly payments and remaining principal to the CPI. The payment amount of CPI-linked mortgage loans changes in direct correlation with changes to the CPI index, such that, for any given period, any increase in inflation increases the monthly payment and outstanding principal by a corresponding amount. Historically, CPI-linked mortgage loans have been the most popular type of mortgage loans in Iceland *(source: Arion Bank Research)*. The mortgage loans market has also benefited in recent years from a number of government incentives to encourage home ownership, including a tax system that provides tax benefits and rewards for homeowners and support for first-time home buyers.

There has historically been a high level of government participation in funding the mortgage loan market in Iceland through the Housing Financing Fund, an independent government institution that grants mortgage loans to individuals, municipalities, companies and organisations to finance housing purchases and construction. The Housing Financing Fund remains the largest player in the mortgage loans market for the refinancing of existing mortgage loans, although it has curtailed its origination of new mortgage loans. The Retail Banking division's main competitors in the mortgage loans market currently are Landsbankinn and Íslandsbanki. Pension funds have also become increasingly active in the mortgage loans market and, in 2017, gained market share through aggressive lending rates enabled, in part, by different regulatory requirements applicable to them (in particular, they are not subject to the Bank Levy and capital requirements). As a result, pension funds have driven margin pressure in the mortgage loans market and have taken up a large amount of market share, predominantly at the expense of the Housing Financing Fund, which is also losing its market share of the mortgage loans market to the pension funds.

Mortgage loans market (ISK bn)



Source: Icelandic Central Bank, Statistics Iceland

As of 31 December 2017, 2016 and 2015, the total value of Arion Bank's mortgage loan portfolio was ISK 310 billion, ISK 283 billion and ISK 268 billion, respectively. Mortgage loan portfolios in Iceland tend to be of a relatively high quality due to stringent regulatory requirements, including lending limits based on salary and interest rate caps, customer credit ratings and mortgage loans payment plans. In addition, it is Arion Bank's policy to accept a maximum loan-to-value ratio up to 80%, with the exception for the first-time homebuyers for whom the maximum loan-to-value ratio is up to 85%. All of these measures are intended to contribute to a low default rate on mortgage loans.

Corporate Banking

Iceland's corporate banking market is comprised predominantly of Arion Bank, Íslandsbanki and Landsbankinn. Other active participants in the corporate credit market include public funds (*e.g.*, the Housing Financing Fund and Municipality Credit Iceland), foreign institutions and smaller financial companies. Indirect corporate lending also occurs via the capital markets, particularly in the real estate sector, where pension funds are key investors in asset-backed securities of property companies. Arion Bank estimates that domestic banks hold approximately 55% market share in total lending to Icelandic corporates while foreign lenders, capital markets and public funds comprise the remaining 45% of the market. Arion Bank estimates its market share in the total Icelandic corporate lending market to be approximately 21% as of 31 December 2017.

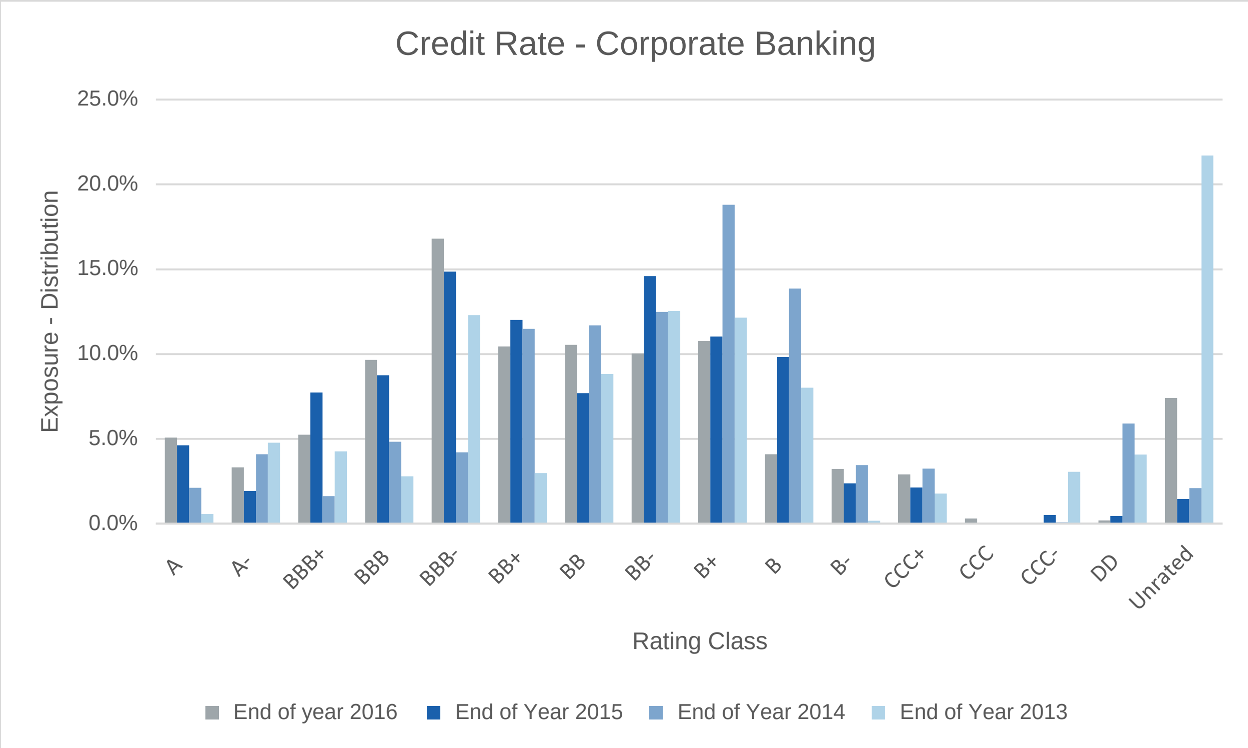
The three main industry sectors which attract domestic corporate bank lending activity are (i) real estate and construction, (ii) commerce and services and (iii) fisheries. The table below sets forth Arion Bank's estimated market share in domestic bank lending for each of these three sectors as of 31 December 2017. The "Other" category in the table below includes information technology, financial and insurance services, industry, energy and manufacturing, transportation, public sector and agriculture and forestry industry sectors.

	Real Estate and Construction	Fisheries	Commerce and Services	Other	Total
Arion Bank	6.7%	4.1%	4.0%	6.1%	20.9%
Other	20.7%	10.5%	14.6%	33.3%	79.1%
Total	**27.4%**	**14.6%**	**18.6%**	**39.4%**	**100.0%**

Source: Arion Bank Research estimates, based on annual reports or other most recent publications

Arion Bank estimates that that total non-domestic corporate lending is in excess of ISK 600 billion, with a primary focus on Icelandic export sectors like the energy, tourism and fisheries.

Icelandic corporates have been reducing their borrowings in recent years, with corporate debt as a percentage of GDP decreasing from 108% as of 31 December 2014 to 91% as of 31 December 2015, to 84% as of 31 December 2016 and increasing slightly to 86% of GDP as of 31 December 2017, as demand for corporate credit accelerated on the back of a strong economic growth *(source: Icelandic Central Bank)*. Less leverage and stronger balance sheets are reflected in credit scores Arion Bank assigns internally to its corporate customers, as demonstrated in the graph below.



The Icelandic corporate banking market is currently experiencing growing demand for credit, and Arion Bank estimates that the total corporate lending market in Iceland (including corporate bond issuance) amounted to ISK 1,904 billion, ISK 1,771 billion and ISK 1,706 billion for the years ended 31 December 2017, 2016 and 2015, respectively.

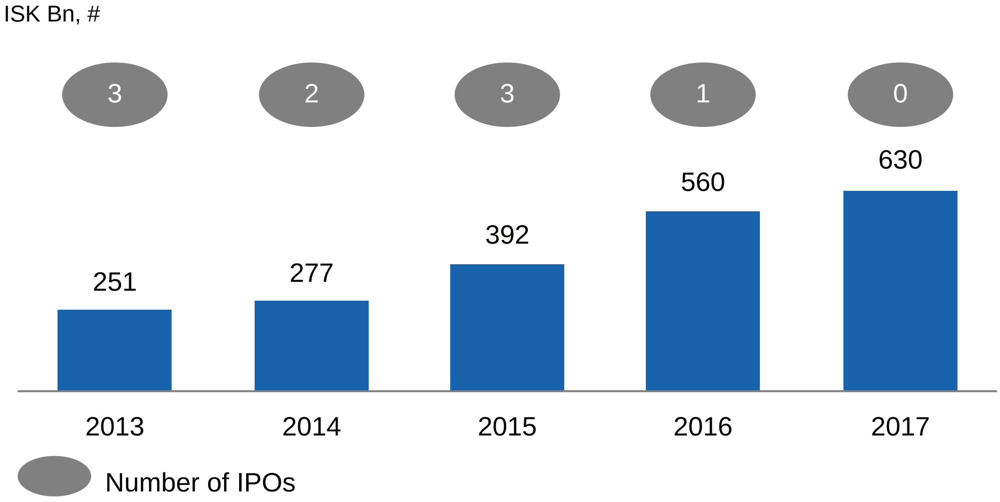
Nevertheless, the corporate banking market has experienced margin pressures since 2013, mainly driven by competition from local pension funds (which, while they do not conduct direct corporate lending, do provide an indirect source of funding through investment in real estate asset-backed securities) and, to a limited extent, foreign banks. Lower yields in the local real estate backed bond market, combined with limited issuances of government debt, made real estate asset-backed securities more attractive to pension funds, which have a cost advantage as compared with the banks due to less stringent regulatory requirements (*e.g.*, the Bank Levy does not apply to them). In addition, foreign banks have increasingly been entering the Icelandic corporate banking market, targeting corporates with international operations, in particular in the seafood industry sector.

Investment Banking

The Icelandic investment banking market is small by European standards with several local competitors primarily comprised of the investment banking divisions of Arion Bank, Íslandsbanki, Landsbankinn and Kvika as well as local boutique firms Arctica Finance, Fossar and others.

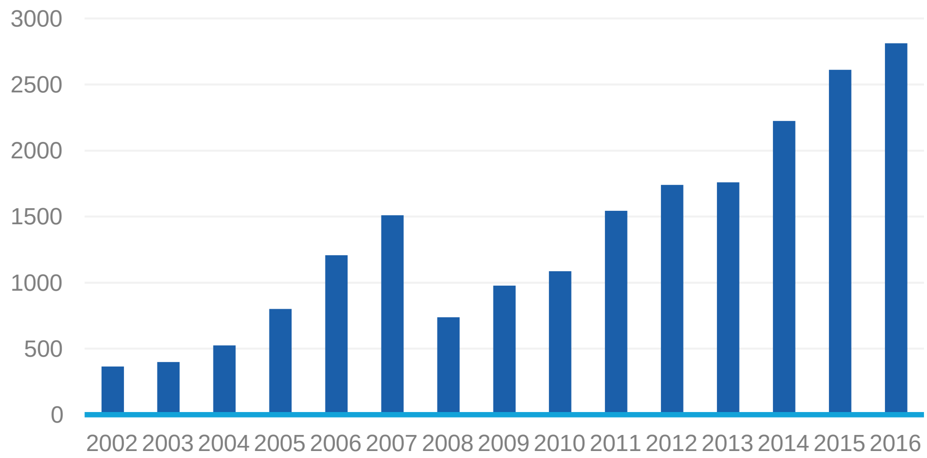
The investor base of the Icelandic stock market is a combination of institutional investors and high net worth individuals. Pension funds are by far the largest investors in the Icelandic stock market, followed by investment companies, mutual funds and insurance companies. The proportion of foreign investors has gradually been increasing since mid-2015, particularly in Icelandic listed equities.

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



Source: NASDAQ Iceland

Total equity of Icelandic companies—excluding financials and pharmaceuticals in ISK Bn

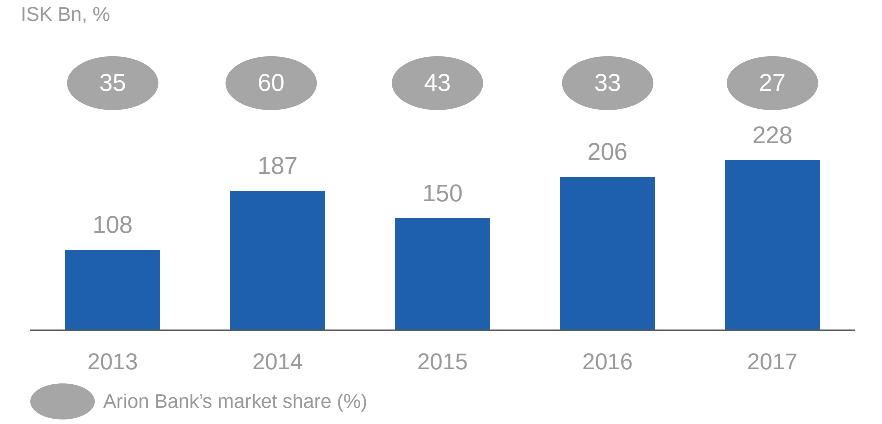


Source: Statistics Iceland, Arion Bank Research

The years between 2009 and 2014 were characterised by considerable activity on the Icelandic fixed income market. Since then, issuance of new Icelandic government debt has slowed down while issuance of other instruments, such as covered bonds and asset-backed bonds, has increased. Government bonds remain the most traded fixed income instruments.

New bond issuances amounted to ISK 228 billion, ISK 206 billion and ISK 150 billion for the years ended 31 December 2017, 2016 and 2015, respectively (*source: Nasdaq Iceland*). Of such new bond issuances, Arion Bank estimates that its market share in terms of ISK amounted to 27%, 33% and 43% for the years ended 31 December 2017, 2016 and 2015, respectively. Real estate asset-backed and covered bond issuances by Icelandic banks have been the key drivers of such new bond issuances, with institutional investors driving the demand. Historically, Icelandic companies have relied on credit facilities from financial institutions as their primary source of funding, with the corporate bond market being relatively small compared to other European countries, but Arion Bank expects that the corporate bond market will continue to grow in the future.

Bonds - New issues and market share[1]



(1) Includes new bond issues of corporates and municipalities but excludes bond issues of the Icelandic government.

Source: NASDAQ Iceland

There are various macroeconomic factors that could encourage increased M&A activity in Iceland, including the lowering of the Icelandic Central Bank's benchmark interest rates, low inflation and strong GDP growth in Iceland. The Capital Controls have been significantly lifted, and foreign investors' interest in Icelandic investment opportunities has increased. Furthermore, Icelandic companies have experienced several years of strong earnings and cash conversion, resulting in deleveraging which enables them to access the credit markets in order to finance acquisitions.

Asset Management

Arion Bank estimates that total assets under management in the domestic investment management industry sector reached approximately ISK 2,500 billion as of 31 December 2017 (including fund management companies). This number does not include assets managed directly by pension funds in-house.

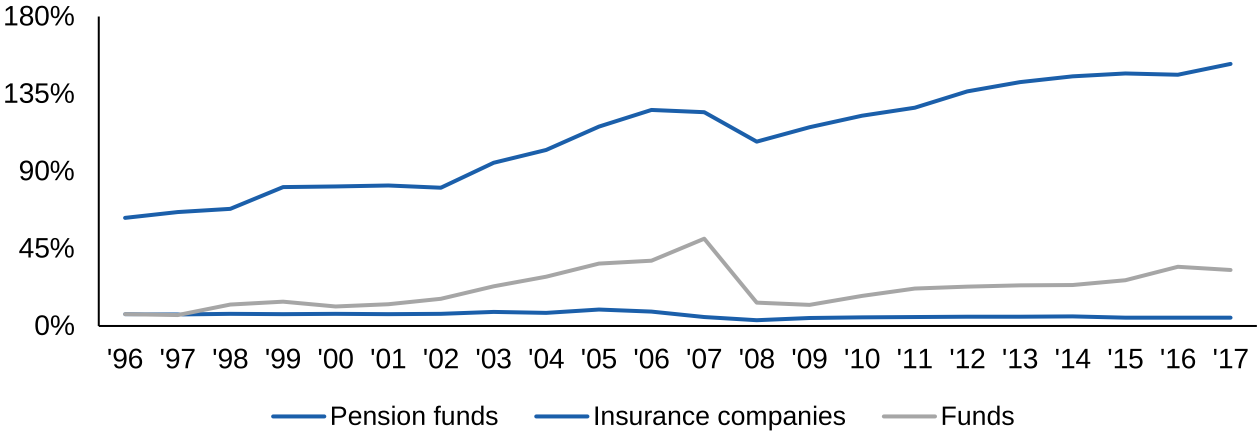
Arion Bank's subsidiary Stefnir is the largest fund management company in Iceland in terms of assets under management *(source: FME)* with ISK 346,965 million in assets under management as of 31 December 2017. The main competitors of Stefnir are Íslandssjódir (Íslandsbanki) and Landsbréf (Landsbankinn) in addition to smaller fund management companies such as GAMMA, Júpiter (Kvika), ALDA (Kvika) and ÍV. The Board of Directors believes that the Asset Management division is perceived to be the leader in the asset management market, competing with wealth management firms such as VÍB (Íslandsbanki), Landsbankinn, Kvika and ÍV. It is well-positioned to participate in the domestic dealflow and to capture the opportunities from changes in regulation, enabling it to maintain its leading position in the pension market. However, there is a significant number of competitors in the market exerting pressure on fees. The increasing cost pressure and regulations on pension funds have driven consolidation in the pension market and in-housing of asset management, and this trend is expected to continue in the future.

The savings market in Iceland has historically been largely dominated and driven by pension funds, and Arion Bank expects there to be a continued inflow into pension schemes in the coming years, notwithstanding the recent trend on the part of certain Icelandic pension funds to bring asset management responsibilities back in-house rather than relying on third-party asset managers like the Bank. Since the financial crisis in 2008, the market has seen continued growth and a broadening of product offerings.

The Icelandic pension fund system is currently one of the largest pension fund systems in the world in relative GDP terms, representing 152.4% of GDP in 2017 *(source: Statistics Iceland, Icelandic Central Bank)*, and Arion Bank expects it to grow significantly. It has experienced strong organic growth in pension funds due to favourable demographics and regulatory requirements resulting in inflows in the pension fund system, while new legislation could further increase inflow into and postpone outflow out of the Icelandic pension system. The number of pension funds in Iceland has decreased in recent years as a result of consolidations, which are likely to continue due to regulatory changes, with 65 pension funds managing assets that represented approximately 62% of GDP in 1996, as compared to 22 pension funds managing assets that represented approximately 152.4% of GDP in 2017 *(source: Statistics Iceland, Icelandic Central Bank, FME)*.

The assets held by pension funds in Iceland are currently approximately 30 times larger than the financial assets managed by insurance companies *(source: Icelandic Central Bank)*.

Institutional investors—investable assets as % of GDP

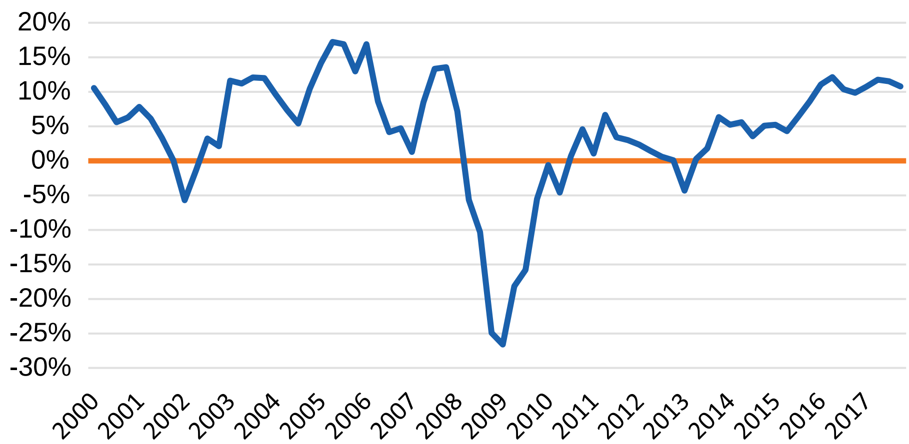


Source: Statistics Iceland, Icelandic Central Bank

Card and Electronic Payments

The Icelandic card payments market is growing, with a steady increase in total household payment card turnover since 2014. The chart below sets forth the total seasonally adjusted household payment debit and credit card turnover deflated by CPI, less housing costs.

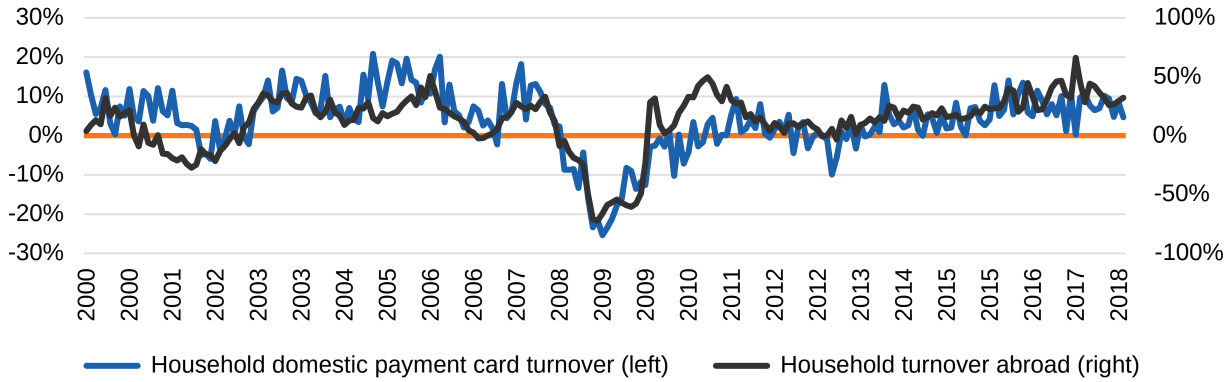
Total household payment card turnover—
domestic and abroad, year-on-year change (%)



Source: Statistics Iceland, Icelandic Central Bank

Foreign card payments have also been growing every month (on a year-on-year basis) since 2014, following a clear seasonal pattern. The chart below sets forth the debit and credit household domestic payment card turnover deflated by CPI, less housing costs, and the household payment card turnover abroad deflated by the exchange rate index.

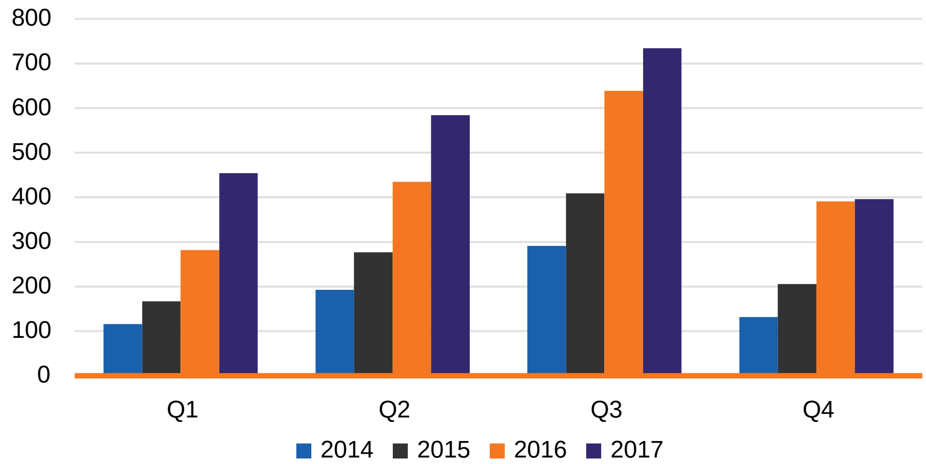
**Payment card turnover—
12 month % change, constant exchange rate and prices**



Source: Statistics Iceland, Icelandic Central Bank

The chart below sets forth foreign payment card turnover in Iceland deflated by the CPI, less housing costs, and the import-weighted exchange rate index.

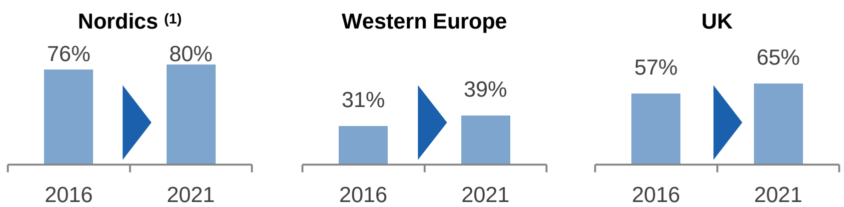
**Foreign payment card turnover in Iceland—
EUR m**



Source: Statistics Iceland, Icelandic Central Bank

Trends in the electronic payments market are also driving high growth, as countries worldwide increasingly move towards a cashless society. During the year ended 31 December 2016, card transactions accounted for 56% of all consumer payment transactions in the United Kingdom, 76% of all consumer payment transactions in Norway, Denmark and Sweden and 31% of all consumer payment transactions in Western Europe, and these numbers are expected to increase to 65%, 80% and 39%, respectively, by 2021 *(source: Euromonitor, WW New Media Market Model)*.

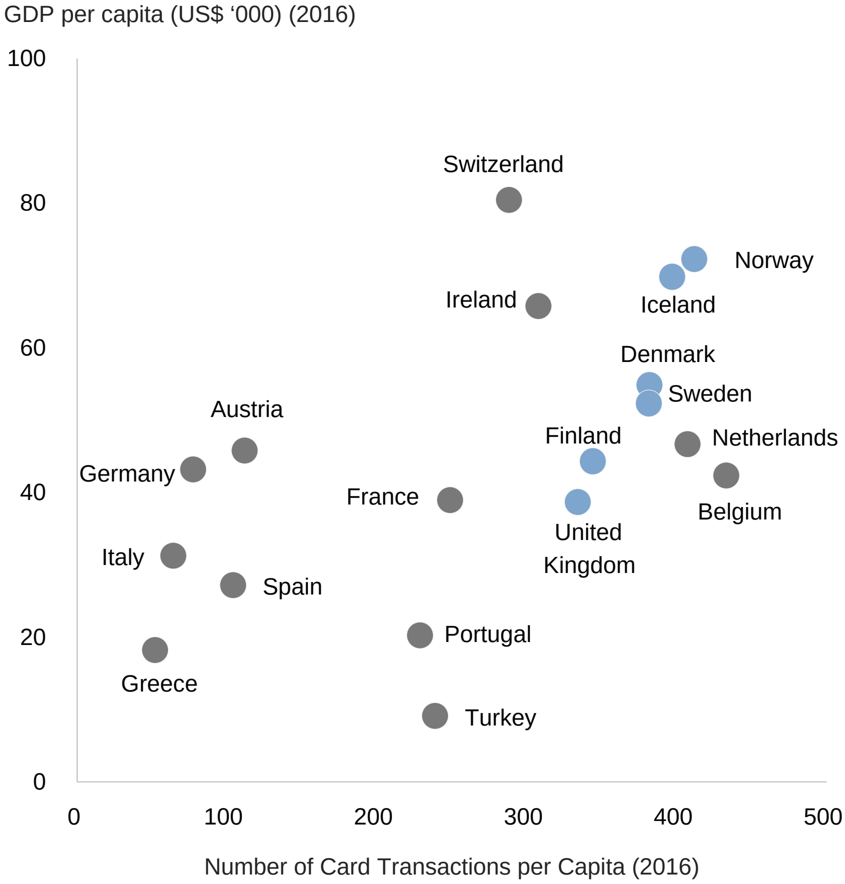
Number of card transaction/number consumer payment transactions (%)



(1) Includes Norway, Finland, Denmark and Sweden

Source: Euromonitor, WW NewMedia Market Model

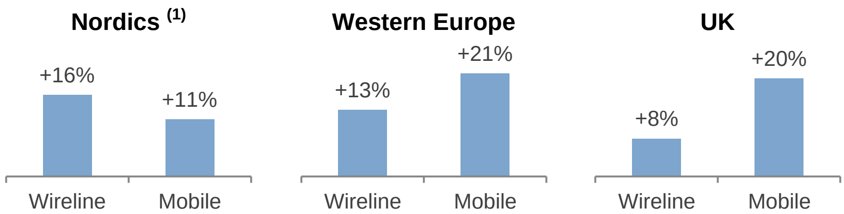
The volume of cashless payment transactions in Iceland is growing at a rate of 2.4 times greater than nominal GDP growth, with the highest cashless payments penetration globally.



Source: Icelandic Central Bank, Euromonitor

The move towards a cashless society is expected to increase the significance of new mobile and wireline payment channels. The graph below sets forth the projected compound annual growth rate ("**CAGR**") for e-commerce spending by access mode between 2015 and 2020.

2016–2021 CAGR eCommerce Spending by Access Mode (%)



(1) Includes Norway, Finland, Denmark and Sweden

Source: Euromonitor, WW NewMedia Market Model

This increase in cashless payments is also expected to cause a corresponding increase in demand for value added services, such as data analytics, biometric payment, peer-to-peer payment, contactless payment and loyalty schemes.

BUSINESS OVERVIEW

Overview

Arion Bank is a leading, privately owned universal relationship bank in Iceland with a differentiated and innovative approach. Arion Bank has established itself as a broad and well-balanced bank that provides products and services which meet the needs of Icelandic households and companies. To ensure it is well-balanced and diversified in its product and services offering and expertise, Arion Bank has organised itself across four dedicated divisions and operates strategic subsidiaries that add valuable products and services to the business, such as payment processing and insurance. Arion Bank's diversified and balanced approach to its business also means that it has a broad revenue base and a balanced and diverse loan portfolio with a moderate risk profile serving individuals and companies. As a result, Arion Bank enjoys a strong position within domestic financial markets in terms of its return on equity, operational efficiency and product and services offering.

Arion Bank's focus is on building and strengthening long-term customer relationships by delivering excellent products and services and tailored solutions. Its main customers are corporations and individuals, who seek a wide variety of financial solutions and, as a universal relationship bank with a wide product and services offering (including a leading digital offering), Arion Bank seeks to meet those needs whatever they may be. While Arion Bank considers itself to be an Icelandic bank first, it is also increasingly but selectively providing financial services outside of Iceland, mainly to companies related to the seafood industry in Europe and North America. As the only privately owned major bank in Iceland, Arion Bank has the freedom to manage its business in accordance with this strategy and adapt to the changing needs of its customers.

Arion Bank's core values (the "**Cornerstones**") were introduced in 2012 and are:

- We make a difference.
- We say what we mean.
- We get things done.

The Cornerstones guide Arion Bank in everything it says and does, particularly in its interaction with its main stakeholders: customers, employees, society and investors.

For the years ended 31 December 2017, 2016 and 2015, respectively, Arion Bank's net interest income was ISK 29,835 million, ISK 29,900 million and ISK 26,992 million, its net fee and commission income was ISK 15,357 million, ISK 13,978 million and ISK 14,484 million, its operating income was ISK 53,378 million, ISK 54,546 million and ISK 86,620 million, and its net earnings were ISK 14,419 million ISK 21,739 million and ISK 49,679 million. As of 31 March 2018, Arion Bank's total assets were ISK 1,131,769 million.

History

Arion Bank's predecessor, Kaupthing, was the product of a merger in May 2003 of two leading Icelandic banks, Kaupthing Bank hf. and Bunadarbanki Islands hf. (the "**Agricultural Bank of Iceland**"). The Agricultural Bank of Iceland was established in 1929 by a law passed by the Parliament of Iceland and began operations in 1930. At the beginning of 1998, the Agricultural Bank of Iceland became a limited liability company and was privatised in stages up to the beginning of 2003. Kaupthing hf. was established in Reykjavík in 1982, coinciding with the launch of the free capital markets in Iceland. Kaupthing hf. later became an investment bank before its merger with the Agricultural Bank of Iceland in 2003. The branch network of the Agricultural Bank of Iceland became the backbone of Arion Bank's retail branch network.

2010–2012: Restructuring of Arion Bank and its customers

Arion Bank was established in October 2008 as the entity to which certain assets and liabilities of Kaupthing were transferred following the assumption of control of Kaupthing by the FME. The transfer of these assets and liabilities posed a significant challenge. In March 2010, a new Board of Directors was appointed at the Annual General Meeting and, in June 2010, the Board of Directors appointed a new CEO. In addition, a strategic plan was adopted in October 2010, which aimed to position Arion Bank as a universal relationship bank, providing a range of quality financial products and services and focused on improving Arion Bank's competitiveness. From 2010 onward, under its new leadership and in accordance with its strategy, Arion Bank has systematically restructured and improved the credit quality of its customer loan portfolio. Immediately following the financial crisis in 2008, Arion Bank emerged from restructuring with a newly valued balance sheet, reflecting a loan portfolio transferred from Kaupthing at fair value, which in most cases was a discount on the face value of the loans. As a result of Arion Bank's restructuring and refinancing efforts, the discounts on these legacy loans have been progressively released as the restructuring of the customer loan portfolio continued, whether as a result of prepayments, write-offs or otherwise. During this period, Arion Bank also began reducing its number of problem loans, defined as loans more than 90 days past due but not impaired and other problem (*i.e.*, individually impaired) loans. Arion Bank also took an innovative approach to mortgage loan products, being the first Icelandic bank to introduce the fixed rate non-CPI-linked mortgage loans, a strategy which it supported through selective portfolio acquisitions.

2013–2014: Streamlining and building of the business

Following the success of its restructuring efforts, Arion Bank was in a position to begin building up its business. In 2013, Arion Bank launched its "lean banking initiative" and undertook a number of changes to its core banking operations, including the optimisation of its branch network by reducing total branch size and focusing on increased self-service opportunities for customers. Arion Bank also launched its digitalisation initiative to further drive efficiency, including the implementation of an extensive CRM system to provide better services and increase staff productivity. Digitalisation also allowed Arion Bank to strengthen its customer focus and decentralise credit decisions.

During this period, Arion Bank began to build up its Icelandic market leadership in its core products. The Investment Banking division also established itself as innovator in the Icelandic capital markets through its involvement in three out of five initial public offerings during 2013 and 2014. Arion Bank adopted a first mover approach as exemplified by its early adoption of next generation personal banking technology, which led to Arion Bank becoming a market leader in personal online and mobile banking.

During this period, Arion Bank also continued to improve its underlying asset quality and reduce the number of problem loans as part of the restructuring process of its customer loan portfolio.

2015 to present: Strengthening market leadership and harvesting full value potential

Since 2015, Arion Bank has been able to focus on growing and improving its business by strengthening its presence and leadership in key markets, including capital markets, project financing and asset management. Arion Bank managed all four initial public offerings listed on the Main Market of NASDAQ Iceland in 2015 and 2016, managed the only listing on NASDAQ Iceland First North in 2017, and provided the project financing for a new five star hotel in Reykjavík, a deal worth over USD 125 million. Arion Bank is also in the process of optimising its capital structure and improving its risk-weighted assets profile. It continued with its first mover approach in 2015, being the first Icelandic bank to issue a benchmark eurobond since 2008. In its business divisions, Arion Bank has continued to drive commercial excellence in its markets and is actively exploring new business opportunities. In addition, Arion Bank acquired Vördur, a universal insurance company in 2016.

Arion Bank has also worked to improve its operational efficiency. For example, Arion Bank has scaled its digitalisation initiatives and continues to invest in its IT infrastructure as well as applying the project delivery model, which originated in the IT division, across the Bank's other divisions, in order to promote speed and efficiency of project implementations. In March 2018, the Bank announced plans to merge certain branches and focus on optimising its branch network by reducing square metres occupied and to have digital branches, resulting in closing three branches.

Strengths

Attractive banking market with stable market shares supported by a strongly growing economy

Iceland's economy is based on strong fundamentals and has proven to be flexible and resilient as demonstrated by its strong recovery in the aftermath of the financial crisis of 2008. Iceland's growing population of approximately 350,000 people enjoys a high standard of living and has strong culture and heritage. The nation also has one of the highest GDPs per capita in the world, amounting to approximately U.S.$52,000 in 2017 *(source: IMF)*. Real GDP in Iceland increased in each of 2015, 2016 and 2017 by 4.3%, 7.5% and 3.6%, respectively *(source: Statistics Iceland)*, while its unemployment rate has decreased over the corresponding period from 4.0% in 2015 to 3.0% in 2016 and 2.8% in 2017, which was significantly below many other countries, including Sweden, Ireland and the average in the eurozone *(source: Statistics Iceland, IMF)*. Government gross debt as a percentage of GDP has been decreasing since 2011, and the IMF projects that it will continue to decline from 63% in 2017 to 33% in 2020 *(source: Statistics Iceland, IMF)*. Iceland also has a robust current account surplus which stood at 3.7% of GDP in 2017 and a budget surplus at 1.2% of GDP as of and for the year ended 31 December 2017 *(source: Statistics Iceland)*. These economic fundamentals are supported by a modern legislative framework and public institutions.

In addition, Iceland has an increasingly diversified economy supported by four export pillars: tourism (*i.e.*, as a source of foreign income), seafood, energy and other industrial goods and services. Iceland has experienced an accelerated growth in tourism, which has contributed to the strength of its GDP, with an annual increase in the number of tourists of 30% in 2015, 40% in 2016 and 24% in 2017, in each case, as compared to the previous year, but growth is expected to moderate in the medium term *(source: Statistics Iceland, Isavia, Arion Bank Research)*. In 2017, exports contributed approximately 47% to Iceland's GDP, with tourism and seafood industry sectors amounting 42% and 16% of exports, respectively.

This strong economic backdrop has supported Iceland's growing and stable banking sector, which is concentrated around Arion Bank (which is privately owned), Landsbankinn and Íslandsbanki (both of which are owned by the Icelandic government), with the three banks having a combined market share of 52% of loans to households, 80% of loans to corporates and 98% of deposits from customers as of 31 December 2017 *(source: Ministry of Finance and Economic Affairs, Landsbankinn and Íslandsbanki annual reports)*. Arion Bank believes there is a high correlation between the increase in GDP and growth in the Icelandic banking sector.

In addition, the Capital Controls, which limited the ability of the Icelandic population and corporates to buy or sell foreign currency, were largely lifted in March 2017, which has resulted in new opportunities in Iceland's banking sector as well as increased investment activity from Icelandic individuals, corporates and funds due to a broader range of investment opportunities as well as result in a potential increase of foreign investments in Icelandic assets. Furthermore, easing of the Capital Controls may lead to a potential decrease in competitive pressure from pension funds with respect to Icelandic mortgage loans and provision of corporate credit through investment in real estate asset-backed securities due to the availability of new investment opportunities abroad. Finally, easing of the Capital Controls may increase foreign exchange trading activity.

Arion Bank has an experienced management team with a proven track record of strategy execution

Members of the Executive Committee have extensive experience in banking and the corporate sector. The Executive Committee has a low turnover rate, with members of the Executive Committee having an average of over seven years of experience at Arion Bank or its predecessor across business segments or support functions, or both, with seven members of the Executive Committee having served at least five years on the Executive Committee. Arion Bank also benefits from management and supporting teams to assist in the execution of proposed strategies.

The Executive Committee has a proven track record of strategy execution, including successfully restructuring Arion Bank and handling various challenges in the wake of the financial crisis in 2008. In the aftermath of the financial crisis of 2008, operations were consolidated under Arion Bank, which received a clean and newly valued balance sheet. Arion Bank encountered significant foreign exchange, interest rate and liquidity mismatches and had to focus on restructuring the customer loan portfolio which it had acquired from its predecessor Kaupthing. Arion Bank believes that it has made significant progress in restructuring its customer loan portfolio and has reduced its problem loans from 54% of the total customer loan portfolio as of 31 December 2010 to 1.0% of the total customer loan portfolio as of 31 December 2017. Arion Bank has also reduced its asset mismatches, has achieved improvements in underlying asset quality and plans to seek further improvements in underlying asset quality. Furthermore, Arion Bank has been steadily disposing of assets which it acquired as a result of debt restructurings and other enforcement actions and has now disposed of the majority of such assets. Arion Bank also achieved a CAGR of 7.8% in its customer loan portfolio from 2010 to 2017 and diversified the customer base of its customer loan portfolio, with corporate and SME customers comprising 75.3% and individual customers comprising 24.7% of the loan portfolio as of 31 December 2010, as compared to corporate and SME customers comprising 52.3% and individual customers comprising 47.7% of the customer loan portfolio as of 31 December 2017. In addition, Arion Bank has concentrated on rebuilding customer trust and expanding its sources of funding, with deposits from customers and equity representing 75.1% of funding, borrowings and subordinated liabilities representing 12.2% and other loans representing 12.7% of Arion Bank's funding as of 31 December 2010, as compared to funding as of 31 December 2017 from deposits from customers and equity (63.7%), covered bonds (15.6%), senior unsecured bonds (18.8%) and bills issued and other loans (1.9%). Funding in this context is understood as total equity, subordinated liabilities, borrowings, deposits and due to credit institutions and Central Bank.

In addition to managing these challenges, the Executive Committee has introduced a number of successful initiatives, including successfully implementing the lean banking initiative across all divisions of Arion Bank. Among other things, the lean banking initiative resulted in improvements to core banking operations, becoming a digital banking leader in Iceland and optimisation of Arion Bank's branch network. In recent years, the Bank has also continued to build its strong market position in Iceland, particularly in its core products. The Executive

Committee has a clear and strong vision for the future and plans to use available incentivisation to continue to create value. See "*—Strategy*".

Arion Bank is a leading, universal relationship bank in Iceland with a differentiated and innovative approach

Arion Bank is a leading, privately owned universal relationship bank with an Icelandic focus. It offers a broad and balanced range of financial products and services through its four dedicated divisions as well as its strategic subsidiaries in the insurance and card payments industries, which add value and diversity to the business. Through this broad product and services offering and diversified revenue base, Arion Bank seeks to meet the varied needs of the Icelandic economy and provide solutions to a wide range of customers in both the retail and corporate spheres. Arion Bank was chosen by Euromoney magazine as the best bank in Iceland in 2017.

Arion Bank's customer-focused approach to its business derives from Arion Bank's longstanding history with its customer base which it plans to grow and harness into future opportunities as it moves the business forward. Accordingly, Arion Bank has adopted a first mover attitude and a progressive approach to the banking industry, pioneering new financial products and services in the Icelandic market and increasing investment in areas such as IT to ensure it is always bringing its customers the most innovative banking solutions. This general strength of Arion Bank is underpinned by the individual strengths of each of its four main divisions and subsidiaries.

Retail Banking

The Retail Banking division holds a strong and stable market position in Iceland, providing a wide range of financial products and services to individuals and SMEs. It generates operating income through the provision of financial products and services to retail customers, on which Arion Bank earns interest income and fee and commission income. As of 31 December 2017, the Retail Banking division had a market share of individual customers of 27.9% *(source: Capacent monthly survey of individuals, based on the question, "What is your main retail bank?")*. The Retail Banking division is the largest private provider of residential mortgage loans in Iceland. The operating income of the Retail Banking division has grown steadily from ISK 16,887 million in 2015 to ISK 19,702 million in 2016 and ISK 21,151 million in 2017, which represents a CAGR of 11.9%. Building on its solid income base, the Retail Banking division intends to generate additional income from new opportunities afforded by the full market coverage of its product and services offering and the integration of its banking and insurance businesses.

The Retail Banking division emphasises efficiency and is guided by the lean banking principles in its operations. Accordingly, the Retail Banking division has continuously optimised its nationwide branch network since 2008 and has a strong focus on digitalisation, making investments in advanced digital banking solutions for customers, such as the Arion Bank mobile app and digital customer onboarding. The advent of new digital solutions has resulted in a major change in customer behaviour over the past few years. The vast majority of contact with customers is now via digital channels such as the Arion Bank mobile app, the internet, online banking and ATMs. Arion Bank has achieved a great deal in this respect in recent years with innovations including automatic credit assessments, a new method for onboarding customers, credit card payment plans in the Arion Bank mobile app and online banking, new ways to open accounts and obtain cards online, in addition to digital mortgage loans, car loans and other online and mobile banking services. Arion Bank is also making increasing use of web chat and other media in order to provide its services. The growth of digital solutions enables delivery of the Retail Banking division's products and services through multiple channels, enhances efficiency in its operations and contributes to customer satisfaction. The Retail Banking division has also decentralised its decision-making processes to bring decisions closer to individual customers, which likewise enhances customer satisfaction and experience. At the same time, the focus for personal banking products has been on standardisation and automation with a goal of being able to deliver products and services digitally, anytime, anywhere and instantly if possible. Whether in executing its strategy, implementing the lean banking principles or conducting its day-to-day operations, the Retail Banking division relies on its experienced management team with a successful record of executing challenging projects.

Corporate Banking

The Corporate Banking division is a full service corporate bank, providing customised solutions to large corporate customers in Iceland across all industry sectors through dedicated industry sector teams. It generates operating income through the provision of credit products and services to large corporate customers, on which the Corporate Banking division earns interest income and fees and commission income. The Board of Directors believes that the Corporate Banking division is a leading lender to large corporate customers in Iceland with a market share of the total Icelandic corporate lending market of approximately 21% (based on outstanding loan value) as of 31 December 2017. In addition to enjoying an established leadership position across various industry sectors in Iceland, in particular the seafood industry sector and the energy sector, the Corporate Banking division also engages in international lending activities in the seafood and related industries. The operating income of the Corporate Banking division amounted to ISK 7,019 million in 2015, ISK 7,874 million in 2016 and ISK 8,543 million in 2017.

The Corporate Banking division has cultivated a loyal customer base with close and long-standing relationships. The relationship based model of the Corporate Banking division benefits from and provides synergies across the various divisions of Arion Bank, enabling successful cross-selling of products and services with the Investment Banking division and the Private Banking subdivision. In addition, Arion Bank intends to leverage its strong customer relationships in growing industry sectors, such as energy, real estate and trade and services.

Capitalising on the strengths of Arion Bank across all divisions, the Corporate Banking division has proven its ability to deliver large and complex transactions (*e.g.*, clubs and syndicates). The Corporate Banking division has articulated a clear strategy for profitable growth, which it intends to execute with the support of its dedicated and experienced team.

Investment Banking

The Investment Banking division is a leading capital markets house and M&A advisor in Iceland, providing a full and diverse range of investment banking services. It generates operating income through specialist services, such as M&A and capital markets advisory as well as equity and fixed income brokerage and research. The Investment Banking division has a solid track record and reputation and is a recognised leader in equity brokerage and initial public offerings, managing all four initial public offerings listed on the Main Market of NASDAQ Iceland in 2015 and 2016 and 62% (8 out of 13) of all initial public offerings in Iceland since 2011. Furthermore, in 2017, the Investment Banking division managed the only listing on NASDAQ Iceland First North. In addition, the Investment Banking division enjoys a strong position in foreign exchange brokerage and bond issuances. The operating income of the Investment Banking division amounted to ISK 36,434 million in 2015 (primarily as a result of non-recurring events), ISK 3,746 million in 2016 and ISK 1,467 million in 2017.

The Investment Banking division benefits from strong infrastructure and has implemented the lean banking principles in its operations, allowing it to focus on developing customer relationships and deal flow. The Investment Banking division enjoys a large and reliable customer base featuring strong and trusted relationships with Icelandic investors, who are the key component of the Investment Banking division's placement power and deal flow. Utilising Arion Bank's financial strength and infrastructure, the Investment Banking division relies on Arion Bank's strong balance sheet to engage in transactions and support its customers, for example by providing underwriting capabilities through the Corporate Finance subdivision and offering forward contracts in capital markets. The Investment Banking division takes advantage of the significant cooperation across the various divisions of Arion Bank by leveraging customer relationships to ensure deal flow to the Investment Banking division and supports its distribution capabilities. The Investment Banking division is supported in its operations by highly capable and experienced employees with a good track record, low turnover and an average of 13 years of relevant professional experience as well as a well-known and respected Research subdivision.

Asset Management

The asset management operations of Arion Bank, comprising the Asset Management division and Stefnir, provide a full range of products and services with a focus on institutional investors, high net worth individuals and a digital distribution for retail customers. Each of the Asset Management division of Arion Bank and Stefnir generates operating income through interest income and management fees, which are calculated as a percentage of assets under management and vary based on product type and other factors. In addition, Stefnir generates operating income through performance fees, which are based on the performance of its products above certain benchmark. Both the Asset Management division and Stefnir have a long term record in providing high quality services and returns on investments to their customers, enabled in part by their experienced employees who cultivate a team approach to investment decisions. The operating income of the Asset Management reportable segment, comprising the Asset Management division and Stefnir, amounted to ISK 4,882 million in 2015, ISK 4,345 million in 2016 and ISK 4,677 million in 2017.

The Asset Management division and Stefnir are dedicated to building long-term relationships with their customers and benefit from increased inflow from existing customers, particularly pension funds. The asset management operations are well-positioned to participate in local dealflow and have access to investment opportunities as a result of strong teams, a good reputation, the size of assets under management and a proven track record in performance and innovation. Furthermore, the asset management operations expect to take advantage of their operational strength to meet increasing risk management, transparency and regulatory requirements. Finally, the strong expertise and product range in global funds make the asset management operations well-positioned following the lifting of the Capital Controls and execution of their strategy for further growth.

Complementary Product and Services Offering from Key Strategic Subsidiaries

In addition, Arion Bank's independent subsidiaries offer further diversification and growth opportunities across various industry sectors. For example, Arion Bank has a growing insurance network through Vördur, the fourth largest universal insurance company in Iceland based on insurance premiums *(source: FME)*. Upon acquisition of Vördur in September 2016, Arion Bank merged the operations of Vördur with its existing life insurance operations, which were operating under the Okkar Life Insurance brand, which was the second largest life insurance company in Iceland based on insurance premiums *(source: FME)*. The acquisition has helped further integrate Arion Bank's banking and insurance businesses, increase commercial, financial and operational synergies and present an opportunity for the Retail Banking division to cross-sell to Vördur's existing customers.

Track record of significant and growing income from core banking operations

Arion Bank's diversified business model, across a wide spectrum of comprehensive financial product and services offering, has enabled it to generate stable and diversified income streams with a significant portion of non-interest income, from both fee and commission income and insurance income. Net interest income and net fee and commission income are the basis of the Group's core banking operations, with increasing insurance income.

Net interest income increased by 10.5% between 2015 and 2017, mainly due to increased interest bearing assets and increased focus on liquidity and funding resulting in lower average interest rates. Net fee and commission income increased by 6.0% between 2015 and 2017, mainly due to increased activities in asset management and international operations in card and payment solutions at subsidiary Valitor, partly due to the acquisition of new subsidiaries, along with increased fee and commission income from the Retail Banking division.

The table below sets forth the net interest income, the net fee and commission income and the total operating income, as disclosed in the Annual Financial Statements and on an adjusted basis, for the periods indicated.

	Year ended 31 December					
	2017		2016		2015	
	Actual	Adjusted(1)	Actual	Adjusted(1)	Actual	Adjusted(1)
	(ISK in millions)					
Net interest income	29,835	29,852	29,900	30,430	26,992	28,339
Net fee and commission income	15,357	15,357	13,978	14,059	14,484	14,491
Total operating income	**53,378**	**53,396**	**54,546**	**49,898**	**86,620**	**50,882**

(1) Adjusted information constitutes Non-IFRS Information. Adjustments relate to non-recurring items, primarily impacts from non-core assets and legacy equity holdings. See "*Presentation of Financial and Other Information—Presentation of Financial Information—KPIs and Non-IFRS Information*" and "*Selected Consolidated Financial, Operating and Other Information—Certain Other Financial Information*".

Net interest income decreased by ISK 65 million or 0.2% between 2016 and 2017, as an increase in interest-bearing assets was offset by low inflation and pre-financing costs. Net fee and commission income increased by ISK 1,379 million or 9.9% between 2016 and 2017, mainly due to the impact of the acquisition of new subsidiaries at Valitor, which generated increased fees, and increased lending activity.

The table below sets forth the respective contributions of Arion Bank's products and services to net fee and commission income, as disclosed in the Annual Financial Statements, for the year ended 31 December 2017.

	Year ended 31 December 2017
Cards and payment solution	39.9%
Asset management	27.1%
Collection and payment services	9.6%
Investment banking	5.0%
Lending and guarantees	14.3%
Other	4.1%
Total	**100.0%**

Strong balance sheet with scope for significant dividends

Arion Bank believes that it has a strong balance sheet with robust capital buffers, prudent leverage ratios and high capital ratios. As of 31 December 2017, its CET1 ratio calculated in accordance with the definition set forth in the Regulation ((EU) No. 575/2013) (the "**CRR**") was at 23.6% and its Tier 1 and capital adequacy ratios calculated in accordance with Icelandic legislation were at 23.6% and 24.0%, respectively, in each case taking into account the equity reduction of ISK 25 billion by means of the buyback of Shares and the related First Monetisation Dividend (as defined below), which occurred in February 2018 and March 2018, respectively. Furthermore, the risk-weighted assets density of Arion Bank remained stable at conservatively high levels, as compared to banks in Norway, Denmark, Sweden and Finland. Arion Bank's risk-weighted assets as a percentage of total assets amounted to 66.8%, 72.7% and 79.9%, as of 31 December 2017, 2016 and 2015, respectively.

The business model of Arion Bank is oriented toward maintaining a well-diversified and well-balanced loan portfolio with a broad set of industries and types of loans as well as a mix of corporate and individual customers, with loans to individual customers comprising 47.7% and loans to corporate customers comprising 52.3% of Arion Bank's loan portfolio as of 31 December 2017. Since its establishment in 2008, Arion Bank has focused on restructuring its loan portfolio and has made significant progress in loan restructuring, with the result that Arion Bank's credit profile today is of high quality and has experienced greatly improved provisioning levels. As of 31 December 2017, 2016 and 2015, problem loans represented 1.0%, 1.6% and 2.5%, respectively, and the proportion of loans in default for more than 90 days represented 0.8%, 1.2%, 2.1%, respectively, of the total loan portfolio. Arion Bank has also experienced greatly improved provisioning levels, with provisions for losses as a percentage of gross impaired loans (coverage ratio) increasing from 75.8% in 2015 to 77.4% as of 31 December 2016 and 80.5% as of 31 December 2017.

Arion Bank also benefits from a diversified funding structure that is predominantly based on deposits and complemented by wholesale funding in the form of various debt securities. Arion Bank has experienced a high degree of stickiness in its deposit base and expects its deposit base to remain stable in the future. In addition, Arion Bank was the first Icelandic bank to re-enter international debt markets with an inaugural issuance in March 2015 of euro senior unsecured bonds under the EMTN Programme, which was the first issuance from an Icelandic bank since 2008, and it continues issuances of bonds under its covered bond facilities in the Icelandic market. As of 31 December 2017, deposits from customers comprised 42.8%, shareholders equity comprised 20.9%, other borrowings comprised 18.8%, bonds issued under covered bond facilities comprised 15.6% and other liabilities comprised 1.9% of Arion Bank's funding structure. Arion Bank has a robust liquidity position with limited near term refinancing needs, with its liquidity reserve equal to ISK 228,909 million and its liquidity coverage ratio ("**LCR**") equal to 221% as of 31 December 2017. Arion Bank is currently rated BBB+ for senior unsecured debt with a stable outlook by Standard & Poor's.[1]

As a result of these factors, Arion Bank has significant dividend capacity underpinned by solid profit generation, targeted reduction of excess capital and further capital optimisation, in line with its medium-term target to reduce its CET1 ratio to approximately 17% from 23.6% as of 31 December 2017. However, the speed and quantum of such special distributions would depend on a number of factors, including (but not limited to) management of the Bank's foreign exchange imbalances, its capital optimisation strategy and regulatory consents, and such returns would likely take place over a number of years. The year-end CET1 ratio of 23.6% takes into account the equity reduction of ISK 25 billion by means of the First Monetisation Dividend (as defined below), which was paid in February 2018 and March 2018. See "*Shares and Share Capital—Dividends and Dividend Policy—Dividends Paid*". Based on Arion Bank's expected financial performance over the

[1] Standard & Poor's is established in the European Union and is registered under the CRA Regulation. As such, Standard & Poor's is included in the list of credit rating agencies published by the European Securities and Markets Authority on its website in accordance with the CRA Regulation. A security rating is not a recommendation to buy, sell or hold securities and may be subject to suspension, reduction or withdrawal at any time by the assigning rating agency.

medium term, Arion Bank targets to pay an annual dividend, before special distributions, in line with a payout ratio of approximately 50% of net earnings attributable to shareholders.

Strategy

Arion Bank strives to position itself as a universal relationship bank in Iceland, providing a diverse and well-balanced range of financial products and services which reflect broadly the composition of the Icelandic economy. This allows Arion Bank to provide tailored and personalised solutions to its customers, particularly those who require comprehensive and diverse financial products and services.

The Board of Directors has adopted a strategic plan for Arion Bank, the key points of which are summarised below. Some of the information contained in this section, including with respect to the strategic plan, contains forward-looking statements that involve risks and uncertainties. See "*Presentation of Financial and Other Information—Forward-Looking Statements*".

Build long-term business relationships

Arion Bank intends to increase its focus on developing long-term business relationships through regular dialogue with customers so as to fully understand their needs and responsive and pro-active development of its products and services, which Arion Bank believes is fundamental to its business. Arion Bank aims to innovate and develop products and services which respond to the changing needs of its customers and to put the interests of its customers first in all transactions. For instance, Arion Bank is increasingly investing in its IT division to expand its digital products and services offering and to improve its customers' experience and satisfaction when using the Bank's digital products and services. In order to move credit authority closer to its customers, Arion Bank has also automated a number of credit decisions through its digital projects and decentralised certain smaller credit decisions to SMEs, by providing further training to employees in branches and giving them sufficient credit authority to make credit decisions locally and in less time. This decentralisation has not affected the current structure of Arion Bank's credit committees, which will continue to assess larger credit cases.

Increase operational efficiency

Arion Bank has recently implemented and expects to implement additional operational efficiency initiatives, which are expected to have bottom-line impact, in line with its medium-term target to reduce its cost-to-income ratio to approximately 50% (the ratio was 56.1% for the year ended 31 December 2017). The lean banking initiative aims to implement effective processes to help meet customers' needs by eliminating waste, instability and inflexibility in Arion Bank's infrastructure with the overall goal of improving customers' experiences. In addition, Arion Bank plans to increasingly pursue its digitalisation initiatives in several areas, particularly onboarding for private banking and capital markets and also focusing on the corporate lending process. These initiatives are expected to enhance customer satisfaction and experience, ultimately increasing the value of Arion Bank's brand, and to have bottom-line effect by reducing salary expenses and increasing customer demand and sales by streamlining product and loan delivery. Arion Bank has also announced cost cutting and plans to implement operational improvements and streamline its operations through outsourcing of non-core functions to reduce overhead and administrative costs. In March 2018, the Bank announced plans to merge certain branches and focus on optimising the branch network by reducing square metres occupied and to have digital branches, resulting in closing three branches.

Strengthen the core business

Arion Bank expects its core banking business (particularly with respect to net interest income, net fee and commission income and net insurance income) to benefit in the coming years from underlying market growth fuelled by anticipated growth in the Icelandic economy. For instance, the growth of private consumption in Iceland is expected to increase opportunities for mortgage lending. Arion Bank also expects to harness this growth to help bolster its leading position across businesses and increase its share in lending to SMEs as well as in leasing and insurance businesses. Arion Bank further anticipates that it will be able to capitalise on its broad revenue base to maintain the levels of fee and commission income with potential for growth, contributing to a positive outlook for Arion Bank's core business development. Arion Bank also expects its cost of risk to decrease in the future through a focus on collateralisation and closer relationships with its customers, allowing Arion Bank to encourage improved lending practices and early intervention should customers face financial difficulties.

Pursue value creation opportunities

Arion Bank plans to improve its competitiveness by pursuing several anticipated value creation opportunities in the upcoming years and taking a proactive approach to its business. One such opportunity is for increased cooperation across Arion Bank's divisions, in particular between the Retail Banking division and Vördur, for example through the use of Arion Bank's branch network to sell Vördur's products as a registered insurance intermediary. Arion Bank also intends to pursue additional opportunities in the financial technology space and seeks to increase income diversification within the Corporate Banking division. With increased clarity regarding future regulatory capital requirements with the introduction of CRD IV, there is a potential for Arion Bank to optimise its capital structure through distributions of surplus capital to shareholders and to reduce its risk-weighted assets as a percentage of total assets.

These initiatives are expected to tie into Arion Bank's overall strategies by enabling Arion Bank to remain balanced and diverse and to meet the changing needs of its customers. Arion Bank has also developed a number of specific strategic priorities and focus areas for each of its divisions. See "*—Business—Retail Banking Division—Strategic Priorities*", "*—Business—Corporate Banking Division—Strategic Priorities*", "*—Business—Investment Banking Division—Strategic Priorities*" and "*—Business—Asset Management—Strategic Priorities*".

Financial Targets

The Board of Directors has adopted the following financial targets. For additional information on Arion Bank's dividend policy, see "*Shares and Share Capital—Dividends and Dividend Policy*".

The Bank's financial targets set forth below constitute forward-looking statements that are subject to considerable uncertainty. The financial targets are based upon a number of assumptions relating to, among other things, the development of the banking industry, business, results of operations and financial condition. The Bank's business, prospects, financial position and results of operations, and the development of the banking industry and the macroeconomic environment in which it operates, may differ materially from, and be more negative than, those assumed by the Bank when preparing the financial targets set forth below. As a result, the Bank's ability to reach these financial targets is subject to uncertainties and contingencies, some of which are beyond its control, and no assurance can be given that the Bank will be able to reach these targets or that its financial position or results of operations will not be materially different from these financial targets. See "Presentation of Financial and Other Information—Forward-Looking Statements".

Profitability

Arion Bank's medium-term target is to achieve a competitive return on equity (post-tax) with a medium-term target of exceeding 10%. To do this, Arion Bank targets the following means of value creation.

Capital Targets

Based on the current regulatory framework and economic outlook, Arion Bank's medium-term target is to reduce its CET1 ratio to approximately 17% from its CET1 ratio of 23.6% as of 31 December 2017, which is expected to have the most significant impact on its return on equity target. The year-end CET1 ratio of 23.6% takes into account the equity reduction of ISK 25 billion by means of the First Monetisation Dividend (as defined below), which was paid in February 2018 and March 2018. See "*Shares and Share Capital—Dividends and Dividend Policy—Dividends Paid*".

The speed and quantum of such special distributions would depend on a number of factors, including (but not limited to) management of the Bank's foreign exchange imbalances, its capital optimisation strategy and regulatory consents. Any such capital reductions would likely take place over a number of years. Initially, the Bank anticipates that this strategy would involve an issuance of senior unsecured bonds and ultimately Tier 2 and AT1 instruments, depending on market conditions, in order to fund further capital distributions. In each case, such a reduction of capital would be subject to applicable laws and regulations, the financial condition of the Bank and available liquidity at the time.

Loan Growth

On the back of the underlying growth in the Icelandic economy, the Bank targets to grow its customer loan portfolio in line with nominal Icelandic GDP growth (noting that real GDP is forecast at 3.2% in 2018, 3.0% in 2019 and 2.7% in 2020 and inflation is forecast at 2.6% in 2018, 2.2% in 2019 and 2.8% in 2020 *(source: Icelandic Central Bank Monetary Bulletin 2018/1)*). Growth in the customer loan portfolio is expected to have a moderate impact on the Bank's return on equity target.

Cost-to-Income Ratio

Arion Bank's medium-term target is to reduce its cost-to-income ratio to approximately 50% (the ratio was 56.1% for the year ended 31 December 2017), subject to the growth of its loan portfolio, maintaining a stable net interest margin and increasing commission income. It targets these effects by means of implementation of (i) efficiency measures through lean banking, operational improvements and outsourcing; (ii) continued implementation of digitalisation across both client-facing offerings and automation of back-office functions; and (iii) further realisation of synergies from integration of Vördur (expected to have less of an impact than either the efficiency measures or digitalisation). Reduction of the cost-to-income ratio is expected to have a moderate impact on the Bank's return on equity target.

Business

The Bank comprises the following operating segments:

Retail Banking provides a comprehensive range of products and services, including mortgage loans, savings and checking accounts, vehicle and equipment financing, factoring, payment cards, pension services, insurance and funds, to both individuals and SMEs. The Retail Banking division has a strong emphasis on digital banking solutions, including internet banking, the Arion Bank App and automated teller machines ("**ATMs**"). As of 31 December 2017, the Retail Banking division operated out of 24 branches across Iceland and its 367 full-time equivalent employees ("**FTEs**") served over 100,000 customers during the year. In March 2018, the Bank announced plans to merge certain branches and focus on optimising its branch network by reducing square metres occupied and to have digital branches, resulting in closing three branches.

Corporate Banking provides customised lending solutions, including term loans, revolving credit facilities and guarantees, to large corporate customers across all industry sectors with an emphasis on top 100 companies in Iceland. The Corporate Banking division derives the majority of its income from the provision of loans to corporate customers. As of 31 December 2017, the Corporate Banking division served 191 large corporate customers with 15 FTEs working out of headquarters with day to day customer service support from dedicated corporate service representatives in 13 branches.

Investment Banking provides a full range of investment banking products and services, including equity and fixed income brokerage, initial public offerings and M&A advisory and bond and equity trading services, to a broad range of customers, including corporate customers, professional investors, asset management companies and pension funds. As of 31 December 2017, the Investment Banking division had 30 FTEs organised across the three subdivisions: Capital Markets, Corporate Finance and Research.

Asset Management (which includes Stefnir, an independently operating financial company wholly owned by Arion Bank) provides a full range of asset management products and services to institutional investors, such as pension funds and insurance companies, and high net worth individuals. As of 31 December 2017, the Asset Management division had more than 100,000 customers and 34 FTEs organised across the four subdivisions, Private Banking, Institutional Asset Management, Investment Services and Pension Funds Administration, and Stefnir had approximately 10,600 investors in over 40 funds served by 18 FTEs.

Treasury, which is a part of the Finance division, is responsible for liquidity, currency and interest rate management for the Bank. Treasury is also responsible for the internal pricing of interest rates and currency and for liaising with other financial institutions.

Other divisions and subsidiaries include Arion Bank's market making business in currencies and domestic securities. The subsidiaries are Valitor, Vördur, Eignarhaldsfélagid Landey ehf. ("**Landey**") and other smaller entities.

- *Valitor* is the Bank's international payments platform and comprises both card acquiring services and card issuing services. Valitor provides e-commerce and card-present card acquiring services to merchants and corporate customers and provides card issuing services and payment processing solutions to domestic and international partners.
- *Vördur* is a universal insurance company providing policies for motor vehicles, home protection, property and life and health products.
- *Landey* is the Bank's wholly owned property development company which manages assets, such as unfinished housing developments and building lots, and maintains and increases the value of these assets.

The tables below set forth operating income and earnings before tax for each reportable segment and the total assets for each reportable segment for the periods and as of the dates indicated.

	As of and for the year ended 31 December 2017							
	Retail banking[(1)]	Corporate banking	Investment banking	Asset management[(2)]	Treasury[(3)]	Other divisions and subsidiaries[(4)]	Headquarters and elimination[(5)]	Total
	(ISK in millions)							
Operating income	21,151	8,543	1,467	4,677	6,216	12,251	(927)	53,378
Earnings (loss) before tax	11,504	3,297	(57)	2,338	4,377	2,392	(3,420)	20,431
Total assets	527,652	274,917	16,165	75,564	483,794	89,936	(320,274)	1,147,754

(1) Includes Arion Bank Mortgages Institutional Investor Fund (the "**ABMIIF**").

(2) Includes Stefnir.

(3) The "Treasury" reportable segment includes internal interest income and internal expense (which are eliminated upon consolidation) as well as interest income on the Group's cash, cash equivalents and other liquid assets held as a liquidity buffer.

(4) Includes Valitor, Landey and Vördur (including what was formerly Okkar Life Insurance). The operating income of Valitor and Vördur on a standalone basis was ISK 7,401 million and ISK 3,139 million, respectively; the earnings before tax of Valitor and Vördur on a standalone basis were ISK 206 million and ISK 1,164 million, respectively; and total assets of Valitor and Vördur on a standalone basis were ISK 50,313 million and ISK 19,980 million, respectively.

(5) "Headquarters and elimination" includes the netting out of intragroup accounts, dividends paid in respect of the Bank's holdings in listed equity and valuation changes. "Headquarters" include overhead and the following support divisions: Risk Management, Finance (excluding Treasury), Legal, IT and Operations.

	As of and for the year ended 31 December 2016							
	Retail banking[(1)]	Corporate banking	Investment banking	Asset management[(2)]	Treasury[(3)]	Other divisions and subsidiaries[(4)]	Headquarters and elimination[(5)]	Total
	(ISK in millions)							
Operating income	19,702	7,874	3,746	4,345	6,160	12,310	409	54,546
Earnings before tax	11,996	4,307	3,643	1,832	4,069	5,164	(2,641)	28,370
Total assets	506,483	251,821	16,836	87,307	427,037	72,128	(325,588)	1,036,024

(1) Includes ABMIIF.

(2) Includes Stefnir.

(3) The "Treasury" reportable segment includes internal interest income and internal expense (which are eliminated upon consolidation) as well as interest income on the Group's cash, cash equivalents and other liquid assets held as a liquidity buffer.

(4) Includes Valitor, Okkar Life Insurance, Landey and Vördur. The operating income of Valitor, Vördur and Okkar Life Insurance on a standalone basis was ISK 9,428 million, ISK 847 million and ISK 850 million, respectively; the earnings before tax of Valitor, Vördur and Okkar Life Insurance on a standalone basis were ISK 3,590 million, ISK 454 million and ISK 195 million, respectively; and total assets of Valitor, Vördur and Okkar Life Insurance on a standalone basis were ISK 38,588 million, ISK 12,436 million and ISK 4,554 million, respectively. Additionally, it includes the Bank's share of operating income, earnings before tax and assets from BG12 slhf., EAB 1 ehf. and Kolufell, in which the Bank sold a majority of its shareholding in July 2016.

(5) "Headquarters and elimination" includes the netting out of intragroup accounts, dividends paid in respect of the Bank's holdings in listed equity and valuation changes. "Headquarters" include overhead and the following support divisions: Risk Management, Finance (excluding Treasury), Legal, IT and Operations.

	As of and for the year ended 31 December 2015							
	Retail banking(1)	Corporate banking	Investment banking(2)	Asset management(3)	Treasury(4)	Other divisions and subsidiaries(5)	Headquarters and elimination(6)	Total
				(ISK in millions)				
Operating income	16,887	7,019	36,434	4,882	6,758	7,260	7,381	86,620
Earnings before tax	2,055	802	37,375	2,490	4,507	738	4,973	52,904
Total assets	471,482	243,199	67,468	89,336	411,676	59,997	(332,115)	1,011,043

(1) Includes ABMIIF and AFL-sparisjódur ("**AFL**"), a savings bank which was merged into the Bank in October 2015.

(2) Includes BG12 slhf., EAB 1 ehf. and Kolufell, in which the Bank sold a majority of its shareholding in July 2016.

(3) Includes Stefnir.

(4) The "Treasury" reportable segment includes internal interest income and internal expense (which are eliminated upon consolidation) as well as interest income on the Group's cash, cash equivalents and other liquid assets held as a liquidity buffer.

(5) Includes Valitor, Okkar Life Insurance, Landey and Eignabjarg ehf. ("**Eignabjarg**"), a wholly owned subsidiary of the Bank which was liquidated in 2015. The operating income of Valitor and Okkar Life Insurance on a standalone basis was ISK 5,157 million and ISK 1,012 million, respectively; the earnings before tax of Valitor and Okkar Life Insurance on a standalone basis were ISK 131 million and ISK 459 million, respectively; and total assets of Valitor and Okkar Life Insurance on a standalone basis were ISK 39,134 million and ISK 4,663 million, respectively.

(6) "Headquarters and elimination" includes the netting out of intragroup accounts, dividends paid in respect of the Bank's holdings in listed equity and valuation changes. "Headquarters" include overhead and the following support divisions: Risk Management, Finance (excluding Treasury), Legal, IT and Operations.

Retail Banking Division

Overview

The Retail Banking division is a leading and innovative retail bank in Iceland that provides a comprehensive range of financial products and services to individuals and SMEs and seeks to build long-lasting and profitable relationships with its customers. In the period from 2009 to 2012, the Retail Banking division's key focus was to work with its customers to restructure their debts. However, during 2012, market conditions improved and, accordingly, demand for traditional financial products and services increased, which enabled the Retail Banking division to switch its focus to providing such products and services. In addition, the Retail Banking division continuously strives to differentiate its product and service offerings, for example by offering factoring, or asset-based lending, to SMEs in connection with trade finance and launching a new unit in 2012, which specialises in financing vehicles and various other types of equipment for personal and commercial use. The focus in recent months has been on digital services and improving the internet bank and the Arion Bank mobile app.

The table below sets forth certain operational data for the Retail Banking division as of 31 December 2017.

Market share of individual customers	27.9%(1)
Total number of customers (individuals and SMEs)	130,291(2)
Individual customers	114,167
SMEs	16,124
Total number of branches	24
Number of FTEs	367
Total loans outstanding	ISK 500,442 million
Households	ISK 361,651 million
SMEs	ISK 138,791 million
Deposits from customers and credit institutions	ISK 341,797 million

(1) Based on the monthly customer survey of individuals conducted by Capacent on a three-month average as of 31 December 2017.

(2) Includes active customers of Arion Bank. Based on the Finalta, McKinsey and Arion Bank's definition of active customers. Active customers are defined as customers of the Retail Banking division who either (i) have a product in force (such as a loan, mortgage or insurance policy) or (ii) have made a customer-initiated financial transaction in the preceding six months on an account-based product (such as a current account, credit card or debit card). For these purposes, financial transactions exclude any automated payments such as direct debits (there is no distinction between the different channels through which the transaction was conducted); or (iii) have a balance of more than EUR 250 or equivalent in a current account or term deposit account.

Strategic Priorities

The Retail Banking division has a track record of successfully implementing strategic initiatives and has a clear strategy for achieving further growth and enhancing efficiency in its operations with the specific areas of focus set forth below.

Maintain leading position in the mortgage loans market among the three largest banks and pension funds by market share and continue growing its market share in lending to SMEs and to maintain position as the leading digital bank in Iceland

The Retail Banking division, which has been a market leader in connection with introduction of new products and services for mortgage loans, intends to maintain its leading position through increased emphasis on digitalisation and simplification of the mortgage loan processes. The Retail Banking division has continuously optimised its nationwide branch network since 2008 and has a strong focus on digitalisation, making investments in advanced digital banking solutions for customers, such as the Arion Bank app and digital customer onboarding. The advent of new digital solutions has resulted in a major change in customer behaviour over the past few years. The vast majority of contact with customers is now via digital channels such as the Arion Bank mobile app, the internet, online banking and ATMs. Arion Bank aims to offer outstanding digital services. Arion Bank has achieved a great deal in this respect in recent years with innovations including automatic credit assessments, a new method for onboarding customers, credit card payment plans in the Arion Bank mobile app and online banking, new ways to open accounts and obtain cards online, in addition to digital mortgage loans, car loans and paying credit card bills in instalments. The Bank is also making increasing use of web chat and other media in order to provide its services. Digitalisation seeks to ensure delivery of the Retail Banking division's products and services through multiple channels, enhances efficiency in its operations and contributes to customer satisfaction. The Retail Banking division has also decentralised its decision-making processes to bring decisions closer to individual customers, which likewise enhances customer satisfaction and experience. At the same time, there has been a focus on standardisation.

In addition, the Retail Banking division strives to provide its customers with a more personalised service and improve the quality of customer service by implementing customer relationship management system to log customer activity and enable front line staff to answer questions and provide relevant services in both branches and through the call centre.

The Retail Banking division also intends to continue growing its market share with SMEs, in particular in the real estate and construction, wholesale and retail trade and seafood industry sectors, which have driven growth in the SME loans market. The decentralisation of the decision-making processes and creation of SME units in branches has fuelled growth in lending to SMEs by bringing the lending decisions closer to individual SME customers and resulting in faster processing times and a customised approach to individual lending decisions. In addition, the Retail Banking division seeks to build strong SME teams to provide a tailored approach by area and industry sector. The Retail Banking division began cooperating with the European Investment Fund to offer lending to SMEs at lower rates, with a particular focus on start-ups and development projects.

The organisation of the Retail Banking division has been reviewed and strategic changes implemented. In 2017, a new unit team for products, pricing and digital future was established in order to build on the success of the Bank's digital channels. A further priority has been the effective management and development of products in the Retail Banking division, and the division now has five product managers who are authorised to manage prices and interest rates and sales on the products for which they are responsible. Integrating the role of product managers and digital channels in one team seeks to streamline processes and improve customer experiences by delivering product and services where and when customers themselves choose to purchase them. Another new unit was launched for SME business in order to grow this market. The SME unit has staff with extensive experience in servicing and lending to SMEs and has achieved good results in lending activity in the past few years.

Increase efficiency and reduce costs

The Retail Banking division strives to provide better customer service at lower costs. In accordance with the lean banking principles which guide the operations of Arion Bank, the Retail Banking division has continuously optimised its branch network since 2008 in order to respond rapidly to changes in customers' needs. The optimisation process has included reducing opening hours and the total size of the branch network by either relocating to smaller branches or renting out part of the excess space at existing branches as well as closing or merging certain branches, such as the Holmavík branch and the Reykjavík branches. Other initiatives included opening the only branch at the Keflavík international airport, merging two existing branches to open a flagship branch in the Borgartún financial area and opening a new digital branch concept for the Kringlan mall branch. The new digital branch has been successful and is piloting new projects such as remote advisors, new ATM technology and events management to attract new customers. The Retail Banking division continues to pursue additional opportunities to further optimise its existing branch network, including through combination with Vördur's insurance networks and strategic location choices for its branches.

The Retail Banking division has introduced specially trained employees to direct customers to use either regular branch staff or ATMs depending on the intended transaction, thereby encouraging further self-service among customers and enabling increased productivity of the branch network. The Retail Banking division continues to streamline its organisational structure to enhance the operational efficiency and free up time for proactive tasks that result in better customer service. The Retail Banking division also seeks to improve continuously its operations and services and plans to establish better process monitoring tools, such as key performance indicators.

Implement digitalisation initiatives

The Retail Banking division plans to focus on digitalisation to drive further cost savings and customer satisfaction and experience. Through the promotion of self-service channels, it seeks to reduce the number of low value transactions in its branches and through its call centre. To this end, the Retail Banking division has continuously introduced and improved digital solutions for its customers, such as the Arion Bank app, internet banking and multi-purpose ATMs as well as digitalisation of customer onboarding and the loan mortgage application process. In this respect, customers can now open accounts online immediately and have credit cards delivered the next day, enabling the self-service of 22,500 new accounts and credit cards annually. In addition, the Retail Banking division has introduced self-service capabilities for paying credit card bills in instalments through the Arion Bank app and internet banking, which is expected to reduce manual work arising from approximately 25,000 call centre transactions per annum. This has had an effect on the demand for Arion Bank's products and services, for example, by offering an in-app option of paying credit card bills in instalments, the number of such transactions increased by 60% at the beginning of 2018 compared with the same period in 2017. The digitalisation of the mortgage process allows customers to go through the entire mortgage process online, including an automatic credit assessment. This solution allows customers to obtain a credit assessment and loan offer in 15 minutes in contrast to traditional processes, which can take three to five days to process. The number of credit assessments provided in 2017 increased by 85% compared to 2016, and 41% of these assessments were produced online, outside of bank opening hours. The mortgage portfolio grew by 9.7% in 2017, with a 99% increase in lending activity from 2017 to 2018 in terms of total loan volumes extended in each year. Digital refinancing of mortgages and SME onboarding have already been implemented successfully. Three more digital projects, automatic personal lending (which focuses on streamlined data collection, automated risk assessment and document creation), one financial view (which provides a comprehensive view of customers' end-of-month banking tasks and notifies customers of new claims) and simplification of the car loan process, were implemented at the beginning of 2018. Automated personal loans were implemented at the beginning of 2018, with an increase in demand compared to the same period in 2017.

Based on the above, the Bank believes that the digital solutions it offers have created increased demand for Arion Bank's products and services, furthermore, measurements of customer satisfaction measured by net promotor score have also improved in line with new digital solution offerings. With this in mind, the Retail Banking division intends to invest additional resources in other initiatives designed to further digitalise its product and services offering and to conduct extensive follow up after their implementation to monitor their efficacy.

Enhance product and services offering

The Retail Banking division focuses on diversifying its product and services offering, through cooperation with other divisions of Arion Bank and revamping its existing loyalty schemes to give its customers more choices. The Retail Banking division also anticipates taking advantage of the Bank's acquisition of Vördur, the fourth largest universal insurance company in Iceland based on insurance premiums *(source: FME)*, to further integrate the Bank's banking and insurance businesses and to diversify its product and services offering, such as the use of the branch network to sell Vördur's insurance products. Finally, the enlargement of the vehicle and equipment financing and leasing unit has expanded the choices available to the Retail Banking division's customers, and the Retail Banking division intends to pursue further opportunities in vehicle and equipment financing.

Operations and Distribution Capabilities

The Retail Banking division generates operating income through the provision of financial products and services to retail customers, on which the Bank earns interest income and fee and commission income. Operating income for the Retail Banking division was ISK 21,151 million, ISK 19,702 million and ISK 16,887 million for the years ended 31 December 2017, 2016 and 2015, respectively. As of 31 December 2017, 2016 and 2015, the Retail Banking division's customer loan portfolio amounted to ISK 500,442 million, ISK 460,420 million and ISK 443,368 million, respectively, and the total amount of deposits with the Retail Banking division amounted to ISK 341,797 million, ISK 299,912 million and ISK 269,263 million, respectively.

The Retail Banking division serves its customers through its branch network and other points of contact, such as ATMs, a call centre, internet banking and the Arion Bank app, focusing on customer relationships to address different areas with different needs.

<u>Branches</u>

Following its establishment in late 2008, the Bank has sought to streamline its retail banking operations by closing or merging a number of its branches as well as reducing the total size of its branch network, with six branches closed in the Reykjavík area and approximately 2,771 m^2 reduced since 2013 (equivalent to approximately 9% of the size of its current operations). In recent years, the focus has been on making the branch network even more efficient and convenient for customers. There was no reduction of branch m^2 in 2017; however, the Bank sold more than 1,000 m^2 of its storage space during the year. In implementing the further branch changes that were recently announced, it is estimated that square metres will decrease by about 3,023 m^2. The overall branch experience has been redefined, moving from traditional branches to more flexible units by adding new service formats. In the last four years, the Bank has opened a flagship branch in the Borgartún financial area, an airport branch in Keflavík airport and a digital branch in Kringlan shopping mall. New, flexible micro branch units have been designed and will open in new locations in 2018. In addition, the Bank has opened self-service areas which are open 24/7, remote bank services with extended opening hours and has operated a mobile ATM van.

This strategy has resulted in a flexible and optimised branch network with stronger individual branches, which the Retail Banking division believes are better suited to meet the needs of its customers. To maximise operational efficiency, the branch network is divided into five regions, each of which has its own business manager. The branches in the Reykjavík area have been merged into a single region instead of the previous two. This change makes it easier to coordinate services and to combine employees' expertise in order to meet customers' demands. This change also reduces the overall costs of operating the branch network and boosts efficiency. Smaller branches capitalise on the strength of larger branches within each cluster. This organisation of the branch network transfers more executive authority and responsibility to the branches, which are closer to the needs and concerns of the customers, thereby bringing the decision-making power closer to the customers and enhancing the customer satisfaction and experience. See "*—Strategic Priorities*". In March 2018, the Bank announced its intent to merge certain branches and put more focus on optimising its branch network by reducing square metres and to have smaller, flexible branches resulting in the closing of three branches.

Owing to Arion Bank being an indirect successor of the Agricultural Bank, which was an old agricultural bank of Iceland, Arion Bank's branches are strategically situated in key tourism areas as well as in agricultural areas. The maps below show the locations of Arion Bank's branches (left, with circles around key tourist areas) and the tourism hot spots in Iceland (right).

Source: Icelandic Tourist Board

As of 31 December 2017, the Bank had 24 branches throughout Iceland, of which eight branches were located in the greater Reykjavík area and 16 branches were located in rural areas in light of their agricultural heritage background. The Bank intends to close three branches in 2018, as announced in March 2018. In addition, nine of Arion Bank's branches were located in major tourist towns or by the main road in Iceland and Arion Bank was the only bank in the area in 11 locations. Arion Bank has also launched the only branch at the Keflavík international airport.

The Retail Banking division has trained and certified financial consultants within its larger branches in order to improve the level of service to its customers. The financial consultants are knowledgeable in a wide range of fields, including banking services, pensions and insurance and other financial instruments.

Internet Banking, Arion Bank App and ATMs

The Retail Banking division has continuously endeavoured to be a market leader in digital solutions to banking, increasing channel diversification to improve efficiency. Accordingly, the Retail Banking division has taken advantage of the major changes in customer behaviour in recent years, as customers have transitioned away from branches to internet and mobile banking as the preferred channel, by successfully implementing the Arion Bank app in August 2012. Internet banking enables customers to access the majority of the most utilised services available at a traditional branch, while the increasingly popular Arion Bank app allows customers to keep track of their finances with a single click. In addition, the new generation of ATMs enables customers to save time by allowing them to deposit and withdraw cash as well as pay their bills without assistance from a cashier.

The Retail Banking division plans to steadily reduce the volume of low value transactions handled at branches by putting greater emphasis on customers' experience, through the Arion Bank app and other digital solutions. By focusing on digitalisation of various processes, the Bank has reduced the internal lead time for customer onboarding by approximately 88% and launched new digital initiatives with respect to the mortgage loan application process, credit cards, leasing SME onboarding, mortgage refinancing and other services. The public response to these digital initiatives has been very positive, with the majority of credit assessments and mortgage applications being performed digitally and payment plans for credit cards, overdrafts and other functions are set up almost entirely by using the Arion Bank app.

The table below sets forth certain operational data for the Retail Banking division as of the dates and for the periods indicated.

	As of and for the year ended 31 December				
	2017	**% Change**	**2016**	**% Change**	**2015**
Number of active internet banking users[(1)]	75,615	(2.6)%	77,706	5.3%	73,769
Number of active Arion Bank app users[(1)]	53,717	30.9%	41,044	43.9%	28,519
Number of digital account openings	12,387	320.2%	2,948	39.6%	2,111
Number of interactions through ATMs (000s)	1,753	—	1,753	20.2%	1,458
Number of visits to branches (000s)	541	(8.7)%	593	(2.9)%	611
Number of calls to the call centre (000s)	323	1.2%	319	(2.7)%	328

(1) Defined as customers active for 90 days and counted on 30 June of each year.

The table below sets forth the range of services available to the Retail Banking division's customers through internet banking, the Arion Bank app and ATMs.

Internet banking	Arion Bank app	ATMs
Balance check	Balance check	Balance check
Current accounts	Electronic overview	Cash management (deposits and withdrawals)
Savings	Real-time money transfers	
Loans	Payments	Money transfers
Real-time money transfers	Credit / debit cards	Payments
Payments and payment scheduling	Overdrafts / credit card limits	Currency sales[1]
Credit / debit cards, limits and bill split	Bill payments / split, in real time, simultaneous	
Loan payments	Announcement of new bills	
Overdrafts		
Fund transactions		
Domestic equities transactions		
Financial overview, pension, insurance and tax		

(1) Available at the ATM in the Keflavík international airport, at Kringlan Mall, Borgartún, Smaratorg and Vesturbær.

The Payment Services Directive 2 and related open banking requirements will affect all banks in the near future. The Payment Services Directive 2 has not yet been implemented in Icelandic law (expected to be in 2019), and so its effect will happen later than in the EU. Arion Bank, as the leading digital bank in Iceland according to a consumer survey by Maskína in December 2017 and also by the number of implemented digital solutions, sees opportunities in the development of open banking that is being encouraged by the Payment Services Directive 2. As a result, Arion Bank is currently developing and refining the Bank's open banking strategy. The main emphasis in Arion Bank's open banking strategy will be to further develop the advantage gained in digital offerings and to leverage those solutions by making them available to other potential customers besides existing Arion Bank customers. Furthermore, the Arion Bank app is considered the best banking app in the Icelandic market, according to a survey performed by MMR in August 2017. As a result, the Bank sees an opportunity to offer account aggregation and payment initiation services to customers of other banks, along with further developing the Arion Bank App into a platform offering a greater variety of solutions both produced in-house but also and increasingly in cooperation with others.

Customers

As of 31 December 2017, the Retail Banking division had an estimated 130,291 active customers (defined as customers of the Retail Banking division who either (i) have a product in force (such as a loan, mortgage or insurance policy) or (ii) have made a customer-initiated financial transaction (excluding any automated payments such as direct debits) in the preceding six months on an account-based product (such as a current account, credit card or debit card); or (iii) have a balance of more than EUR 250 or equivalent in a current account or term deposit account), of which 87.6% were individuals and 12.4% were SMEs. The Retail Banking division enjoys a loyal and relatively stable customer base in Iceland, with its customers accounting for 27.9% of individual customers in Iceland and 27.4% of SMEs in Iceland for the year ended 31 December 2017 *(source: active customers definition based on Finalta, McKinsey; Capacent Gallup)*. The Bank measures customer satisfaction on the basis of net promoter scores for its most important customer services.

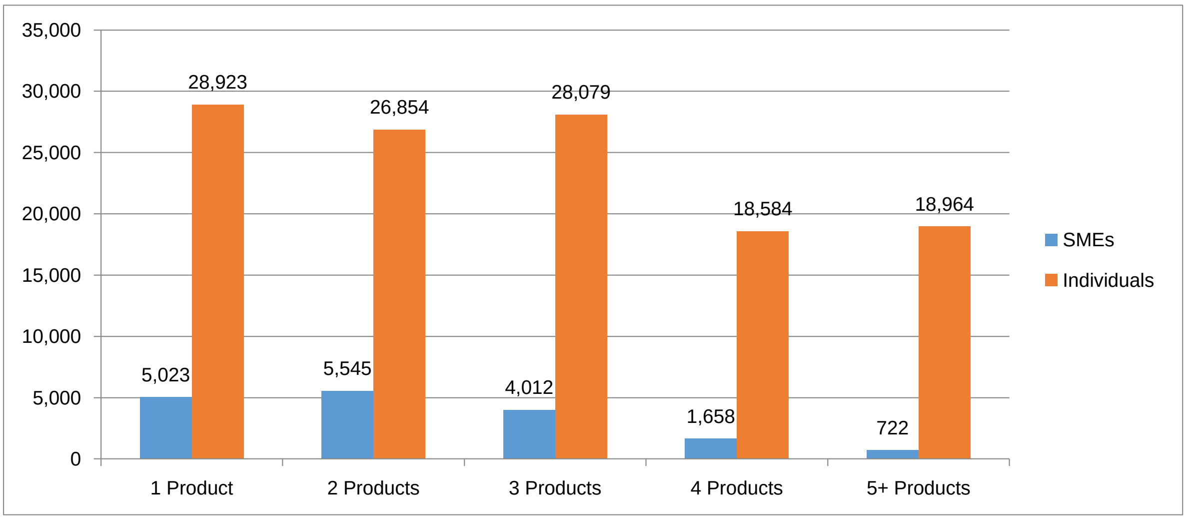
Products and Services

The Retail Banking division offers a comprehensive range of financial products and services, including mortgage loans, savings and checking accounts, vehicle and equipment financing, payment cards, pension services, insurance and funds. The Retail Banking division also offers factoring, or trade financing, which is used by SMEs, both importers and exporters. In particular, the Bank uses factoring in connection with trade finance, where inventory financing is linked with the financing of receivables which suits the needs of exporters, such as seafood companies. The Bank also offers SME loans in cooperation with the European Investment Fund.

The table below sets forth the financial products and services offered by the Retail Banking division.

Mortgage loans	Other lending / households	Deposits	Credit / debit cards
CPI-linked	Term loans	Accounts	Visa
Non-CPI-linked	Overdrafts	Funds	MasterCard
Mixed	Property loans	Pension savings	World Elite
	Vehicle and equipment financing		
	Factoring		

The Retail Banking division's goal is to provide personalised services to distinct customer segments and SME market sectors to meet its customers' needs. In addition, the Retail Banking division seeks to establish multi-product relationships with its customers by offering various financial products and services offered by Arion Bank's divisions through diversified delivery channels. The graph below sets forth the number of products being used by the Retail Banking division's customers as of 31 December 2017 classified by the type of customer.



To increase product penetration and increase the number of products per customer, the Retail Banking division has also developed more proactive methods with respect to its product and services offering, including exploring new opportunities with Vördur's current customers (*e.g.*, offering the Retail Banking division's mortgage loans), as well as the use of the branch network to sell Vördur's insurance products as a registered insurance intermediary.

Mortgage Loans

The Retail Banking division provides a full range of products and services relating to mortgage loans and has historically introduced innovative products and services designed for the evolving needs of its customers. This has enabled the Retail Banking division to maintain or increase its market share in an increasingly competitive market. Arion Bank was the first to introduce fixed five-year interest rates on non-CPI-linked mortgage loans in 2011. The Retail Banking division further strengthened its first mover advantage and competitive position in the market by offering mixed CPI-linked and non-CPI-linked mortgage loans, allowing customers to select the type of mortgage loan that best suits their risk appetite and ability to repay. Recent product developments include a mortgage product designed to temporarily lower the borrower's debt repayments during parental leave and a mortgage product for first-time home buyers with an up to 85% loan-to-value ratio. When mortgage loans are issued, the Retail Banking division strives to improve its product and services offering by implementing digitalisation initiatives. See "—*Strategic Priorities*".

The table below sets forth the volume of ISK-denominated mortgage loans to individuals as of the dates indicated.

	As of 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
CPI-linked mortgage loans[(1)]	225,409	213,340	197,705
Non-CPI-linked mortgage loans	84,909	69,656	70,342
Total mortgage loans	**310,318**	**282,996**	**268,048**

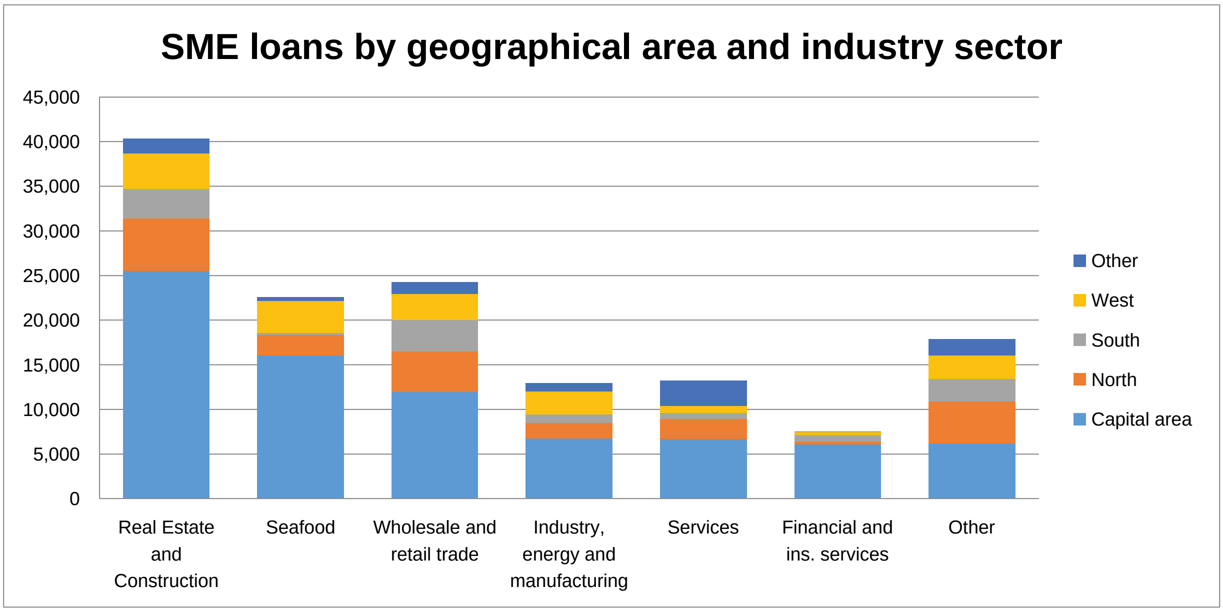
(1) CPI-linked mortgage loans denominated in Icelandic Krona have an early prepayment fee of up to 2.0%. For information on CPI-linked mortgage loans in Iceland, see "*Industry Overview—Retail Banking—Mortgage Loans Market*". In 2017, approximately 60% of the new volume of the Bank's mortgage loans portfolio was CPI-linked, with the remainder non-CPI-linked.

The Retail Banking division has experienced a growing mortgage loans portfolio and a strong position in the mortgage loans market, providing a degree of cross-selling potential with Arion Bank's other products and services, such as deposits. See "—*Customer Deposits*". The Retail Banking division's conservative approach to borrower loan-to-value ratios, coupled with the fact that approximately 90% of properties in Iceland are occupied by their owners (as estimated by Arion Bank), have resulted in low default rates in the mortgage loans portfolio. Accordingly, the weighted average loan-to-value ratio of the mortgage loan portfolio decreased from 81.5% as of 31 December 2013 to 54.9% as of 31 December 2017, and the ratio of mortgage loans in 90 or more days default decreased from 6.7% as of 31 December 2013 to 1.0% as of 31 December 2017, whereas the proportion of the mortgage loans portfolio with a loan-to-value ratio of less than 80% increased from 49.2% as of 31 December 2013 to 87.1% as of 31 December 2017. For additional information on Arion Bank's loan portfolio, see "*Selected Statistical Information—Loan Portfolio*".

Loans to SMEs

The Retail Banking division has significantly grown its portfolio of loans to SMEs in recent years, which has traditionally been relatively small, as compared to its competitors. In November 2017, the Retail Banking division established a new unit for SMEs to further enhance the Bank's market position in that sector. The new unit is responsible for loans, sales and quality management to SMEs. Loans to SMEs increased from ISK 120,671 million as of 31 December 2015 to ISK 127,275 million as of 31 December 2016 and ISK 138,685 million as of 31 December 2017, mainly driven by the increase in the volume of loans to SMEs in the real estate and construction industry sector (ISK 31,526 million as of 31 December 2015 to ISK 40,323 million as of 31 December 2017), wholesale and retail trade industry sector (ISK 22,592 million as of 31 December 2015 to ISK 24,216 million as of 31 December 2017) and the seafood industry sector (ISK 20,526 million as of 31 December 2015 to ISK 22,604 million as of 31 December

2017). The graph below sets forth the distribution of loans to SMEs by industry sector and geographical area as of 31 December 2017.



The Retail Banking division believes that there is additional appetite for growth to achieve further diversification and to deliver growth in the Retail Banking division's loan portfolio to SMEs and intends to execute on its strategies to attain such diversification and growth. See "—*Strategic Priorities*".

Customer Deposits

The Retail Banking division seeks to leverage its base of mortgage loans customers to achieve further growth in its market share of customer deposits, which is currently smaller than the market share of other large banks. The Retail Banking division's share of individual deposits increased from 25.7% as of 31 December 2015 to 27.0% as of 31 December 2016 and 27.2% as of 31 December 2017 *(source: Icelandic Central Bank)*. The table below sets forth the composition and total customer deposits of the Retail Banking division as of the dates indicated.

	As of 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
CPI-linked (ISK)	46,268	47,445	50,828
Non-CPI linked (ISK)	268,895	233,192	198,429
Foreign exchange	26,634	19,275	20,006
Total deposits	**341,797**	**299,912**	**269,263**

As customers in Iceland are accustomed to keeping deposits with their main bank and because CPI-linked deposits are generally thought to be less likely to move from bank to bank due to regulations which limit the time periods during which such deposits can be withdrawn, there is a relatively stable market for deposits from individual customers, with deposits from SME customers being more price sensitive. However, the Retail Banking division believes that there is an opportunity to attract deposits from customers who have their mortgage loans with the Retail Banking division but deposits with another bank. The cooperation of the Retail Banking division with the Asset Management division has enabled many cross-selling opportunities, including combining the product and services offering of the Retail Banking division with insurance and pension products. Higher levels of SME activity in Iceland also provide cross-selling opportunities for the Retail Banking division. In addition, Arion Bank believes that its new digital customer onboarding platform together with the comprehensive digital offering will become a catalyst for attracting new customers to the Retail Banking division. In addition, a new role was created in November 2017 for a product manager for deposits, who is authorised to manage prices and interest rates on deposits as well as promote deposits within the branch network and via digital channels.

Credit Cards

Arion Bank offers its customers a selection of payment cards from both Visa and MasterCard. It offers standard, gold and platinum, as well as Arion Bank's flagship card, the World Elite MasterCard. Two types of prepaid cards are also available: the gift card for Icelandic customers and the currency card for travellers visiting Iceland.

Regulation (EU) 2015/751 on interchange fees for card-based payment transactions (the "**EU Interchange Fee Regulation**") has not been implemented in Iceland yet, but according to information from the Ministry of Finance it is expected to be implemented in the course of 2019. The EU Interchange Fee Regulation will not generally affect debit card income as the cap is already set at 0.2% in Iceland. However, it will affect Arion Bank's revenue from domestic credit card turnover. The domestic interchange rate fee cap is now set at 0.6% but is expected to be lowered to 0.3% upon implementation of the EU Interchange Fee Regulation, resulting in revenue loss. Arion Bank budgeted for this expected revenue loss and has taken certain steps to mitigate the effect, mostly by reducing cost associated with the cards, simplifying the card product portfolio, reducing the number of third party processors and increasing card related revenues other than interchange fees. See also "*Regulatory Overview—Principal Legislation and Regulations—EU Interchange Fee Regulation*".

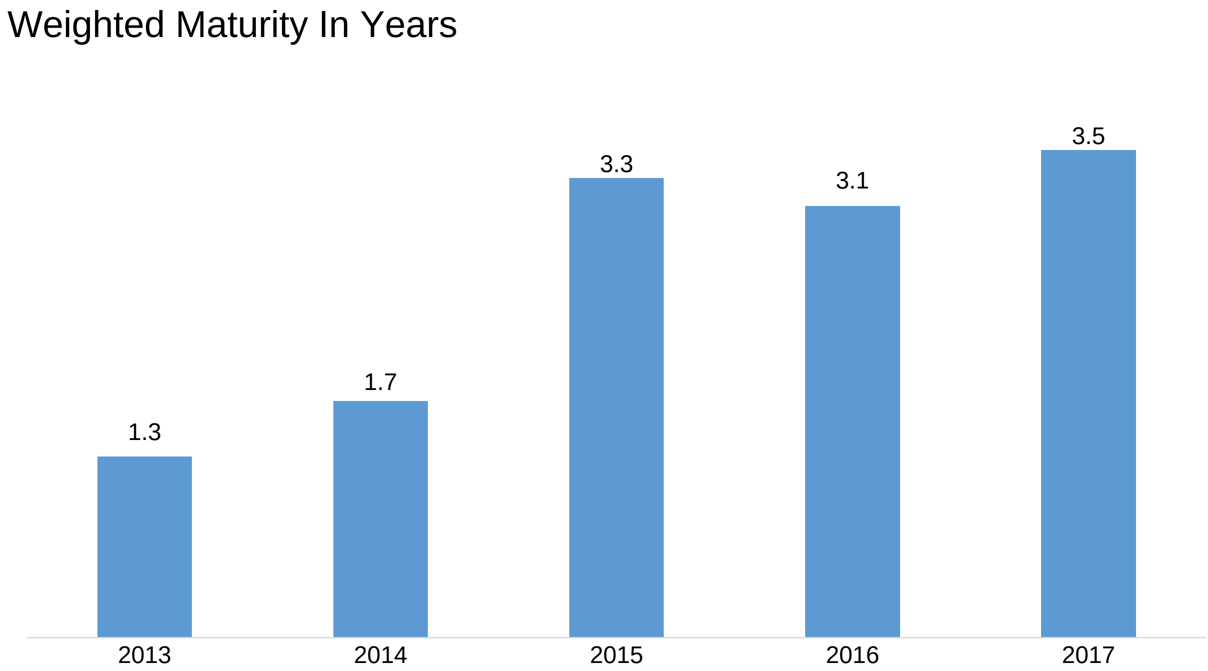
Corporate Banking Division

Overview

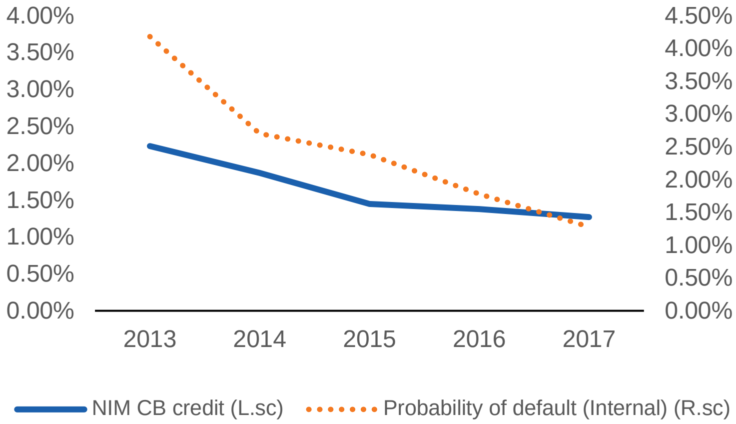
The Corporate Banking division is a full service Icelandic corporate bank, providing a range of financial products and services to larger corporate customers across all industry sectors through dedicated industry sector teams. The primary focus of the Corporate Banking division is to maintain long-term relationships with its existing customers and to deliver integrated solutions as well as personalised services to achieve revenue diversification. Arion Bank believes that its long-term relationships with leading corporate customers enable the Corporate Banking division to maintain its strong competitive position. In addition, the Corporate Banking division's relationship-based model benefits from and provides synergies across the other divisions of Arion Bank, in particular the Investment Banking division and the Private Banking subdivision of the Asset Management division.

The Corporate Banking division's proactive approach has significantly improved its market position in recent years. Since 2013, there has been margin pressure in high quality credits due to increased competition from pension funds (typically investors in real estate asset-backed securities, rather than as direct corporate lenders), as yields on government bonds decreased and the credit quality of companies gradually improved due to deleveraging and the improving economy. In addition, following the financial crisis, local banks had imposed accelerated repayment schedules on corporate borrowers, resulting in shortening maturity profiles in the Bank's corporate loan portfolio. The Corporate Banking division managed to stabilise its margins and to extend maturity profiles in 2015 and onwards after realigning operations in 2013 and returning to a proactive approach in 2014. This proactive approach included reducing recovery efforts and increasing focus on the competitive landscape to identify new business opportunities, improving the mix of margins and maturity profiles and originating new loans to existing and new customers. As shown in the graph below, the Corporate Banking division has been able to increase the average maturity of its loan portfolio, which has materially reduced repayment risk and the risk of losing a customer or transaction as a result small price differentials.

Increasing Loan Book Maturity



The graph below sets forth the credit risk analysis of the Corporate Banking division's loan portfolio based on the division's weighted net interest rate for the periods indicated. The left scale represents net interest margin for loans to customers in the Corporate Banking division, which is calculated as the net interest income divided by the average interest bearing assets in the Corporate Banking division for each quarter for the respective year. The right scale represents the Corporate Banking division's internal estimate of probability of default on those loans.



The adjustment and stabilised periods in the graph above refer to the internal circumstances experienced by the Corporate Banking division as a reaction to the external factors explained above. During the adjustment period (2013–2014), the Corporate Banking division eliminated its restructuring team. The adjustment period was characterised by the Corporate Banking division losing some transactions as a result of a price differential, with Arion Bank's pricing being higher than the pricing for funding in the capital markets from the local pension funds. Furthermore, the local price competition from other banks and the pension funds during the adjustment period led to lower net interest margins on loans extended by the Corporate Banking division.

During the stabilised period (2015–2017), the Corporate Banking division managed to offset decreasing margins by pursuing business opportunities in large, less price sensitive industries, such as infrastructure and energy projects, as well as the international seafood industry. Also contributing to lower probability of default during the stabilised period, the Corporate Banking division invited foreign financial institutions to participate in syndicated loan transactions, with Arion Bank being able to obtain the second lien in the financings due to its knowledge of local borrowers, thereby contributing to maintenance of its margins and its relationships, while foreign financial institutions took the lower-yielding first liens. The Corporate Banking division has also maintained its customer base and stabilised margins in the stabilised period by focusing on longer-dated credits as well as employing its full range of products through cross-selling, which enabled the Corporate Banking division to sustain its revenue. The Corporate Banking division also took advantage of its ability to offer favourable rates to customers on long-term transactions, because of Arion Bank's improved access to long-term funding, in particular foreign exchange funding.

In the aftermath of the financial crisis in 2008 and the sharp depreciation of Icelandic Krona, many customers of the Corporate Banking division were overleveraged. The loans of almost all of the customers in this position have either been restructured or refinanced, and the loan portfolio of the Corporate Banking division is currently well-diversified and balanced.

Furthermore, the Corporate Banking division has placed an increased emphasis on customer retention and relationship development by organising into industry sector teams and focusing further on the relationship management role in the Corporate Banking division.

The table below sets forth certain operational data for the Corporate Banking division as of 31 December 2017.

Market share in Icelandic corporate lending (including corporate bond issuance)	21%(1)
Number of large customers serviced from the branch at Arion Bank headquarters	191(2)
Total number of branches supporting distribution	13(3)
Number of FTEs	15(4)
Total loans and bonds outstanding to corporate banking customers	ISK 270,897 million(5)
Deposits	ISK 21,169 million

(1) Management belief based on internal analysis of competitors' public disclosures, based on book value of loans to corporates at period end. SMEs are covered by the Retail Banking division but are included in the market share of Corporate Banking.

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

(3) Represents branches with a dedicated corporate services presence.

(4) Represents the number of FTEs in the Corporate Banking division working out of Arion Bank's headquarters.

(5) Consists of loans to customers and bond instruments issued by customers but held by the Corporate Banking division.

Strategic Priorities

The Corporate Banking division has a clear strategy for maintaining its position in the market with the specific areas of focus set forth below.

<u>Lead in large transactions</u>

Capitalising on its integrated and tailored product and services offering, the Corporate Banking division intends to be the logical first call for large transactions. To achieve this objective, the Corporate Banking division plans to leverage its existing relationships with large corporate customers to further promote its universal relationship banking model. The Corporate Banking division also intends to further strengthen its syndication abilities, including by enhancing cooperation and cross-selling with the Investment Banking and the asset management operations of Arion Bank. The Corporate Banking division views retention of key talent as an integral part of this strategy.

<u>Further diversify its loan portfolio</u>

The Corporate Banking division seeks to further diversify its loan portfolio and preserve its current customer retention rate (defined as existing customers' share of the loan portfolio) of over 80% and to be selective when sourcing new deals, thereby managing loan portfolio growth. The Corporate Banking division intends to closely monitor its domestic loan portfolio to ensure that it reflects the breadth and composition of the Icelandic economy. Furthermore, the Corporate Banking division's international loan portfolio, although currently small and with a seafood industry bias, is expected to contribute to de-risking Arion Bank on a loan portfolio basis by providing exposure to international markets and reducing reliance on the Icelandic economy.

<u>Optimise margins and increase commission income</u>

The Corporate Banking division also intends to optimise margins and increase commission income through selectively targeting profitable growth. Arion Bank expects that corporate demand for credit extension will be robust, although with continued margin pressure. Credit quality continues to improve, as shown by strong reduction trends in problem loans and defaults as well as the improved internal credit ratings of Arion Bank's customers. Accordingly, the Corporate Banking division plans to monitor the current high credit demand in the Icelandic economy. It also seeks to enhance the sale of multiple products and increase its current product and services penetration by selling multiple products and services to individual customers and by acquiring customers with multi-product and multi-service needs.

There are additional opportunities in foreign exchange lending, and the Corporate Banking division expects to take advantage of expected growth in energy-related projects and in the seafood industry sector, which require foreign exchange funding that Arion Bank can offer, to generate additional income from loans to corporate customers. In addition, the Corporate Banking division believes that attracting additional foreign lenders into larger transactions and projects and becoming an expert and first point of contact for capital intensive projects will generate further income from loans to corporate customers. Finally, the Corporate Banking division aims to enhance its expertise in the niche seafood industry sector, especially in North America, as a means of generating additional income from loans to corporate customers. With respect to generating further services income, the Corporate Banking division intends to capitalise on strong relationships with large corporate customers to bid for additional future opportunities in the digital services space, underpinned by Arion Bank's digital progress and ambition.

Provide services outside local market

The Corporate Banking division plans to cautiously expand its product and services offering outside domestic markets, seeking to understand the needs of its existing customers to grow beyond Iceland and building key international relationships. The Corporate Banking division also aims to benefit from the expected consolidation trends in the seafood, commercial real estate and tourism industry sectors as well as from the easing of the Capital Controls by supporting its existing customers in their business endeavours abroad and leveraging its experience and expertise in the seafood industry sector, in terms of its knowledge of the industry dynamics, seasonality and collateral, in the somewhat underserved seafood lending markets in the European Union and North America.

Operations and Commercial Capabilities

The Corporate Banking division generates operating income through the provision of credit products and services to corporate customers, on which the Corporate Banking division earns interest income and fee and commission income. Operating income for the Corporate Banking division was ISK 8,543 million, ISK 7,874 million and ISK 7,012 million for the years ended 31 December 2017, 2016 and 2015, respectively. As of 31 December 2017, 2016 and 2015, the Corporate Banking division's loan portfolio amounted to ISK 270,897 million, ISK 248,222 million and ISK 239,600 million, respectively.

The Corporate Banking division is organised into three customer facing units and a small operations unit. A special recovery unit, which was responsible for Arion Bank's debt recovery, existed until the end of 2013 within the Corporate Banking division. The recovery unit was primarily involved in restructuring companies that experienced payment difficulties. During the restructuring process, Arion Bank acquired assets previously owned by the restructured companies. These assets were transferred into separate holding companies under the control of Arion Bank, and most have already been divested. The restructuring process is now overseen by the Legal division of Arion Bank.

The Corporate Banking division comprises teams of experienced account managers working out of Arion Bank's headquarters, who specialise in specific industry sectors to ensure strong expertise and with a focus on key performance indicators. The account managers are each responsible for specific customers, ensuring personal services and a clear overview of each customer's financial and service requirements. Each account manager also relies on the assistance of staff in a range of Arion Bank's support function divisions, including the Credit Office, trade finance and guarantees, legal and documentation.

The Corporate Banking division relies on a relationship based model with a sales approach driven by key performance indicators. There are 12 designated business relationship managers in three expert sector teams in key industry sectors (*i.e.*, trade and services, seafood and real estate and energy). Eight designated credit managers, reporting to the Chief Credit Officer, support credit quality through the structuring and analysis team which allows the account managers to focus on sales and loan portfolio growth as well as cross-selling and building relationships. The direct relationships of the key account managers with existing customers ensure tailored lending solution offerings. Sales targets are driven by a compensation plan and the division's management focus on monthly targets based on key performance indicators, which are aligned with Arion Bank's strategic goals.

The goal of the Corporate Banking division is to become a more efficient organisation with strengthened focus on front-end customer service. To achieve this goal, the Corporate Banking division implemented the lean banking initiative in 2013. Accordingly, the team aspect of the Corporate Banking division's organisation promotes specialisation and division of labour, which, in turn, enable better and more efficient processing, thereby allowing for a leaner organisation with improved customer service response times and fewer employees handling increased volumes of business.

The Corporate Banking division also strives to streamline credit analyses to increase efficiency of the relationship managers, who focus exclusively on maintaining and creating relationships as part of Arion Bank's relationship banking strategy implemented in 2012. As a result of the relationship banking strategy, the commission income from loans to corporate customers has grown. In addition, the Corporate Banking division seeks to increase the quality and consistency of credit work, including increased quality of analysis and credit papers, thereby reducing defaults with a more proactive approach and achieving higher satisfaction of key customers. The Credit Office plays a vital role in this process.

The Corporate Banking division expects to have the ability to capitalise on strong relationships with large corporate customers to bid for digital services in conjunction with regular lending activities. Accordingly, the Corporate Banking division foresees undertaking further investments into a corporate digital platform in the future to improve its digital products and services and gain increased market share in digital services.

Customers

The Corporate Banking division provides products and services to large corporate customers. The Corporate Banking division's loan portfolio principally comprises large corporate customers and is well-diversified across all the main Icelandic industry sectors, with emphasis on the top 100 companies in Iceland. In addition, the Corporate Banking division acquires new customers through senior account managers of individual sector teams, industry relations and events as well as through active involvement of senior and/or executive management of the Bank.

The Corporate Banking division has had long-lasting relationships with its customers, with a credit relationship of more than ten years with approximately 45% of its customers, a credit relationship between five and ten years with approximately 11% of its customers, a credit relationship between two and five years with approximately 30% of its customers and a credit relationship of less than two years with approximately 13% of its customers. The Corporate Banking division's retention rates, defined as the existing customers' share of the loan portfolio, amounted to 94% in 2017, 94% in 2016 and 83% in 2015.

For the year ended 31 December 2017, the growth in the loan portfolio to existing customers (comprising new loans, extended credit and drawn credit lines to existing customers in the period) was primarily driven by the seafood industry sectors, with 26.7% extended in the seafood industry sector, 20.4% extended in the real estate and construction industry sector, 10.5% extended in the wholesale and retail trade industry sector, 19.5% extended in the financial and insurance services industry sector, 9.0% extended in the industry, energy and manufacturing industry sector and 13.8% extended in other industry sectors.

For the year ended 31 December 2017, new customers of the Corporate Banking division accounted for approximately 6.0% of the lending volume during the period, with 2.0% attributed to the real estate and construction industry sector, 1.3% attributed to the seafood industry sector, 0.4% attributed to the information and communication technology industry sector and 0.5% attributed to the financial and insurance services industry sector.

Products and Services

Although a significant proportion of the Corporate Banking division's business is the provision of credit, the Bank offers a wide range of financial products and services to meet the needs of each customer. Examples of such products and services include cash management solutions, a range of deposit products, automatic billing and collection services, online payment slips, internet banking and business-to-business solutions.

<u>Loans to Corporate Customers</u>

Loans to corporate customers are the core product that drives the operating income of the Corporate Banking division, with net interest income from loans to corporate customers amounting to ISK 6,002 million, ISK 6,436 million and ISK 6,023 million for the years ended 31 December 2017, 2016 and 2015, respectively, amounting to 70.3%, 82.5% and 85.9%, respectively, of the total operating income of the Corporate Banking division, with the remainder derived from financial services as fee and commission income and other operating income, as described below.

The table below sets forth the proportion of the Corporate Banking division's net interest income represented by the various types of loans to corporate customers offered for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
ISK	70.5%	65.0%	68.3%
CPI-linked	7.3%	14.7%	10.4%
Foreign exchange	22.2%	20.2%	21.4%

With respect to the portion of the operating income of the Corporate Banking division derived from the loans to corporate customers, Arion Bank believes that the Corporate Banking division has benefited from the organisational structure of Arion Bank that allows for execution of complex, higher yielding transactions and enables proprietary dealflow, which in turn could lead to higher structuring and arrangement fees if the Corporate Banking division acts as a leading financial institution on syndicated, club and/or debt capital markets transactions. The strong relationships with large corporate customers allow for cross-selling across various divisions of Arion Bank. In addition, access to foreign funding has allowed for foreign exchange lending with higher yields.

Financial Services

In addition to generating income from loans to corporate customers, the Corporate Banking division also generates fee and commission income from provision of financial services, including guarantees, transaction / arrangement services and electronic services, which complement loans to corporate customers and have grown in recent years. The net fee and commission income from financial services amounted to ISK 1,171 million, ISK 1,082 million and ISK 1,059 million for the years ended 31 December 2017, 2016 and 2015, respectively. Arion Bank believes that the financial services portion of the operating income of the Corporate Banking division will benefit from scalability, deep understanding and expertise of its employees and its efficient cash management systems, such as electronic claims, which have proved to be a source for other value-added financial services, improving customer satisfaction and experience and thereby contributing to the acquisition of new customers. Accordingly, Arion Bank expects this area of the Corporate Banking division to grow somewhat in importance in the future, with increased sales focus and economic growth, resulting in growth in income from financial services.

The table below sets forth the proportion of the Corporate Banking division's fee and commission income represented by the various types of financial services offered for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
Guarantees	13.7%	18.6%	14.4%
Transaction / arrangement services(1)	59.3%	52.2%	62.7%
Electronic services	27.1%	29.3%	22.9%

(1) Transaction / arrangement services include prepayment fees. Prepayment fees do not constitute a sustainable income source and are only relevant during the periods of rapid prepayments.

The focus on fee and commission income from financial services has resulted in a positive trend of increasing fee and commission income per FTE from 2015 as compared to 2017, with fee and commission income increasing from ISK 1,059 million in 2015 to ISK 1,082 million in 2016 and ISK 1,171 million in 2017, as well as the relative contribution of the fee and commission income from financial services to the total operating income of the Corporate Banking division.

Term Loans

The Corporate Banking division has a diversified loan portfolio, with term loans being the highest volume product in all customer sectors and the key driver of both operating income and net interest margin. Term loans are loans with predefined payment schedules for interest and principal. The Corporate Banking division had ISK 235,354 million, ISK 210,467 million and ISK 202,119 million of term loans outstanding as of 31 December 2017, 2016 and 2015, respectively. New investment in the Icelandic economy and consolidation trends in commercial real estate, tourism and seafood industry sectors are expected to drive the current demand for term loans. Arion Bank estimates that total domestic corporate lending amounted to ISK 1,683 billion, ISK 1,675 billion and ISK 1,595 billion for the years ended 31 December 2017, 2016 and 2015, respectively. Although the market for term loans is competitive and price sensitive, the Corporate Banking division has experienced increasing dealflow in large scale project finance transactions, especially in the energy and real estate sectors, as the Icelandic economy has recovered and has sourced new large scale project finance transactions since 2015, which are expected to be realised through 2020. In addition, the Corporate Banking division redefined its customer segment from Iceland's 300 largest to 100 largest companies in 2014, resulting in a transfer of SME customers to the Retail Banking division.

The table below sets forth the components of the term loans as a percentage of total term loans outstanding as of the dates indicated.

	As of 31 December		
	2017	2016	2015
ISK	25.8%	31.2%	34.7%
CPI-linked	31.2%	33.7%	28.7%
Foreign exchange	43.0%	35.1%	36.6%
Total	**100.0%**	**100.0%**	**100.0%**

Revolving Credit Facilities

Revolving credit facilities are a lower volume and lower margin product of the Corporate Banking division, with ISK 30,493 million, ISK 32,168 million and ISK 31,001 of revolving credit facilities outstanding as of 31 December 2017, 2016 and 2015, respectively. The revolving credit facilities are characterised by seasonality and high price sensitivity, with the seafood industry sector being the key source of demand, and the most significant seasonal drawdown period typically beginning in September/October, peaking in February and ending April/May. The Corporate Banking division provides current accounts, overdrafts and trade finance services in connection with the credit revolving facilities.

The table below sets forth the components of the revolving credit facilities as a percentage of total revolving credit facilities outstanding as of the dates indicated.

	As of 31 December		
	2017	2016	2015
ISK	25.7%	25.1%	44.1%
Foreign exchange	74.3%	74.9%	55.9%
Total	**100.0%**	**100.0%**	**100.0%**

The total committed amounts under the revolving credit facilities amounted to ISK 56,472 million, ISK 53,095 million and ISK 56,472 million as of 31 December 2017, 2016 and 2015, respectively.

For additional information on Arion Bank's loan portfolio, see "*Selected Statistical Information—Loan Portfolio*".

Investment Banking Division

Overview

The Investment Banking division provides a full range of investment banking products and services, including equity and fixed income brokerage, initial public offerings, capital markets and M&A advisory to a broad range of customers, including corporate customers, professional investors, asset management companies and pension funds. In addition, the Investment Banking Division holds a strong position in foreign exchange brokerage and bond issuances. The Investment Banking division was chosen by Global Finance magazine as the best Investment Bank in Iceland in 2017. As of 31 December 2017, the Investment Banking division had 30 FTEs organised across the three subdivisions: Capital Markets, Corporate Finance and Research.

The Investment Banking division is recognised as a leader in equity brokerage and initial public offerings, having managed all four initial public offerings listed on the Main Market of NASDAQ Iceland in 2015 and 2016, as well as eight out of 13 initial public offerings in Iceland since 2011. Furthermore, the Investment Banking division managed the only listing on NASDAQ Iceland First North in 2017.

The Investment Banking division benefits from the Bank's developed infrastructure and has implemented the Bank's lean banking principles in its operations, allowing it to focus on acquiring and developing customer relationships and deal flow. The Investment Banking division enjoys a large and solid customer base featuring strong and trusted relationships with Icelandic and international investors, which is the key component of the Investment Banking division's placement power and transaction capabilities. Leveraging Arion Bank's relative size, strong balance sheet and infrastructure enables the Investment Banking division to support its customers, for example by providing underwriting capabilities through the Corporate Finance subdivision and offering forward contracts in capital markets. The Investment Banking division further benefits from the significant cooperation among the various divisions of Arion Bank by leveraging customer relationships and the bank's broad product range. The Investment Banking division is supported in its operations by highly capable and experienced employees with a good track record, low turnover and an average of 13 years of relevant professional experience.

The table below sets forth certain operational data for the Investment Banking division as of and for the year ended 31 December 2017, unless noted otherwise.

Net fee and commission income	ISK 1,298 million
Number of initial public offerings in 2015 / 2016 / 2017	3 / 1 / 0(1)
Number of initial public offerings since 2011	8(2)
Market share in equities brokerage on NASDAQ Iceland	24.3%
Market share in fixed income brokerage on NASDAQ Iceland	16.5%
Number of FTEs	30

(1) Out of three initial public offerings in Iceland in 2015, one in 2016.

(2) Out of 13 initial public offerings on the Main Market of NASDAQ Iceland since 2011.

Strategic Priorities

The Investment Banking division has a strong customer focus, a diverse product and services offering and a clear strategy for continuing to capitalise on its capabilities and the Bank's franchise to pursue further market opportunities with the specific areas of focus set forth below.

Leverage the universal relationship banking model

The Investment Banking division intends to continue utilising the customer base of Arion Bank to market the Investment Banking division's product and services offering. In addition, the Investment Banking division plans to leverage the Bank's relative size, strong balance sheet and infrastructure, providing its customers a unique product and services offering. For these purposes, the Investment Banking division plans to increase its cooperation with other divisions such as the Corporate Banking division and the Asset Management division, as well as with the Bank's insurance arm, Vördur.

Generate continuous strong growth in key capital markets

The Investment Banking division intends to maintain Arion Bank's leading position in equity brokerage as well as its strong position in foreign exchange brokerage and bond issuances. Furthermore, the Investment Banking division foresees opportunities to strengthen its position in the secondary bond market. To achieve these goals, the Investment Banking division aims to utilise and further invest in its strong customer relationships and to leverage Arion Bank's universal relationship banking model to maintain strong deal flow. In addition, the Investment Banking division plans to further develop the corporate bond market and provide and market hedging solutions to corporate customers and investors.

Cross-border transactions

The Investment Banking division intends to continue to build and develop its relationships with foreign investors interested in trading in the Icelandic equity and bond markets and to capture opportunities in cross-border M&A. Compared to other Nordic countries, foreign investment in both the equity and bond markets in Iceland is relatively low, and the Bank expects that the full liberalisation of the Capital Controls will help to bolster the Icelandic equity and bond markets and support cross-border M&A. The Investment Banking division also plans to develop further relationships with foreign investors through partnerships and marketing events. At the same time, the Investment Banking division intends to support its Icelandic customers in their expansion abroad.

Capitalise on the expected increase in M&A activity with lower interest rates and debt levels

The Investment Banking division plans to capitalise on the expected increase in M&A transactions following a few years of slow activity. There are various macroeconomic factors that could encourage increased M&A activity in Iceland, including the lowering of the Icelandic Central Bank's benchmark interest rates, low inflation and strong GDP growth in Iceland. The Capital Controls have been significantly lifted, and foreign investors' interest in Icelandic investment opportunities has increased. Furthermore, Icelandic companies have experienced several years of strong earnings and cash conversion, resulting in deleveraging which enables them to access the credit markets in order to finance acquisitions. Consolidation is expected in various sectors. The Investment Banking division plans to leverage the unique expertise and experience of its employees and the strength of being a part of a universal bank in order to increase its market share.

Develop a diverse and enhanced capital markets advisory business based on economic growth and investment needs

The Investment Banking division aims to maintain its leading position in initial public offerings and listing activities on NASDAQ Iceland and to become the first choice for secondary market offerings. In order to achieve this goal, the Investment Banking division plans to build on its strong reputation as well as experience and track record with initial public offerings and other advisory activities related to capital markets. It also intends to pursue aggressively potential opportunities as they arise during interactions with its existing customers.

Maintain leading Research subdivision with strong reputation

The Investment Banking division seeks to maintain the market leading status of its Research subdivision, which plays a vital role in the generation of business ideas and is the only integrated Research subdivision among the three large banks in Iceland. Accordingly, the Investment Banking division intends to uphold the reputation of the Research subdivision with specific focus on quality, value generation and independence of its research team. The Research subdivision is expected to continue preparing forecasts and views that could be of value to Arion Bank and its customers as well as develop specific customer pitches to attract new business.

Operations and Distribution Capabilities

The Investment Banking division generates operating income through specialist services, such as M&A and capital markets advisory as well as equity and debt brokerage and research. The operating income of the Investment Banking division was ISK 1,467 million (of which ISK 1,298 million was fee and commission income), ISK 3,746 million and ISK 36,434 million (primarily as a result of non-recurring events) for the years ended 31 December 2017, 2016 and 2015, respectively.

Customers

The Corporate Finance and Capital Markets subdivisions provide products and services predominantly to corporate customers, institutional investors, insurance companies and investment companies as well as high net worth individuals and families. The Research subdivision supports and provides services to customers of other fee-generating divisions of Arion Bank, such as Corporate Banking and Asset Management. The Research subdivision also conducts introductory customer meetings for other divisions of Arion Bank.

Customer relationship management of the Investment Banking division plays an important role in monitoring business relationships and opportunities as well as tracking customer communications and product initiatives. For example, existing and potential customers are contacted on a regular basis depending on potential deal flow and business relationship potential. The list of customers is based on previous business relationships of the Investment Banking division. In addition, the key companies of Iceland's 300 largest companies and various prominent institutional and private investors are contacted. The frequency of contacts varies based on the nature of previous business transactions, pending potential activity and the prospect of tapping into emerging opportunities.

The Investment Banking division has an extensive reach in a small market and has consistently demonstrated high adaptability to customers' needs and market trends, leveraging the universal relationship banking model of Arion Bank and tailoring its product and services offering depending on the micro- and macroeconomic conditions and the market needs. The Investment Banking division holds daily meetings to discuss current events and potential opportunities for new business, with a specific focus on product and services offering for certain industry sectors based on analysis and strategic direction. In addition, the Investment Banking division conducts regular campaigns for new product and services offering based on the perceived needs of its customers.

Products and Services

Arion Bank leverages its universal banking service offerings, infrastructure and balance sheet to enable projects that generate diversified income from a broad customer base. The table below sets forth the Investment Banking division's product offerings to its customers and the proportion of its fee and commission income by product for the years ended 31 December 2017, 2016 and 2015.

Products	Fee and commission income by product 2017	2016	2015	Pension funds	Asset management companies	Professional investors	Corporate customers
Foreign exchange	45.4%	27.9%	19.9%	✓	✓	✓	✓
Equity brokerage	21.5%	15.4%	15.7%	✓	✓	✓	
Bonds brokerage and issuance	13.4%	8.8%	6.8%	✓	✓	✓	✓
M&A, restructurings and refinancings	6.4%	27.6%	21.5%				✓
Derivatives	2.8%	1.4%	4.6%		✓	✓	✓
Money markets	2.4%	2.8%	1.5%	✓	✓	✓	
Initial public offerings and equity issues	1.4%	4.3%	29.1%	✓	✓	✓	✓
Other	6.8%	11.6%	0.9%				
Total	**100.0%**	**100.0%**	**100.0%**				

Capital Markets

The Capital Markets subdivision provides securities brokerage and foreign exchange sales. The Capital Markets subdivision is a market leader in equity brokerage and enjoys a strong position in foreign exchange brokerage and bond issuances. In addition, the Capital Markets subdivision has been a leading player in restoring the equity markets in Iceland. The Capital Markets subdivision also benefits from strong relationships with all major investors in the domestic capital markets. The Capital Markets subdivision focuses on providing its growing customer base with a comprehensive range of capital markets services and access to expert knowledge. The focus in the medium term is expected to shift towards development of products and services as investors seek more opportunities to invest and distribute risk.

The securities brokerage services include domestic and foreign brokerage of equity, fixed income, swaps and forwards as well as related derivative products. The foreign exchange services include spot, forwards, money market, options and swaps. The equity and fixed income desks provide services primarily to pension funds, asset management companies and professional investors, and the foreign exchange desk provides services primarily to corporate customers in spot, forward, swap and option products, with Arion Bank being the only Icelandic bank to provide oil hedging products.

In the equity market, the Capital Markets subdivision focuses on the domestic Icelandic market and has also provided services to its local clients in foreign markets, particularly the United States and Nordic equity markets. Several companies have listed their shares on NASDAQ Iceland since 2011, and Arion Bank had the largest market share in equity brokerage on NASDAQ Iceland amounting to 24.3% as of 31 December 2017 *(source: NASDAQ Iceland)*.

In the fixed income market, the principal instruments traded are government bonds. While issuance of new Icelandic government bonds has slowed, additional investment options, such as asset-backed bonds and corporate bonds, have been introduced. Arion Bank had the third largest market share in fixed income brokerage on NASDAQ Iceland amounting to 16.5% as of 31 December 2017 *(source: NASDAQ Iceland)*.

Corporate Finance

The Corporate Finance subdivision provides advisory services in relation to M&A and capital markets transactions. In particular, the M&A advisory services of the Corporate Finance subdivision include advice on acquisitions, takeovers, divestitures, mergers, corporate restructurings, spin-offs and leveraged buyouts. The capital markets advisory services of the Corporate Finance subdivision include advice on initial public offerings and stock exchange listings, follow-on offerings, private placements, block trades, share buybacks, delistings and bond issues.

In recent years the IPO market in Iceland has been relatively active and since 2011 Arion Bank's Corporate Finance subdivision has been involved in 8 out of 13 IPOs on the Main Market of NASDAQ Iceland. During 2009 and 2010, the Corporate Finance subdivision was involved in a limited number of public offerings and delistings of shares from NASDAQ Iceland as well as the sale of shares in companies which had been acquired by Arion Bank in settlement of debts owed. Since 2010, the Corporate Finance subdivision has introduced a number of strategic initiatives in order to become a leading player in building up the equity and bond markets in Iceland. See "*—Strategic Priorities*". Accordingly, the Corporate Finance subdivision has managed the majority of initial public offerings in Iceland since 2011 and arranged the listing on NASDAQ Iceland of structured covered bonds issued by institutional investor funds managed by Stefnir. The Corporate Finance subdivision has advised on and managed various bond issues by large issuers, such as Reitir fasteignafélag, the largest real estate company in Iceland, and Orkuveita Reykjavíkur, one of Iceland's largest energy providers. The Corporate Finance subdivision has been active in mergers and acquisitions, including a number of high-profile sell-side and buy-side M&A transactions and financial restructurings and managed the acquisitions of Vördur and the Danish group AltaPay A/S. In 2017, the Corporate Finance subdivision advised on two of the largest M&A transactions announced in Iceland, i.e. the acquisition by N1 of Festi and the purchase by Reginn of FAST-1 subsidiaries.

The table below sets forth the composition of net commission income of the Corporate Finance subdivision by industry sector for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
		(%)	
Financial and insurance	64.2%	43.1%	6.1%
Industry, energy and manufacturing	27.9%	0.8%	13.6%
Information and communication technology	7.1%	—	21.7%
Real estate and construction	0.7%	43.7%	57.1%
Seafood	0.0%	—	—
Wholesale and retail	0.0%	12.2%	2.5%
Other	0.2%	0.3%	(0.9)%
Total	**100.0%**	**100.0%**	**100.0%**

Research

The Research subdivision publishes macro research on the Icelandic economy and its developments and equity research on individual companies and industry sectors. The Research subdivision also publishes regular forecasts and updates on key economic issues and covers companies listed on NASDAQ Iceland. The number of publications by the Research subdivision was 217 in 2015, 187 in 2016 and 192 in 2017. In addition, the Research subdivision holds regular conferences and presentations, at which new research and reports produced by the Research subdivision are presented. These include economic forecasts, analyses of the real estate market, and analyses of the finances of various municipalities as well as various other industry sectors.

The Research subdivision provides support to the Capital Markets, Asset Management and Corporate Finance teams by providing their customers with research reports, presentations, opinions, memoranda or data analysis on listed companies and companies planning to go public in the near future. It also provides analysis on specific economic issues and assists with sales meetings with customers. The Research subdivision is independent in its research and analysis. It had 6 analysts as of 31 December 2017.

Asset Management

Overview

The asset management operations of Arion Bank had ISK 984,653 million of assets under management as of 31 December 2017. The Board of Directors believes that Arion Bank's asset management operations are the market leader in Iceland. The asset management operations of Arion Bank are composed of two distinct legal entities, the Asset Management division and Arion Bank's independent subsidiary Stefnir, a fund management company. The asset management operations offer a full range of investment products and services to customers with varying investment objectives, with a core focus on pension funds, institutional investors, high net worth individuals and digital distribution for retail customers, and are dedicated to establishing long-term relationships with its customers. The strong team and track record as well as good reputation make the asset management operations well-positioned to participate in the local transactions. In addition, Arion Bank believes that the asset management operations could benefit from leveraging Arion Bank's broader infrastructure to meet increasing risk management, transparency and regulatory requirements.

The table below sets forth the assets under management of the Asset Management division and Stefnir as of the dates indicated.

	As of 31 December				
	2017	**2016**	**2015**	**2014**	**2013**
	(ISK in millions)				
Asset Management division	637,688	646,471	596,809	519,531	481,828
Stefnir	346,965	408,288	399,839	404,069	413,628
Total	**984,653**	**1,054,759**	**996,648**	**923,599**	**895,457**

As of 31 December 2017, the asset management operations of Arion Bank had 52 FTEs, with 34 FTEs at the Asset Management division and 18 FTEs at Stefnir.

Arion Bank believes that its asset management operations are well-positioned following the lifting of the Capital Controls with their strong expertise and product range in global funds. It is widely expected that retail customers and institutional investors (especially pension funds) are likely to increase their exposure to foreign assets following the lifting of the Capital Controls. For example, as of 31 December 2017, pension funds had only a quarter of their assets invested outside Iceland (*source: Icelandic Central Bank)*, and Arion Bank expects this ratio to increase gradually over the next 15-20 years. As of 31 December 2017, assets under management allocated to international investments represented only 25% of the Asset Management division's total assets under management, with the remaining 75% allocated to domestic investments. Stefnir has a long history of managing international equity funds, in particular actively managed stock-picking funds. In addition, the asset management operations, through their third party fund business, have a reselling agreement with three of the top ten asset management companies in the world in terms of assets under management *(source: IPE Top Asset Managers 2017)*. The combination of track record, expertise and resources make the asset management operations well-positioned to take advantage of the investment opportunities.

Asset Management Division

The Asset Management division has offered asset management to institutional clients, with a full range of financial products and services to pension funds starting in 1994. The Asset Management division also offers private banking services to high net worth individuals, family offices and legal entities. It has a strong relationship with the other divisions of Arion Bank. In addition to being the main distributor of Stefnir funds, the Asset Management division has partnerships with three major global asset and fund managers.

The Asset Management division comprises the Private Banking subdivision, the Institutional Asset Management subdivision, the Investment Services subdivision and the Pension Funds Administration subdivision. The Asset Management division had ISK 637,688 million in assets under management as of 31 December 2017, with 80% growth in assets under management from 2011 to 2017. As of 31 December 2017, the Asset Management division had more than 100,000 customers, the majority of which were retail customers in pension and mutual funds. Of assets under management as of 31 December 2017, 86.1% were assets of institutional investors and the remaining 13.9% were assets of high net worth individuals and other customers, such as pension fund members, mutual fund members and private banking customers. As of 31 December 2017, 54.3% of the assets under management in the Asset Management division were in the form of fixed income, 35.7% were in the form of equity, 9.2% were in the form of cash and 0.8% were in the form of alternative investments.

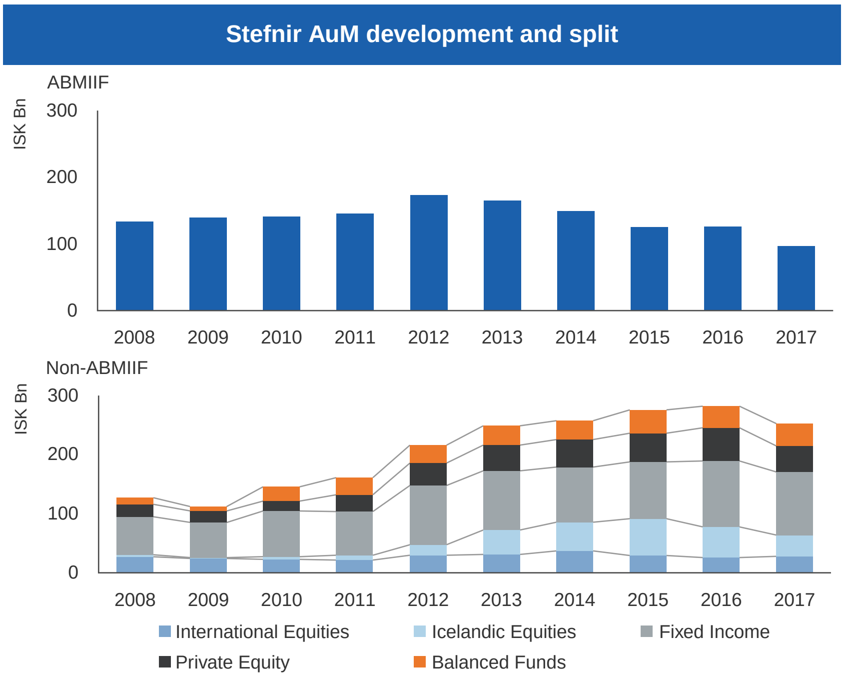
The Asset Management division builds its business on trust and responsibility towards its stakeholders and the society as a whole. Arion Bank takes its responsibilities seriously and has implemented a policy regarding building in-house knowledge on sustainability. This knowledge has been and will be used to educate, inform and to help customers where applicable to develop a policy regarding responsibility and sustainability in their investments in environmental, society and corporate governance topics.

Stefnir

Founded in 1996, Stefnir is Iceland's largest fund management company in terms of assets under management *(source: FME)*, with ISK 346,965 million in assets under management as of 31 December 2017 in more than 40 funds, which were sourced from the Asset Management division as well as from external investors. Its return on equity was 59% for the year ended 31 December 2017. Stefnir provides fund management services to the Asset Management division and external investors and offers a wide range of products. Stefnir's assets under management as of 31 December 2017 consisted of 27.5% in products offered by ABMIIF, 31.1% fixed income, 18.2% equity, 12.4% private equity and 10.7% balanced funds.

As of 31 December 2017, Stefnir had approximately 10,600 customers with investments in mutual funds. Of Stefnir's assets under management as of 31 December 2017, 72.3% were assets of institutional investors and the remaining 27.7% were assets of retail and other investors. Stefnir has a very high market penetration with its key customers, providing services to all of the largest domestic pension funds and all major domestic universal insurance companies. Stefnir is an independent subsidiary of Arion Bank, which is regulated by the FME, and places special emphasis on its independence and corporate governance. Stefnir has obtained financial and market share growth as a result of long-term strategic planning by its board of directors, which was initially implemented in 2009. Stefnir emphasises a healthy revenue mix, with product development and diversification of assets under management resulting in new income sources and higher income yielding products.

Stefnir's product development and the diversification of its assets under management have led to new income sources as well as higher yielding income products, as shown in the chart below.



ABMIIF, initially called the Kaupthing Mortgages Institutional Investor Fund, was established by Kaupthing in 2006 as an institutional investment fund. In 2011, the fund changed its name to Arion Bank Mortgages Institutional Investor Fund and, in 2012, Kaupthing transferred all of its shares in ABMIIF to Arion Bank with the consent of the covered bondholders. The day-to-day operations of ABMIIF are managed by Stefnir pursuant to ABMIIF's articles of association. The business of ABMIIF is to acquire loans and their related collateral pursuant to the terms of mortgage sale agreements to guarantee Arion Bank's covered bonds. ABMIIF has not traded since its establishment date, except for those matters incidental to the covered bonds, and will not do so while the covered bonds or any term advance remains outstanding.

Strategic Priorities

The asset management operations of Arion Bank have a clear strategy for capitalising on their respective positions in the asset management industry sector to drive future results with the specific areas of focus set forth below.

<u>Retain close relationships with customers</u>

The asset management operations intend to retain their close relationships with customers in order to maintain their market positions and achieve prudent growth in assets under management, in line with trends in the asset management industry. See "*Industry Overview—Asset Management*". To achieve this objective, the asset management operations intend to continue providing excellent services to their customers, with a particular focus on institutional investors and high net worth individuals, and obtaining deeper knowledge and understanding of their customers' needs. The asset management operations also plan to follow market activities within focus industry sectors.

Maintain employee motivation

Acknowledging the importance and contribution of employees to their success, the asset management operations plan to keep their highly skilled employees in each position continuously motivated. The Asset Management division and Stefnir seek to offer attractive compensation and encourage a team approach to investment decisions and customer services, which fosters autonomy and flexibility of individual employees. Furthermore, they intend to continue closely monitoring employee engagement through satisfaction surveys.

Capture investment opportunities

The asset management operations intend to capture investment opportunities to achieve prudent investment results in accordance with risk levels. To this end, each of the Asset Management division and Stefnir plans to continue its dedication to investment processes and product innovation. They also seek to maintain access to dealflow and increase global investments as well as offer funds or specialised products to match the needs of their customers.

Maintain strong focus on digitalisation opportunities

The strong focus on digitalisation of the asset management operations is intended to result in improved efficiency and increased sales. The digitalisation initiatives are expected to include digital customer onboarding and payment processing in pension funds, digital sales of pension funds and mutual funds as well as digital portfolio management. In addition, the asset management operations intend to implement digitalisation of customer onboarding and other services of the Private Banking subdivision.

Take advantage of strong capabilities to benefit from increasing regulatory complexities

The asset management operations aim to capitalise on their strong capabilities to benefit from increasing regulatory complexities, including the implementation of MiFID 2 and MiFIR, to seize business opportunities resulting from changes in regulatory environment. Accordingly, the asset management operations will continue monitoring new laws and regulations in the asset management industry sector, with a focus on opportunities resulting from regulatory changes that affect its customers and will adjust its product and services offering in response to such regulatory changes to better serve its customers.

Operations and Distribution Capabilities

Each of the Asset Management division and Stefnir generates operating income through interest income and management fees, which are calculated as a percentage of assets under management and vary based on product type and other factors. In addition, Stefnir generates operating income through performance fees, which are based on the performance of its products above a certain benchmark and are reviewed bi-annually in connection with financial reporting. The performance fees are not recognised on Arion Bank's consolidated statement of comprehensive income until either realised or are considered highly likely to be realised. Operating income for the Asset Management division and Stefnir was ISK 4,677 million, ISK 4,345 million and ISK 4,882 million for the years ended 31 December 2017, 2016 and 2015, respectively. The assets under management of the Asset Management division and Stefnir increased from ISK 996,648 million as of 31 December 2015 to ISK 1,054,759 million as of 31 December 2016 and decreased to ISK 984,653 million as of 31 December 2017, with assets under management of the Asset Management division increasing from ISK 596,809 million as of 31 December 2015 to ISK 646,471 million as of 31 December 2016 and decreasing to ISK 637,688 million as of 31 December 2017. Assets under management of Stefnir were ISK 399,839 million as of 31 December 2015, ISK 408,288 million as of 31 December 2016 and decreasing to ISK 346,965 million as of 31 December 2017. The decrease in assets under management from 2016 to 2017 is primarily due to a decrease in the ABMIIF fund managed by Stefnir, as well as decreases in payments from alternative investments in connection with the closure of major investment projects and the loss of one institutional client for which the Asset Management division managed funds, due to the trend by certain pension funds in Iceland to bring asset management functions back in-house.

Customers

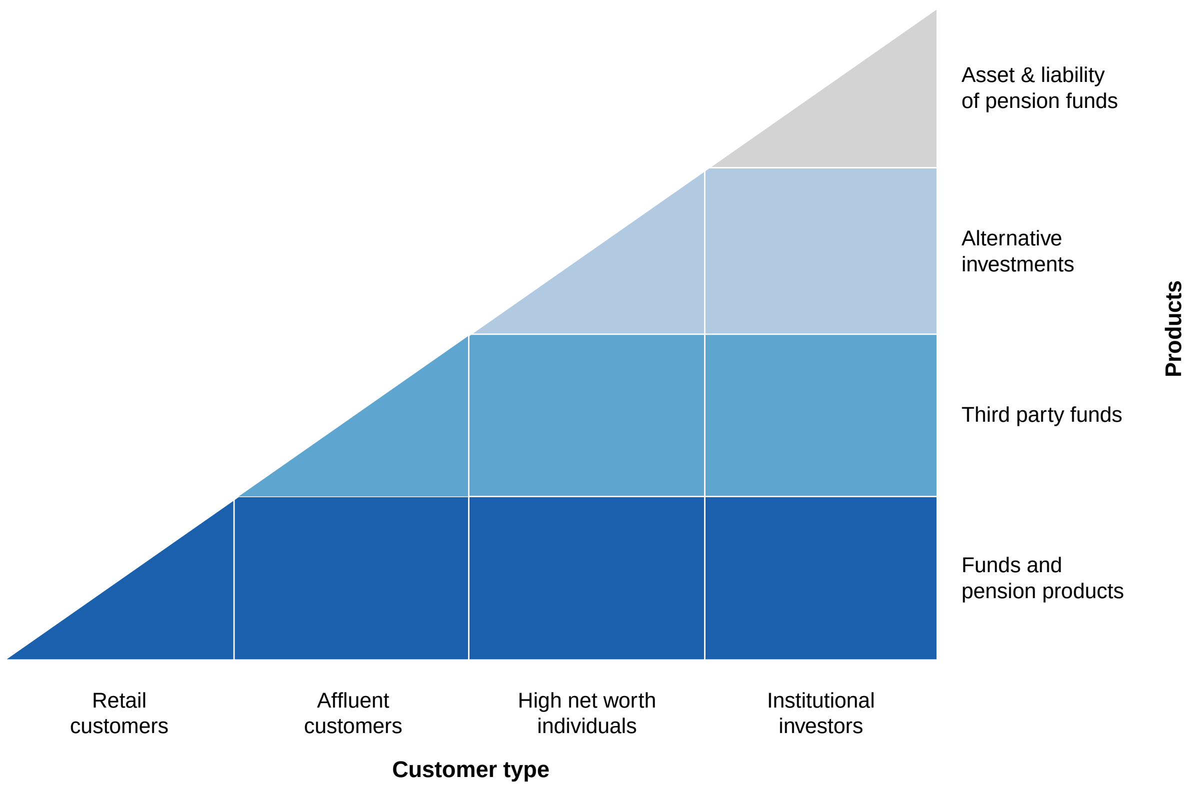
The customers of the asset management operations include institutional investors, corporations, high net worth individuals and retail investors. The Private Banking subdivision caters to individual customers with over

ISK 15 million in assets under management. The Institutional Asset Management subdivision services pension funds, trade unions, insurance companies, government institutions and other institutional investors. The Pension Funds Administration subdivision offers full services to pension funds. The Investment Services subdivision distributes Stefnir funds, selling to individuals, companies, institutions and institutional investors, as well as offering funds of international fund managers.

Stefnir caters to both retail and professional customers, with the aim of managing its customers' assets in the best interests of such customers. Stefnir's dedication to long-term relationships with, and its focus on providing tailored solutions to, its customers make Stefnir a preferred partner of institutional customers. According to a customer satisfaction survey performed in 2016 by Stefnir of 50 institutional investors (with a 52% response ratio), 96% of institutional investors would recommend Stefnir to other institutional investors with 80% assessing the professional knowledge of Stefnir's employees as "above average" and 96% agreeing that Stefnir offers a comprehensive range of products and services that meets the needs of its customers.

Products and Services

The asset management operations offer a comprehensive range of investment products and services. In addition to mutual funds, alternative investment vehicles and pension plan schemes, the asset management operations offer customised asset allocation strategies and managed accounts designed to meet the diverse needs of investors. The asset management operations also offer funds from other leading global fund management companies. The graph below sets forth the main products and services of the asset management operations of Arion Bank.



<u>Institutional Asset Management Subdivision</u>

The Institutional Asset Management subdivision has developed a clear investment process and service philosophy based on the principles of equality and transparency for institutional investors, which they view as a key to maintaining long-term relationships and trust. Initially, investment opportunities are identified and analysed, with worthwhile investment opportunities being subsequently proposed to an investment committee. The investment committee evaluates the proposed opportunities in accordance with the investment policy statements and, if the evaluation is satisfactory, the trade is undertaken. The portfolios are subsequently supervised on a daily basis with periodic risk management assessments. Investments decisions for individual portfolios of institutional investors are made on a daily basis, investment policy statement are reviewed annually and long-term investment goals are reviewed every one to five years.

Pension Funds Administration Subdivision

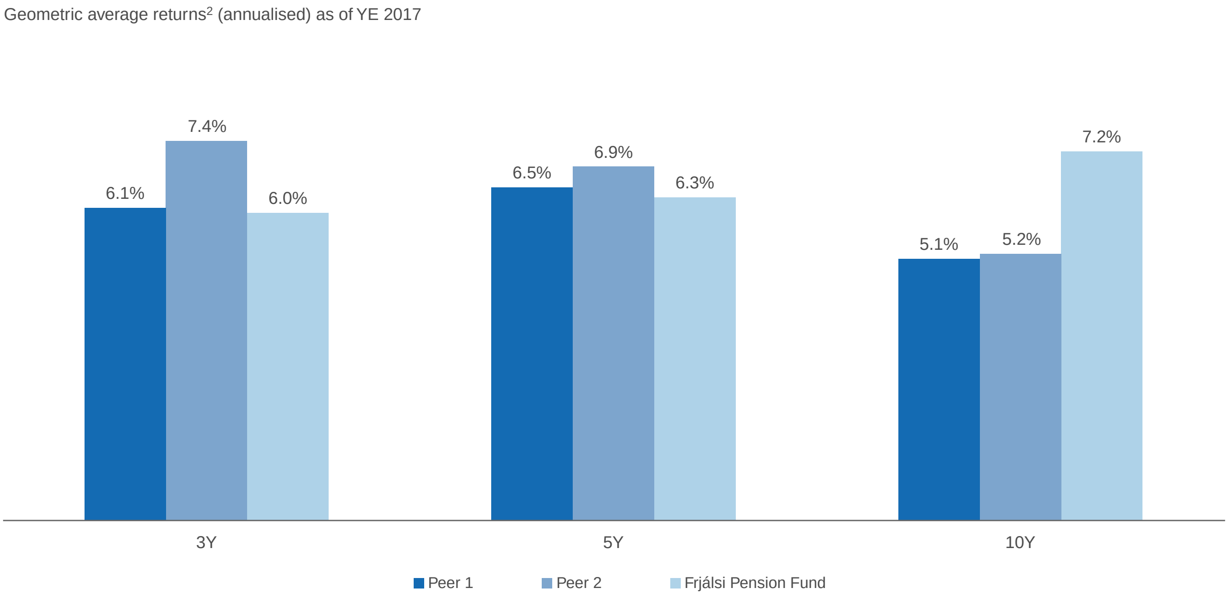
The Pension Funds Administration subdivision has developed a unique product and services offering for pension funds, with extensive services in branches and service centres, own website and targeted marketing and sales, and anticipates taking advantage of the opportunities presented by the robust growth of the Icelandic pension system which is expected to continue. See "*Industry Overview—Asset Management*".

The Pension Funds Administration subdivision offers pension funds full service operations, including marketing, sales and services in branches and service centres and extensive resources to meet regulatory requirements. The ability to provide special services to pension funds has meant that, with the growth of the Icelandic pension system, the asset management operations have experienced comparable growth in their assets under management since 2009.

Solid Returns

The success of individual funds that are managed by the Institutional Asset Management subdivision has also contributed to the growth of assets under management. For example, as of 31 December 2017, Frjalsi Pension Fund, which is one of the funds fully operated by Arion Bank and is the fifth largest pension fund in Iceland *(source: FME)*, had assets under management of ISK 210,493 million. The graph below sets forth the annualised geometric average returns, defined as composite returns computed by asset-weighting individual subfunds or portfolios, of Frjalsi Pension Fund and two of its peers.

Comparison of Frjalsi[1] pension fund with peers



Source: Frjalsi pension fund and peers' annual reports

(1) Source FME. Frjalsi pension fund is the fifth largest pension fund in Iceland with assets of ISK 210 billion at year end 2017.

(2) Composite returns computed by asset-weighting individual sub-funds/portfolios

The Frjalsi Pension Fund has also won numerous awards from Investment & Pensions Europe, including the Best Pension Fund in Iceland in each of the years 2009, 2010 and 2011, the Best Pension Fund in Small Countries in each of the years 2013, 2014, 2016 and 2017, the Best Institutional Real Estate Investor in 2014 and the Best Small Pension Fund in Europe in each of the years 2014 and 2015.

Private Banking Subdivision

The Private Banking subdivision seeks to provide highly personal financial services designed for the needs of individual customers with a special focus on high net worth individuals in Iceland with more than ISK 100 million. The Private Banking subdivision has specialised balanced portfolios and engages in both discretional and non-discretional asset management and has witnessed a healthy growth in assets under management, with the number of customer accounts with account balance in excess of ISK 100 million having a CAGR of 7.4% from 2012 to 2017. During the same period, assets under management of the Private Banking subdivision had a CAGR of 6.5%. The Private Banking subdivision relies on a team-based approach to investments and services, working closely with other divisions of Arion Bank, and has good access to local dealflow due to the size of the Asset Management division.

Each customer of the Private Banking subdivision has his own account manager, who provides personal service and financial advice suited to such customer's needs. The account managers of the Private Banking subdivision are highly experienced with an average of 21 years of experience in the financial markets. According to a customer survey performed in 2016 by Maskína for Arion Bank, in which 583 of Arion Bank's private banking clients were invited to participate (with a 71% response ratio), 86% of customers were satisfied with the services provided by the Private Banking subdivision, 83% of customers experienced the services provided by the employees of the Private Banking subdivision as personal and 93% had good access to their account manager.

The main emphasis of the Private Banking subdivision is to continue providing excellent services to its customers and achieving prudent investment results in accordance with risk levels.

Investment Services Subdivision

The Investment Services subdivision provides services to institutional and corporate customers. Retail services are provided mainly through digital channels and a call centre. The Investment services subdivision also distributes Stefnir funds as well as offering funds from international fund managers, together with overseeing sales of pension products. The emphasis of the Investment Services subdivision has been on increasing usage of digital channels. Transfer of retail sales and services to digital channels is expected to continue with opportunities to increase corporate customers' use of digital channels. The volume of customers' online sales into mutual funds has increased significantly from 2013 to 2017. Monthly subscriptions in funds have also increased over the same period of time. The pension products and services are primarily sold by the Retail Banking division and a subsidiary of Vördur, but going forward emphasis will be on increasing sales and services through digital channels.

Stefnir

Stefnir manages several funds which fall into the category of Undertakings for Collective Investment in Transferable Securities ("**UCITS**"), non-UCITS or institutional investor funds with total assets under management of ISK 347 billion as of 31 December 2017. These funds include:

- eight fixed income funds investing in a wide fund range with assets under management of ISK 79 billion, including the oldest incorporated UCITS fund in Iceland, which was created in 1986;
- five equities funds (two domestic, two international and one international domiciled in Luxembourg) investing in both domestic and international equities with assets under management of ISK 64 billion and consistent growth in assets under management since 2008;
- six balanced funds with assets under management of ISK 36 billion, including the oldest incorporated non-UCITS fund in Iceland, which was created in 1996, with highly distributed retail and private banking ownership; and
- thirteen funds falling into the category of institutional investor funds or other funds with assets under management of ISK 141 billion (including ISK 95 billion in the Arion Bank Mortgages Institutional Investor Fund) with market leading product development.

Stefnir also manages several private equity and real estate funds. These funds include:

- SIA I private equity fund with total commitments of ISK 0.2 billion. SIA I had three successful exits, including two initial public offerings and one trade sale. SIA I had two co-investments, adding approximately ISK 6,800 million in assets under management;
- SIA II private equity fund with total commitments of ISK 8.7 billion. SIA II had two successful exits: one through an initial public offering and the other through a pending acquisition by a listed company. SIA II had three co-investments, adding approximately ISK 15,800 million in assets under management;
- SIA III private equity fund with total commitments of ISK 12.3 billion, which were raised in the spring of 2016. SIA III is the largest private equity fund raised in Iceland by any investment manager; and
- SRE II real estate fund. All of the SRE II investments were sold in the autumn of 2015 and the summer of 2016 to a listed real estate investment trust. SRE II had ISK 0.6 billion in assets under management.

Co-investors in the private equity funds comprise pension funds, insurance companies and other institutional investors, as well as high net worth individuals (based on their business expertise and active role in the proposed investment).

Other Divisions and Subsidiaries

Subsidiaries

The Bank is the parent company of a number of wholly owned and majority owned subsidiaries, the most significant of which are described below.

Valitor

Possible Valitor Disposal

Arion Bank is currently assessing a range of strategic alternatives with respect to its ownership of Valitor. In this regard, the Board of Directors examined the feasibility of a spin-off of Valitor to existing shareholders by means of a dividend in kind. The Board of Directors is of the opinion that, although a disposal of Valitor could be in the strategic interests of Arion Bank, the form of any such disposal requires further evaluation and may take the form of a sale of all or a portion of Valitor to a third party. The Board of Directors has resolved to examine the structural options with a view to disposing of Valitor in the medium term. However, no firm decision has been taken at this point in time with respect to a disposal of all or part of Valitor or with respect to the form or timing of any such transaction.

The Board of Directors has considered whether Valitor constituted a core operation of Arion Bank, in light of the fact that the Bank has focused in recent years on the development of its operations to serve the Icelandic market, while Valitor has expanded further internationally and intends to continue to do so, which will require considerable management and capital investment to undertake. Although the Board of Directors believes that Valitor's growth strategy would have long-term benefits for the Bank, the strategy could take a number of years to realise and may be different from the Bank's strategy of focusing on the Icelandic market. Excluding Valitor, Arion Bank's return on equity for the year ended 31 December 2017 would have been 6.6% (compared to 7.5% for the year ended 31 December 2016 and 29.6% for the year ended 31 December 2015), and its cost-to-income ratio for the year ended 31 December 2017 would have been 50.6% (compared to 59.3% for the year ended 31 December 2016 and 28.2% for the year ended 31 December 2015).

	For the year ended 31 December		
	2017	**2016**	**2015**
Return on equity(1)	6.6%	10.5%	28.1%
* Return on equity excluding Valitor(2)	6.6%	7.5%	29.6%
Cost-to-income ratio(3)	56.1%	56.0%	32.4%
* Cost-to-income ratio excluding Valitor(4)	50.6%	59.3%	28.2%

* Non-IFRS Information

(1) Return on equity is net earnings for the period as a percentage of average total equity, which is calculated as the average of the opening, quarter-end and closing balances for the applicable period.

(2) Valitor's profitability under this period has been significantly impacted by gains related to the sale of Visa Europe during 2016 and mark-to-market changes on Valitor's equity holding in Visa Inc. during 2017, as described in "*Operating and Financial Review—Financial Position and Results of Operations—Results of Operations for the years ended 31 December 2017, 2016 and 2015*". The return on equity excluding Valitor is Non-IFRS Information which the Bank considers in light of a possible disposal of Valitor and is calculated on the basis that transactions and balances between Valitor and the rest of the Group are treated on a third-party basis and are not eliminated upon consolidation.

(3) With respect to cost-to-income ratio, "cost" means salaries and related expense and other operating expense for the period. "Income" means operating income for the period. Cost-to-income ratio is a measure of the Bank's costs as compared with its income. The lower this figure, the lower the Bank's costs relative to its income.

(4) The cost-to-income ratio excluding Valitor is Non-IFRS Information which the Bank considers in light of a possible disposal of Valitor and is calculated on the basis that transactions and balances between Valitor and the rest of the Group are treated on a third-party basis and are not eliminated upon consolidation.

Overview

Valitor, a wholly owned subsidiary of the Bank, is the largest card payments company in Iceland in terms of revenue *(source: Valitor, Borgun and Kortathjonustan annual reports)*, providing both card acquiring and card issuing services in Iceland. Established in 1983, Valitor has a full and well-diversified product range, providing e-commerce and card-present acquiring services to merchants through direct and partner channels and card issuing services and payment processing solutions to domestic and international partners. Valitor has developed proprietary payment software solutions from an early stage, enabling it to employ a differentiation strategy in both card acquiring and card issuing services and to compete successfully in Iceland and internationally. Valitor anticipates that its direct and partner channel strategies, combined with the strength of its proprietary platform and 30 years of technological competence, will enable it to take advantage of the industry growth and trends in technology and financial technology.

Valitor has strong processing volumes, processing approximately 292 million transactions in the year ended 31 December 2017. Valitor processed card acquiring services transactions in the amount of ISK 1,687 billion for the year ended 31 December 2017. Valitor has approximately 26,900 merchants and corporate customers for its card acquiring services and approximately 264,900 payment facilitator sub-merchants. In addition, Valitor has eight card issuing partners and 15 acquiring partners. Valitor has been a principal member of the MasterCard card scheme since 2009 and is currently in discussion with UnionPay and American Express for potential partnership. Since the end of 2015, Valitor has been an associate member of Visa Europe Ltd. ("**Visa Europe**") via Visa Iceland, which is a principal member of the Visa card scheme. Visa Iceland has been a group member of Visa Europe since 1983. Valitor has held PCI-DSS level 1 security certification since 2011.

In March 2017, Valitor Payment Services Limited was granted an Electronic Money Institution authorisation by the Financial Conduct Authority in the United Kingdom. The regulatory authorisation is intended to help ensure ability to support operations and customers within the United Kingdom regardless of Brexit negotiation outcomes.

In May 2017, Valitor announced the acquisition of IPS - International Payment Services Limited, a UK-based secure payment solutions provider. The acquisition will see the consolidation of IPS's technology into Valitor's own e-commerce solution through its subsidiary AltaPay.

In July 2017, Valitor announced the acquisition of Chip and PIN Solutions Ltd, a card-based payment provider located in the United Kingdom. The acquisition is intended to broaden Valitor's own direct merchant services solutions and enhance customer-centric service for merchants in the United Kingdom, in order to offer customers a complete payment solution to streamline all online, mobile and in-store payments.

Valitor's direct and partner channel strategies and innovative approach serve as a foundation for transaction volume growth. Accordingly, for the years ended 31 December 2017, 2016 and 2015, Valitor's international acquiring volume amounted to ISK 1,501 billion, ISK 818 billion and ISK 390 billion, respectively. Revenue from international operations accounted for 68%, 58% and 48% of Valitor's total operating revenue in the years ended 31 December 2017, 2016 and 2015, respectively. For information on Valitor's financial results, see "*Operating and Financial Review—Results of Operations—Segmental Analysis—Other Divisions and Subsidiaries*".

Card Acquiring Services

Valitor has been specialising in international card acquiring services since 2003, being one of the first companies in Iceland to passport its regulatory authorisation to provide its services across borders in Europe, and offers e-commerce and card-present acquiring services to merchants both directly and through its network of selected partners. Valitor works with merchants, independent sales organisations, payment facilitators and payment service providers, offering both e-commerce and card-present acquiring services. In Iceland, Valitor provides its card acquiring services to merchants directly with its end-to-end e-commerce and card-present solutions. Internationally, Valitor provides its card acquiring services in many European countries through its network of selected partners as well as providing card acquiring services to merchants directly in selected markets, which currently include the United Kingdom, Ireland and the Nordic countries. Valitor's revenue from the card acquiring services, representing approximately 82% of Valitor's 2017 revenue, is based on a percentage of the processed volume, terminal rentals and other payment related services.

Card Issuing Services

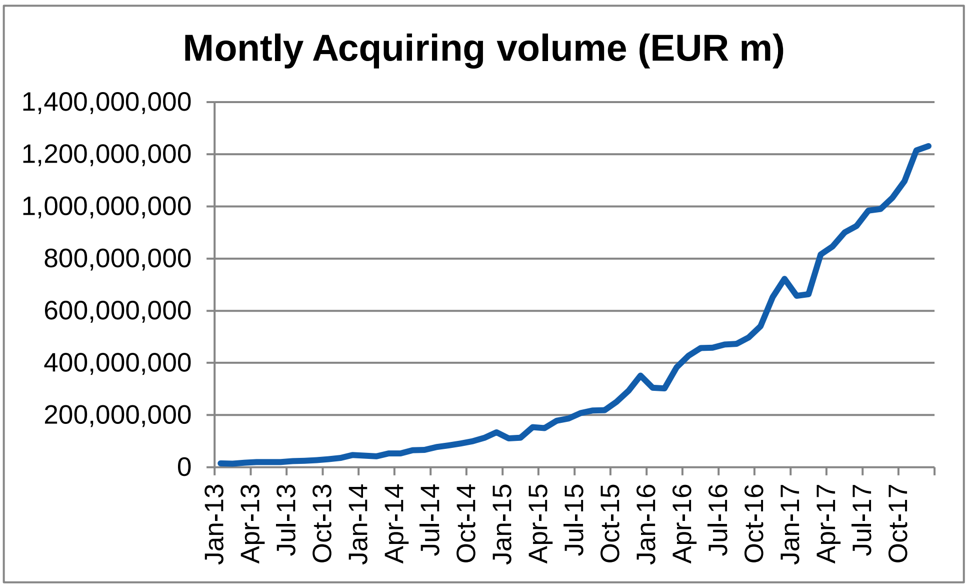
Valitor has more than 30 years of experience in card issuing services and offers both card issuing and processing services. Through principal membership with MasterCard and Visa, Valitor provides card issuing services, both as limited network exempt and issuance of electronic money, to prepaid programmes under programme manager agreements with its business partners. Valitor operates an advanced card issuing platform, which is integrated with Visa and MasterCard systems, and gives it an ability to launch new customised programmes and work alongside partners to develop new products. In addition to providing card issuing services via banking partners, Valitor's card issuing platform is designed to accommodate the specific needs of the prepaid market. Valitor partners with both international issuing programme managers, such as WEX Europe and Caxton FX, as well as with Icelandic banks. Valitor's revenue from the card issuing services is based on processed volume, loads and the number of issued cards, with Valitor's card issuing services representing approximately 18% of Valitor's 2017 revenue.

Strategy

Valitor has consistently delivered double digit growth annually by having clear vision and values as well as following an ambitious growth strategy implemented in 2012. It has significantly penetrated the growing European payments market by selectively using direct channel and partner channel strategies. Valitor delivers all card issuing services through the partner channel. In contrast, Valitor delivers card acquiring services through both direct and partner channels, with card acquiring services delivered exclusively through the direct channel in Iceland and exclusively through the partner channel in certain European markets, and card acquiring services delivered through both channels mostly in the United Kingdom, Ireland and the Nordic countries. Valitor's international operations focus on e-commerce and online payment services, with substantial recent growth in Denmark and the United Kingdom. Valitor plans to continue seeking M&A opportunities to expand into the European payments market as well as growing organically by entering new markets and offering new products and services in its existing markets.

Partner Channel

Valitor has been selected as a principal partner by leaders in financial technology and renowned companies in the card payments industry, with its partners including Paymentsense, Hyperwallet, WEX Europe, Caxton FX, Klarna and Stripe. Valitor's partners typically supply the front-end customer interface, while Valitor supplies the back-end processing for both card acquiring and issuing services. The partner channel enables fast growth in both volume and revenue. A high processing volume translates into lower fees per transaction and increases Valitor's competitiveness in a margin-squeezed industry. Valitor's partner channel strategy is to focus on innovative partners, to nurture long-term relationships and to offer complex and flexible solutions. This strategy has made Valitor a recognised brand in the European payment industry and has yielded positive acquiring turnover results, as shown in the graphic below, which represents Valitor's growth in acquiring turnover in international operations.

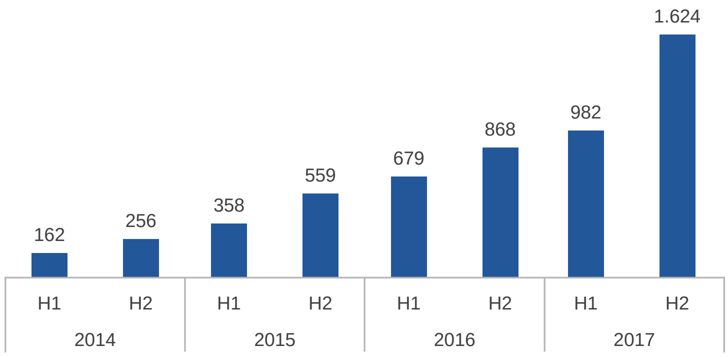


Direct Channel

Valitor provides its card acquiring services to merchants directly in selected markets with its end-to-end e-commerce and card-present solutions and delivers full-service, one-stop solutions for payment needs. Valitor's brands for direct channel card acquiring and card issuing services include Valitor, Markadis, AltaPay A/S and Chip & Pin. AltaPay A/S is Valitor's e-commerce payment platform for multiple markets and omni-channel solutions (e-commerce and card-present) in the Nordic countries. Chip & Pin is Valitor's direct channel platform in the United Kingdom and Ireland with a focus on SME card-present merchants. Valitor's direct channel strategy is to leverage the end-to-end value chain to maximise margins and customer retention rates.

Valitor also focuses on developing and offering differentiated solutions to merchants. The direct channel strategy is supported by Valitor's acquisition strategy. The chart below sets forth the volume growth of the direct channel.

Processing volumes 2014–2017
EURm



Valitor had 341 FTEs as of 31 December 2017. Valitor is included in the "*Other Divisions and Subsidiaries*" reportable segment of the Group.

Vördur

On 30 September 2016, Arion Bank acquired a 100% shareholding in Vördur, which is classified as a subsidiary of Arion Bank from the day of acquisition. The table below sets forth a summary of the transaction.

	ISK in millions
Purchase price, paid in cash	5,300
Loans to credit institutions (bank accounts)	1,068
Financial instruments	8,773
Intangible assets, other than goodwill	2,045
Tax assets	147
Other assets	2,355
Tax liabilities	(409)
Other liabilities	(9,175)
Fair value of assets and liabilities	**4,804**
Calculated goodwill	**496**

The net impact of Vördur on the Statement of Comprehensive Income for the period from 1 October 2016 to 31 December 2016 was ISK 384 million. For further information on intangible assets and goodwill, see note 26 titled "*Intangible assets*" in the 2016 Audited Financial Statements. Vördur had 85 FTEs as of 31 December 2017. Vördur is included in the "Other Divisions and Subsidiaries" reportable segment of the Group. For the year ended 31 December 2017, the operating income Vördur on a standalone basis was ISK 3,139 million and the earnings before tax of Vördur on a standalone basis was ISK 1,164 million. As of 31 December 2017, total assets of Vördur on a standalone basis were ISK 19,980 million.

Vördur provides policies for motor vehicles, home protection, property and life and health products. Vördur is the fourth largest universal insurance company in Iceland based on insurance premiums and, after the merger of its life insurance subsidiary, Vördur líftryggingar hf, with Okkar Life Insurance, Vördur líftryggingar hf became the largest life insurance company in Iceland *(source: FME)*.

Prior to the acquisition of Vördur, Arion Bank operated its insurance business under the name Okkar Life Insurance, which was a wholly owned subsidiary of the Bank, founded in 1966 and acquired by Kaupthing in 2005. For the years ended 31 December 2016 and 2015, the operating income of Okkar Life Insurance was ISK 850 million and ISK 1,012 million, respectively.

Each of Valitor hf., Vördur and Stefnir are independent entities regulated by, and reporting directly to, the FME. Each of the subsidiaries has its own independent risk management function, with Arion Bank exercising ownership through strategy and board memberships.

Other Divisions

The Bank has five support divisions:

Finance

The Finance division includes funding and treasury, which together form the Treasury reportable segment, market-making, as well as accounting, analysis and facilities and property management. The accounting unit is responsible for the Bank's financial reporting, both internally and to external stakeholders, including the FME and the Icelandic Central Bank. The analysis unit is responsible for short- and long-term budgeting and for benchmarking the Bank with comparable financial institutions, both local and international. The funding unit is responsible for the Bank's long-term funding, in both the domestic and international markets, and relationships with credit rating agencies. The treasury unit is responsible for the Bank's liquidity, currency and interest rate management, the internal pricing of interest rates and currency and liaison with other financial institutions. Market-making is responsible for market making in domestic securities. Facilities and Property Management is responsible for managing and investing in the Bank's premises and is also responsible for managing and selling foreclosure assets. The Finance division had 99 FTEs as of 31 December 2017.

Risk Management

For information on the activities of the Risk Management division, see "*Risk Management*". The Risk Management division had 27 FTEs as of 31 December 2017.

Legal

The Legal division handles collection, appropriated assets and legal representation on behalf of the Bank as well as a range of other legal services for the Bank's other divisions. The Legal division had 43 FTEs as of 31 December 2017.

Information Technology

The IT division is responsible for developing, operating and advising on the Bank's information systems and solutions, including internet banking, websites, its internally developed and third party software, its hardware, such as data centres, telephone systems, ATMs and personal computers. The IT division had 86 FTEs as of 31 December 2017. For additional information on the IT division, see "*—Information Technology*".

CEO Office

The CEO office includes human resources, marketing, credit office, communications and the investor relations officer. The CEO office had 61 FTEs as of 31 December 2017.

Human resources offers advice and support when recruiting employees, helps develop leadership skills and nurtures employees' abilities. The team includes the Bank's specialists in lean management.

The marketing department is responsible for brand management, coordinating marketing initiatives, marketing and tactical plans for products and services and market research, such as statistical analysis, focus groups, interviews and surveys. The marketing department is also responsible for developing the Bank's internet banking solutions, websites, online communications and electronic distribution channels.

The Credit Office oversees the Bank's lending process and loan portfolio and is responsible for the operation of the lending committees and updating the credit rules. The Credit Office also conducts credit analysis of the Bank's largest borrowers along with other work related to loan documentation and monitoring of loan book quality.

The communications department handles press releases, internal communications across various divisions of the Bank as well as communication with Icelandic stakeholders and media.

The investor relations officer (along with the CEO and CFO) is authorised as a spokesperson to communicate with capital markets participants. Other responsibilities of the investor relations officer are to provide relevant information about the operation of the Bank to the market, including communications required by applicable regulations *(e.g.*, notifications to NASDAQ Iceland and NASDAQ Stockholm) and other publications to the market.

Asset Holding Companies

Eignarhaldsfélagid Landey ehf. ("Landey")

Landey, a wholly owned subsidiary of the Bank, is a property development company, which manages properties that currently do not generate any revenue but which may do so in the future. Such assets include unfinished housing developments, building lots and the rights attached to them. Landey's objective is to maintain and increase the value of its properties through professional development, design and construction in collaboration with the planning authorities until a satisfactory price can be obtained for such properties. Landey had 2 FTEs as of 31 December 2017.

Eignabjarg

Eignabjarg was a wholly owned subsidiary of Arion Bank which was liquidated in 2015. Eignabjarg had been responsible for managing and selling shareholdings in companies, which Arion Bank has acquired through debt restructurings or other enforcement procedures. Its function was to maximise the value of the shareholdings held, to develop a strategy for each asset and to implement good business practices and good corporate governance in the transferred companies.

In 2018, the Bank established a new entity, also called Eignabjarg ehf., in order to hold the assets of United Silicon which the Bank acquired as a result of foreclosing on its collateral. See also "*Operating and Financial Review—Key Factors Affecting the Group's Business, Financial Position and Results of Operations—Acquisitions and Disposals—United Silicon*".

Asset Portfolio Disposals

In addition to the disposals made by Eignabjarg (see "*—Asset Holding Companies*"), the disposals made by Arion Bank in respect of its asset portfolio have also included the disposals set forth below.

Refresco

Arion Bank holds an indirect stake in Refresco Group B.V. ("**Refresco**") through partial ownership in two holding companies, Stodir hf. ("**Stodir**") and EAB 1 ehf. ("**EAB 1**") In March 2015, following an initial public offering, Refresco was listed on the Euronext Amsterdam exchange at a price of €14.5 per share. At that time, Arion Bank's indirect stake in Refresco through Stodir and EAB 1 was 4.61%. Since then, EAB 1 and Stodir have divested part of their shareholding in Refresco. Arion Bank currently holds a 1.52% indirect stake in Refresco. Since its listing, Refresco shares had traded at prices from €12.98 to €16.44 per share, until 12 April 2017, when Refresco rejected an unsolicited non-binding proposal from PAI Partners SAS to acquire all issued shares in the company. Later in the year, on 25 October 2017, Refresco and a consortium of PAI and bcIMC agreed on a recommended cash public offer of €20 per share. All necessary approvals were granted during the first three months of 2018 and Refresco shares were therefore sold before the end of the first quarter of 2018. However, the final payment between shareholders of Stodir and EAB 1 was not completed until the second quarter of 2018.

Kolufell Disposal

In July 2016, the Bank sold a majority of its shareholding in the subsidiary Kolufell ehf. ("**Kolufell**"). Kolufell's main asset was investment property. The sale, and the resulting valuation change on the Group's remaining interest in Kolufell, had a positive impact on the Group's other operating income, resulting in the recognition of a gain in the amount of ISK 493 million for the year ended 31 December 2016. The Bank owned approximately 19.9% of Kolufell as of 31 December 2017 which is classified within financial instruments on the Group's consolidated statement of financial position.

Visa Europe Disposal

In June 2016, Valitor completed the sale of its shareholding in Visa Europe to Visa Inc., which had a positive impact on the Group's net financial income, resulting in the recognition of a gain in the amount of ISK 5,291 million for the year ended 31 December 2016.

Bakkavor Disposal

The Group, through the subsidiary BG12 slhf., revalued its 46.0% shareholding in Bakkavor Group Limited ("**Bakkavor**"), resulting in a change from a valuation according to the equity method (less impairment) to the sales value (less cost of sale) in anticipation of the disposal thereof. This revaluation had a positive impact on share of profit of associates in the Group's statement of comprehensive income, resulting in revised impairment in the amount of ISK 20,845 million for the year ended 31 December 2015 and profit from sale of ISK 733 million for the year ended 31 December 2016 when the disposal was completed, each of which in turn had a corresponding positive impact on the Group's operating income for both periods.

In January 2016, the Bank's subsidiary BG12 slhf. sold its entire shareholding in the subsidiary Bakkavor Group Ltd. The profit from the sale was ISK 498 million and was recognised in the statement of comprehensive income in 2016.

Síminn Disposal

In October 2015, Síminn hf. ("**Síminn**"), the largest telecommunications company in Iceland, was listed on the Main Market of NASDAQ Iceland. Following Síminn's initial public offering, the Bank sold approximately 22% of its shareholding in Síminn, which had a positive impact on the Group's net financial income, resulting in the recognition of a gain in the amount of ISK 4,185 million for the year ended 31 December 2015. The Bank owned approximately 1.0% of Síminn as of 31 December 2017, as a part of the trading book (which represents positions held with trading intent and associated hedging positions).

Reitir Disposal

In April 2015, Reitir fasteignafelag hf. ("**Reitir**"), the largest provider of commercial property for rent in Iceland, was listed on the Main Market of NASDAQ Iceland. Following Reitir's initial public offering, the Bank sold approximately 17% of its shareholding in Reitir, which had a positive impact on the Group's other income, resulting in a mark-to-market gain and a gain on disposal of a total amount of ISK 3,664 million for the year ended 31 December 2014 and a recognition of a gain in the amount of ISK 4,224 million for the year ended 31 December 2015. The Bank owned approximately 0.1% of Reitir as of 31 December 2017, as a part of the trading book.

Compliance

According to Icelandic law, a financial institution is required to establish and maintain a permanent and effective compliance function, which operates independently and has the following responsibilities:

- to monitor and, on a regular basis, assess the adequacy and effectiveness of measures and procedures put in place to detect and minimise any risk of failure by the financial institution to comply with its obligations under the Securities Transactions Act as well as the associated risks;
- to monitor and assess the actions taken to address any deficiencies in the financial institution's compliance with its obligations under the Securities Transactions Act; and
- to advise and assist the relevant persons responsible for carrying out investment services and activities to comply with the financial institutions' obligations under applicable Icelandic law.

Furthermore, according to guidelines on internal governance issued by the FME, a financial institution is required to establish a compliance function to manage its compliance risk.

The Bank's compliance officer coordinates the Bank's compliance activities. The Bank's compliance division had 9 FTEs as of 31 December 2017.

The compliance officer works independently and reports directly to the CEO in accordance with the FME requirements. The compliance officer has monthly meetings with the CEO, during which the compliance officer presents a report on activities during the past month and refers certain matters to the CEO. The compliance officer also meets the chief risk officer and the internal auditor on a monthly basis. In addition, the compliance officer reports to the Board Audit Committee on a quarterly basis and to the Board of Directors on an annual basis.

The compliance officer is also responsible for coordinating and monitoring the Bank's compliance with applicable anti-money laundering and terrorist financing laws, regulations and guidelines, including monitoring of compliance with international sanctions, and investigating and reporting suspicious activities to appropriate authorities.

Competition

As Iceland's economy continues to recover and demand for new lending and other banking products and services increases, the Bank expects to face increased competition from the other large Icelandic banks, pension funds and smaller specialised institutions as well as foreign banks seeking to establish operations in Iceland. See "*Risk Factors—Risks Relating to Business and Industry—The Bank is exposed to competition, and expects that this competition will increase as Iceland's economy recovers*". The Bank expects to compete on the basis of a number of factors, including transaction execution, its products and services, its ability to innovate, reputation and price. The main competitors of Arion Bank's divisions and subsidiaries in the provision of its various products and services are set forth below.

Retail Banking Division

The Retail Banking division holds a 27.9% market share of individual customers in the retail banking market as of 31 December 2017 *(source: Capacent monthly survey of individuals, based on the question, "What is your main retail bank?")*.

The main competitors of the Retail Banking division in the deposits market are Landsbankinn and Íslandsbanki, both of which are government owned. Savings banks have largely disappeared since the financial crisis in 2008, although some smaller savings banks continue to operate in certain regions.

The Retail Banking division's strongest competition is in the mortgage loans market, in which the Retail Banking division's main competitors are Landsbankinn and Íslandsbanki. Pension funds have also become increasingly active in the mortgage loans market and, in 2017, gained market share through aggressive lending rates enabled, in part, by different regulatory requirements applicable to them (in particular, they are not subject to the Bank Levy). While the pension funds remain active in the mortgage loans market, Arion Bank expects their new lending to decrease as the ratio of mortgage loans in their portfolios has reached very high levels compared to historical averages, the Housing Financing Fund, an independent government institution that grants mortgage loans to individuals, municipalities, companies and organisations to finance housing purchases and construction, remains the largest player in the mortgage loans market for existing mortgage loans, although it has curtailed its origination of new mortgage loans, and its market share is expected to decrease as mortgage loans are refinanced or mortgaged properties are sold.

In addition, there is currently no meaningful foreign bank interest in the Icelandic retail banking market.

Corporate Banking Division

The Corporate Banking division's main competitors in the corporate banking market are Landsbankinn and Íslandsbanki, with a number of other participants active in the corporate banking market, such as pension funds (indirectly through investment in real estate asset-backed securities), public funds (*e.g.*, the Housing Financing Fund), foreign lenders and smaller financial institutions (*e.g.*, Kvika banki hf.). Pension funds, which compete with a cost structure very different from the cost structure of the banks, have also driven competition and increased margin pressure since 2013 as, although they are not direct corporate lenders, they provide funding through investment in real estate asset-backed securities. In addition, foreign banks increasingly consider entering the Icelandic corporate banking market. The Board of Directors believes that Arion Bank's market share in the total Icelandic corporate lending market was approximately 21% as of 31 December 2017 and has been stable.

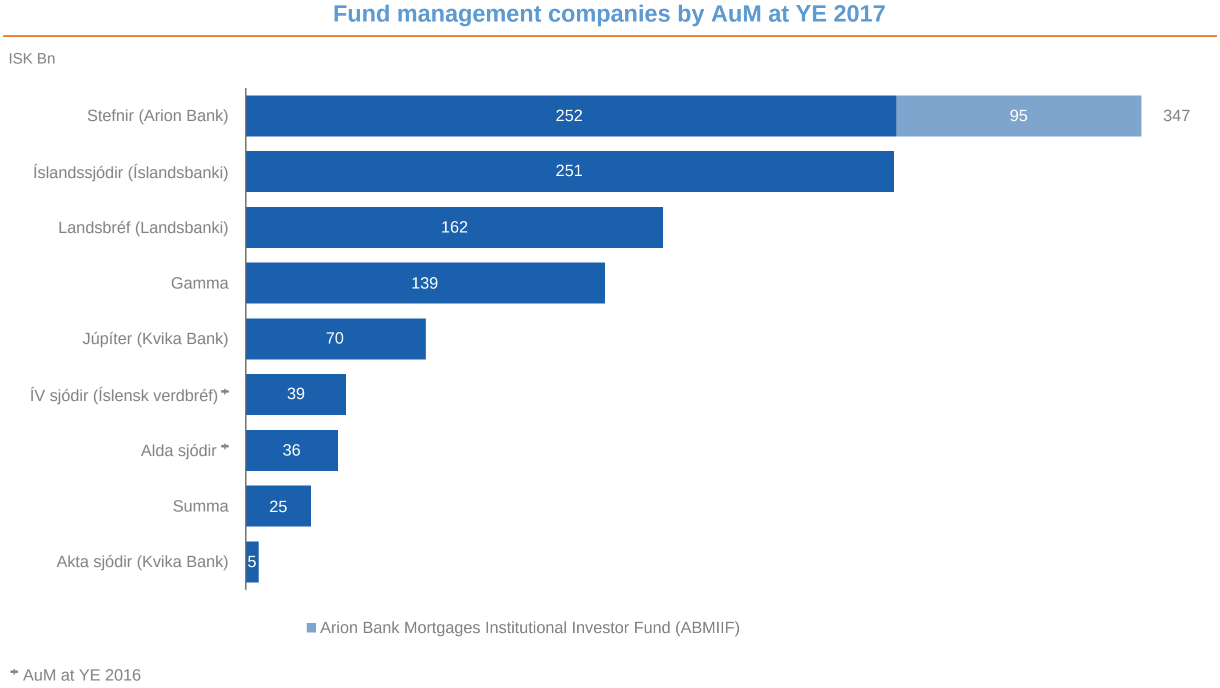
Investment Banking Division

The Investment Banking division's main competitors in the investment banking market are Landsbankinn, Íslandsbanki and Kvika, although a few smaller boutiques also participate in the market. The investment banking market is characterised by intense competition on price and on transaction terms, which results in considerable pressure on margins, especially during times when fewer transactions are being concluded. Arion Bank's market share, measured by value of transactions in 2017, is 24.3% in equity brokerage and 16.5% in fixed income brokerage *(source: NASDAQ Iceland)*.

Asset Management

The asset management industry sector is highly competitive and has only moderate barriers to entry. Competition in the asset management industry sector is largely based on investment performance, the level of fees, the quality and diversity of products and services, name recognition and reputation, the effectiveness of distribution channels and the ability to develop new investment strategies and products to meet the changing needs of investors. The main competitors of the fund management company Stefnir are Íslandssjódir

(Íslandsbanki) and Landsbréf (Landsbankinn) in addition to smaller fund management companies such as GAMMA, Júpiter (Kvika), ALDA (Kvika) and ÍV, as shown in the graph below.



Source: FME, annual reports

The Asset Management division competes with wealth management firms such as VÍB (Íslandsbanki), Landsbankinn, Kvika and ÍV. The Board of Directors believes that the Asset Management division is the leader in the asset management market in Iceland based on estimated size of the asset management market.

Valitor

The market for card and electronic payments is highly competitive and has many players, including dedicated payment processing companies, financial institutions and non-traditional payment processors, such as PayPal. Valitor's main competitor in the Icelandic card and electronic payments market is Borgun, a card issuing and acquiring subsidiary of Íslandsbanki, and also Kortathjonustan or Korti. As Valitor expands outside of Iceland, it also faces increasing competition from global card issuing and acquiring companies, such as Worldpay and Barclaycard (a division of Barclays Bank) which have an established presence in many markets where Valitor seeks to expand, including the United Kingdom, where Elevon, First Data, Wirecard, FIS and Raphaels Bank are also competitors. Valitor is the largest card payments company in Iceland in terms of revenue *(source: Valitor, Borgun and Kortathjonustan annual reports)*.

Information Technology

Arion Bank's IT division is responsible for developing, operating and advising on its IT and communication systems and solutions, including digital banking, internally developed and third party software, and hardware such as data centres, telephones, ATMs and personal computers. The reliability of the IT and communications systems is a key factor in the Bank's activities as a financial enterprise.

The IT division had 86 FTEs as of 31 December 2017. The IT division consist of Software Development, IT Operations, and the Project Office. Support functions focus on information security, quality management, and technical services management.

Arion Bank's IT infrastructure comprises two data centres in two different locations in Iceland, one owned by the Bank and the other outsourced by the Bank. Approximately 83% of the servers are virtual with a physical backup placed in a third location. The IT system serves all branches in the Retail Banking division's network.

The IT division maintains relationships with a wide range of blue chip suppliers, including Microsoft, SAP, Swift, Calypso, Reuters and Bloomberg. In addition, the IT division has substantial in-house expertise which allows for the development and integration of software internally. The IT division supports approximately 244 systems for Arion Bank, 113 of which are classified as important according to the CIA classification system (ISO/IEC 27001/2:2013 standard). There are approximately 10 to 15 development projects running in the IT division at any point in time.

Strategic Initiatives

Creating and maintaining reliable and efficient IT operations are key management focal points at Arion Bank. Continuous improvements include the ongoing maintenance and development of systems currently in operation and an ongoing focus to improve resilience and security. In addition, Arion Bank is focused on maintaining high uptime and continuously improving time to market of its new developments. The IT division underwent several important investments and initiatives between 2010 and 2017.

In the area of infrastructure and security, a new core network was implemented and a secondary data centre was outsourced. Outsourcing of certain IT operations to Origo, a major IT service provider in Iceland, took place in January 2017. These outsourced operations include technical services such as system, application and database administration as well as service desk functions. Arion Bank participates in the Icelandic joint cyber security task force, is a member of Nordic Financial CERT, and employs one FTE with the role of information security manager. The emphasis on stable and reliable operations in recent years has built a strong foundation for the future.

In the area of systems and services, a key initiative is the Arion Bank mobile app which was launched in 2012. The creation of the mobile app, which gives customers quick access to their daily banking, was driven by customer demand for mobile banking applications. The app was developed in-house and new services and features are continuously being added to the app. Thus far, Arion Bank has seen high customer satisfaction levels. Arion Bank has also invested in an extensive ATM network and fore-running ATM capabilities. A document management system was implemented resulting in fewer manual searches for documents at the document centre and, as of 31 December 2017, 95% of all documents have been migrated onto the document management system. The implementation of a customer relationship management (CRM) solution which allows for the tracking of customer communications, case handling and account planning was also completed. The CRM solution has been implemented in all customer-facing units and most supporting units. In addition, an investment was made in 2017 in an analytics and reporting solution which allows Arion Bank to provide reliable data on demand and meet its growing analytics and reporting demands.

The IT division has already undertaken steps to simplify Arion Bank's system landscape through the three-to-one loan system migration scheme. In 2009, Arion Bank had three loan systems in place, each of which serviced a different loan portfolio. Maintaining three separate systems was expensive and inefficient, requiring separate changes, integration and reporting across the three systems as well as three service agreements. The IT division's goal upon simplification was to increase operational efficiency, improve efficiency and quality of reporting, and decrease operational risk. The scheme resulted in maintenance fees decreasing from ISK 103 million for the three systems in 2009 to ISK 22 million in 2017 for the single system Libra Loan, a reduction in cost of approximately 79%.

There are several investments which the Bank plans to undertake in the near future, including the replacement of its core banking systems for deposits and payments. See "*Risk Factors—Risks Relating to Business and Industry—The Bank is exposed to the risk of failure and breaches of its information technology systems*". A new system would allow for continuous operations, lower operational costs, further support analytics and digitalisation, and would replace legacy technology.

The IT division has two clear operational goals for the future: to increase the number of digital customers and digital sales as well as increase efficiency in other departments via digitalisation.

Digital Banking

A key aspect of Arion Bank's business is customer satisfaction. Arion Bank is a leading digital bank in Iceland and believes that further digitalisation is essential to serving its customers in the future. Therefore, Arion Bank has initiated a strategic digital effort to expand digital access to Arion Bank's products and services, automate and simplify processes, make informed decisions based on accessible and reliable data, and offer clever and creative digital solutions.

The IT division is focusing on digital initiatives in order to continue to put customers' needs at the heart of the business. With multiple ring-fenced, cross-functional teams working on digital projects, Arion Bank is now at the forefront of technology and innovation.

Arion Bank's new digital onboarding process completely reimagines the customer's banking experience and signifies the first milestone in Arion Bank becoming a leader in digital banking. Arion Bank launched its digital mortgage service early 2017, which has resulted in increased demand, and decreased manual input and repetitive work. Digital credit card services now include new credit cards, credit card bill split, and credit card limit adjustments. Other digital credit products include vehicle financing, consumer loans and overdraft limit adjustments. The latest addition to Arion Bank's digital service offerings is personal finance management services to help customers manage their finances every month and onboarding for businesses. The objective of the digitalisation initiatives is to increase customer satisfaction, create new sales channels, and reduce costs.

Another initiative is the eID login, which makes digital banking more accessible for customers. The eID login is a national authentication and signature, allowing authentication by internet or mobile phone. In addition, Arion Bank benefits from an enclosed market, which allows for quick adaptation of new digital initiatives.

Arion Bank's digital initiatives have resulted in a steady increase in the number of customers using digital channels. As of 31 December 2017, 76,368 customers of Arion Bank were active users of internet banking and 53,717 customers of Arion Bank were active users of the Arion Bank app (in each case defined as customers active for 90 days and counted on 30 June of each year), as compared to 77,178 of active users of internet banking and 41,044 active users of the Arion Bank app as of 31 December 2016. The number of customers using the Arion Bank app has increased by approximately 12,700 customers during the twelve months ended 31 December 2017, and 70% of customers using internet banking were also using the Arion Bank app. Arion Bank estimates that, by the end of 2018, approximately 75% of customers using internet banking will also use the Arion Bank app.

Regulatory compliance

The regulatory landscape is expanding significantly in financial services and a number of regulations impacting the financial market are pending in Iceland such as GDPR, the Fourth Money Laundering Directive, MiFID 2 and the Payment Services Directive 2. The IT division has launched a number of initiatives in order to close regulatory compliance gaps in Arion Bank's information systems in an efficient manner, and will launch other regulatory initiatives in the near future.

Security

Control of information security is an essential tool to achieve the IT division's objectives. Arion Bank's Information Security Policy forms the basis of the measures used by Arion Bank to ensure the security of information, data systems and communication systems. Through the implementation of this policy, Arion Bank aims to prevent the inappropriate use of information, to safeguard the secure and uninterrupted transfer of electronic data and communications, and to integrate a risk management process into the work processes and daily tasks of all employees.

Legal and regulatory requirements relating to IT, particularly the secrecy of information relating to Arion Bank's customers, must be observed at all times when IT systems are used. Arion Bank operates two data centres in an active mode to ensure continuous system uptime and to minimise downtime in disaster scenarios.

Employees

During 2017, the average number of FTEs in the Group was 1,250 (compared to 1,201 in 2016 and 1,139 in 2015). As of 31 December 2017, the number of FTEs at the Group was 1,284.

The table below sets forth the information on the number of FTEs by division as of the dates indicated.

	As of 31 December		
	2017	**2016**	**2015**
Retail Banking	367	358	355
Corporate Banking	15	28	26
Investment Banking	30	30	31
Asset Management	52	54	56
Asset Management division	34	33	33
Stefnir	18	21	23
Finance(1)	99	51	50
Risk management(2)	27	30	27
Legal	43	42	42
Operations(3)	82	143	152
IT	86	105	107
CEO office(4)	61	48	46
Other divisions and subsidiaries(5)	422	349	255
Total	**1,284**	**1,238**	**1,147**

(1) Includes Treasury.

(2) As of 30 June 2017, part of the employees of Corporate Banking and Risk management were transferred to Credit Management within the CEO Office.

(3) As of 30 June 2017, the employees and functions of the former Operations division had been transferred to Finance and IT.

(4) Includes marketing, HR and Credit Management.

(5) Includes Valitor (335 FTEs as of 31 December 2017, 257 FTEs as of 31 December 2016 and 220 FTEs as of 31 December 2015).

As of 31 December 2017, approximately 35% of the Group's employees were female and approximately 65% of the Group's employees were male. As of 31 December 2017, 5% of the Group's employees were younger than 25 years old, 21% of the Group's employees were between 25 and 34 years old, 29% of the Group's employees were between 35 and 44 years old, 30% of the Group's employees were between 45 and 54 years old and 14% were older than 55 years old. As of 31 December 2017, 60.5% of the Group's employees had a bachelor or higher educational degree, 2.1% of the Group's employees had industrial education, 17.6% of the Group's employees did not matriculate from school and 19.8% employees received some other form of education. Furthermore, the Group had 4.35 (out of 5.00) on its employee engagement survey in 2017, which is a workplace audit consisting of 13 items, including, among other things, satisfaction levels, praise and recognition, care, encouragement to develop and clear expectations, team alignment and opportunities to grow.

Properties

The Bank operates its business through its network of branches, its cash centre and its headquarters. The following table sets out the properties that are material to the Group's operations.

Site	Ownership	Location	Lease termination
Headquarters	Owned	Reykjavík	N/A
Records centre	Owned	Reykjavík	N/A
Main branch	Owned	Reykjavík	N/A
Valitor headquarters	Leased	Hafnarfjördur	31 October 2022
Data centre	Leased	Reykjavík	Annual with automatic renewals

Legal Proceedings

Litigation and other legal proceedings are a common occurrence in the banking industry due to the nature of the business. Due to the current public sentiment in Iceland, the likelihood of litigation against the Bank have increased. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of any possible loss has been reasonably estimated, the Bank takes appropriate steps to mitigate any adverse effects which a given claim may have on its financial standing.

Except as described below, there are no governmental, legal or arbitration proceedings (including such proceedings which are pending or threatened of which the Bank is aware) during the 12 months preceding the date of this Prospectus, which may have, or have had, a significant effect on the Bank's and/or the Group's financial position or profitability.

Claim for Alleged Violations of the Competition Act

With a writ issued in June 2013, Kortathjonustan claimed damages in the amount of up to ISK 1.2 billion plus interest in aggregate from the Bank, Íslandsbanki, Landsbankinn, Borgun hf. and Valitor as a result of losses that Kortathjonustan contends the five parties caused by violations of the Competition Act. The case was dismissed on procedural grounds rather than the merits by the District Court of Reykjavík in March 2017 and confirmed by the Supreme Court on 2 June 2017, citing in particular that the plaintiff had not met with requirements related to standing. In September 2017, Kortathjonustan brought proceedings against the Bank and the other defendants on the same grounds, this time claiming damages in the amount of ISK 922 million plus interest. The case was again dismissed on procedural grounds by the District Court of Reykjavík by a ruling in March 2018, which was confirmed by the Court of Appeal in May 2018. Kortathjonustan has appealed the Court of Appeal's ruling to the Supreme Court. If the defendants would be ordered to pay damages, they would be jointly responsible for the payment of damages. The Bank has not recorded any provision in respect of this matter.

Claims for Damages due to Forced Bankruptcies

In June 2014, the former chairman of the board of directors of BM Valla hf., together with Lindarflot ehf., filed two cases against the Bank claiming damages in the amount of more than ISK 4 billion plus interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Valla hf. and Fasteignafelagid Artun ehf., which had been customers of the Bank, damages by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy, resulting in the sale of assets of the companies at values which the plaintiffs contend are lower than they would have been had the Bank permitted the companies to be financially restructured. In April 2018, the District Court of Reykjavík dismissed the case. The plaintiffs have appealed the judgement to the Court of Appeal. The Bank believes that it will be acquitted of the plaintiffs' claims in both cases and has therefore not recorded any provision in respect of this matter.

Valitor Damages Assessment

In its judgement in case No. 612/2012 from 24 April 2013, the Supreme Court of Iceland ruled that Valitor hf. had not been authorised to rescind an agreement it had entered into with Datacell. In January 2015, Datacell and Sunshine Press Productions brought legal action against Valitor hf. for compensatory damages amounting to approximately ISK 8.1 billion, plus accrued interest, relating to Valitor hf.'s termination of Datacell's vendor agreement. Court-appointed evaluators were subsequently asked to assess the damage in question at the request of the plaintiffs. The court-appointed evaluators announced their conclusions in March 2016. Valitor hf. disagreed with the assessment stated in the report and filed a motion to appoint three court evaluators to re-evaluate the plaintiffs' alleged losses. The District Court of Reykjanes granted this motion. The reassessment has been completed, but it was not filed with the District Court. Valitor hf. requested a new assessment, which would have examined particular aspects which had not yet been assessed, but the District Court has rejected the request. Valitor hf. has appealed the decision to the Court of Appeal. Recently Datacell and Sunshine Press Production claimed a freezing of Valitor hf.'s assets on the basis of the aforementioned claim of compensatory damages but the district magistrate declined the claim. Datacell and Sunshine Press Productions have submitted that decision to the District Court, which has not yet ruled on this claim.

The Group has not recorded any provision in this case.

When the Bank acquired a 39.22% holding in Valitor between 2014 and 2015, the Bank signed agreements with the sellers (Landsbankinn and two Icelandic savings banks) regarding potential losses of Valitor in relation to these compensatory damages. Therefore, the Group believes that it will have the basis for a claim against the sellers for their share in the potential loss should Valitor hf. be required by the District Court to pay damages in this case.

Dispute on Legacy Mortgage Loans Collateral

The Bank is involved in several court proceedings where the Bank's claim as mortgagee to 100% of the value of a property pledged as collateral in a mortgage loan is under dispute, in circumstances where allegedly only one of the two owners has signed a document granting the property as collateral. In 2017 the Supreme Court, in respect of cases which did not involve the Bank, ruled in several cases regarding this issue. In the majority of those cases the Supreme Court found in favour of the mortgagor, holding that the bank in question was entitled to enforce with respect to only 50% of the value of the property. The district court has ruled in several court cases involving the Bank regarding the aforementioned dispute. In the majority of those cases the district court invalidated 50% of the collateral, and the Bank is awaiting further rulings to assess the borderline cases. In judicial decisions to date, invalidation of 50% of the collateral for a given pledge has not affected the remaining 50% of the collateral or the lenders' obligation to repay the debt in full. Therefore, the Bank has not recorded any provision in respect of the matter.

Disputes Relating to United Silicon

United Silicon was granted a moratorium on payments on 14 August 2017 and filed for bankruptcy on 22 January 2018. The Bank had collateral in United Silicon's assets and the estate conveyed the assets to the Bank. The bankruptcy trustee has approved the Bank's collateral claims, but two unsecured creditors have contested that approval and the dispute has been referred to the District Court. The Bank has examined these challenges and believes they are without merit. However, the Bank and the estate have agreed that if the Bank's collateral claims are judged invalid by the District Court, the Bank will refund the estate the amount of the invalidated bond.

Penalty Interest During Extension of Payments

In March 2018, the Supreme Court of Iceland issued a judgement in case no. 159/2017, which concluded that the Bank was not permitted to calculate penalty interest on customers' debts during the period in which the customer was granted an extension of payments under the law on debt mitigation. The Bank is examining how many customers have paid penalty interest on their debts to the Bank during such extension period. A more detailed examination of these cases will reveal whether any customers may be able to claim repayment from the Bank or be entitled to have their debts reduced, particularly in cases where the debt has been paid in full. An evaluation is currently being made of what the impact will be on the Bank.

Possible Criminal Complaint and Related Correspondence

In 2017 and 2018, the Bank received a series of correspondence from a former customer of the Bank's predecessor Kaupthing. The correspondence alleged that the Bank had not conducted sufficient internal due diligence to ensure that its management and directors are fit and proper to carry on the operations of a financial institution, on the basis that certain individuals who are employed by the Bank were employed by its predecessor Kaupthing or the other Icelandic banks at the time of the financial crisis in 2008.

In May 2018, the Bank received further correspondence from this individual, which stated that he had filed a criminal complaint with the prosecutor in Iceland concerning Kaupthing's alleged wrongful appropriation of assets during the "winding up" process of Kaupthing. This winding-up process is explained in more detail in "*Principal and Selling Shareholders—Kaupthing*". The individual alleges that the complaint involves both the Bank and certain of its employees. To date, there has been no indication from authorities in Iceland that any criminal proceedings will be brought against Kaupthing, the Bank or any of its employees in connection with this allegation.

Included in the correspondence described above was information which the individual claimed supports his allegations against the Bank and those employees named in the correspondence. The Bank has considered the allegations in this correspondence, along with the related materials, and has conducted its own review of these allegations and related materials, including with support of external counsel, and it remains of the view that the allegations are without merit and that those employees named in the correspondence are indeed fit and proper.

Resolved Legal Matters

FME Sanctions

In January 2016, the FME published an announcement in relation to the Bank's sale of the shares in Síminn in October 2015, in which the FME concluded that the Bank had not taken reputational risk properly into account when selling the shares in Síminn to certain customers of the Bank. As a consequence, the FME concluded that, as a result of the sale, the Bank was in breach of the sound business practices requirements of the Financial Undertakings Act. The Bank was not subject to any administrative fines in respect of these findings on the basis that the Bank had suffered reputational loss as a consequence of the transaction.

In November 2015, the FME concluded that the Bank had breached the insider trading provisions of the Securities Transactions Act when the Bank sold its interest in Hagar hf. The FME found that the Bank had been in possession of insider information at the time of the transaction and that the Bank had not proved that its counterparties had been in possession of the same information, as the Bank had claimed. As a consequence, the Bank received an administrative fine in the amount of ISK 30.0 million, which it paid in 2015.

In September 2015, following an inspection of certain loans made by the Bank, the FME published an announcement in which the FME concluded that the Bank had not followed its internal rules, specifically in respect of the decision of a credit committee, or provisions of the loan agreements when it annulled and deregistered certain collateral, in breach of the sound business practices requirements of the Financial Undertakings Act. The Bank was not subject to any administrative fines in respect of these findings.

European Surveillance Authority State Aid Investigation

In May 2015, the European Free Trade Association ("**EFTA**") Surveillance Authority ("**ESA**") began an investigation into potentially unlawful state aid granted to Íslandsbanki and the Bank through allegedly preferential terms provided by the Icelandic Central Bank to Íslandsbanki and the Bank on two separate loan conversion agreements for the rescheduling of short-term collateral and securities loans from the Icelandic Central Bank to long-term loans.

ESA investigated whether these loan conversion agreements, which were concluded between the Icelandic Central Bank and Íslandsbanki and the Icelandic Central Bank and the Bank in September 2009 and November 2009, respectively, could be regarded as unlawful state aid within the meaning of the EEA rules.

In November 2016, ESA concluded that the terms agreed by the Icelandic Central Bank were in line with commercial conditions at the time the agreements were entered into and the Icelandic Central Bank acted in line with the conduct of a private creditor and, consequently, the loan agreements did not constitute state aid within the meaning of the EEA rules.

ICA Investigation into Mortgage Loans Arrangements

The Bank, Íslandsbanki and Landsbankinn had been under investigation by the ICA in relation to alleged abuse of their collective dominant position relating to mortgage loan arrangements, on the basis of separate complaints from BYR hf. and MP Banki hf. made in 2010. The Bank has concluded a settlement with the ICA which has the objective of stimulating competition in retail banking services for individuals and small businesses. The Bank has undertaken actions that have the objective of reducing switching costs in financial services, promoting active competition among banks toward individuals and small businesses and negating circumstances that could enforce tacit co-ordination in the market for retail banking services. With the settlement, the ICA has closed its investigation with respect to the Bank.

REGULATORY OVERVIEW

The Icelandic financial sector's regulatory framework is primarily based on European Union instruments adopted pursuant to obligations under the Agreement on the EEA, which entered into force on 1 January 1994 (the "**EEA Agreement**"). Prior to the 2008 collapse of the banking system in Iceland, the financial sector and the legislative environment in Iceland had undergone significant changes.

Icelandic legislation in this field has undergone further extensive revisions since 2008. In part, these amendments were emergency measures enacted in response to the October 2008 banking system collapse. A new regulatory framework was introduced that allowed the Icelandic government, acting through the FME, to take over the failed banks and supervise their winding-up. In addition, preference was given to guaranteed deposit claims which continue to rank ahead of general unsubordinated claims.

Further amendments have been the product of seeking to address shortcomings identified, at a national level, in the regulatory framework in connection with restoring the banking sector. Legislative changes implemented on this basis include increased powers of the FME, stricter rules on large exposures and related party transactions, more robust corporate governance rules, stricter credit risk management requirements, restrictions on transactions with treasury shares, and a ban on lending against security over own shares (*i.e.*, shares issued by the lender).

There have been significant changes at the European Union level in response to the financial crisis in 2008. Although some of the instruments have not yet been transposed into Icelandic legislation, most of the EEA relevant changes introduced in the European Union have either been implemented or are at variously advanced stages of implementation. To the extent these processes have been held up by the extensive scope of the proposed changes and delays in negotiations between EEA EFTA states (comprising Iceland, Liechtenstein and Norway) and the European Union on the transposition of regulations relating to the European supervisory authorities (the "**European Supervisory Authorities**"): the European Securities and Markets Authority ("**ESMA**"), the European Banking Authority ("**EBA**"), the European Insurance and Occupational Pensions Authority ("**EIOPA**") and the European Systemic Risk Board ("**ESRB**").

On 19 May 2017, the Parliament of Iceland approved legislation transposing the regulations regarding the European Supervisory Authorities (EBA, EIOPA, ESMA and ESRB) into Icelandic legislation. The FME and the EFTA Surveillance Authority are supervisory authorities according to the legislation.

Incorporation of the regulations in the EEA EFTA states is considered necessary to ensure effective and homogeneous application of common rules and supervision throughout the EEA. Even though Iceland has not been under a formal obligation to implement some recent instruments in financial markets, the Icelandic government and the legislature have sought to harmonise national law with certain of the minimum requirements applicable in the European Union. The underlying objectives have been to show resolve in the wake of the 2008 crisis and facilitate growing trust in the Icelandic financial market. A similar approach has been adopted in other EEA EFTA states.

Principal Legislation and Regulations

The Group is subject to financial services laws and regulations, corporate governance and administrative requirements and policies in Iceland. Acts relevant to the Group's operations include the Public Limited Companies Act, the Financial Undertakings Act, the Annual Accounts Act, the Securities Transactions Act, Act No. 98/1999 on Deposit Guarantees and Investor-Compensation Scheme, as amended (the "**Deposit Guarantees Act**"), Act No. 120/2011 on Payment Services, as amended (the "**Payment Services Act**"), Act No. 33/2013 on Consumer Credit, as amended, Act No. 118/2016 on Mortgage Credit to Consumers, as amended, Act No. 100/2016 on Insurance Activities, as amended (the "**Insurance Activities Act**"), the Foreign Exchange Act, Act No. 64/2006 on Measures to Combat Money Laundering and the Financing of Terrorist Activities, as amended (the "**AML Act**"), the Interest Act, the Income Tax Act, Act No. 87/1998 on Official Supervision of Financial Activities, as amended (the "**Financial Activities Supervision Act**"), Act No. 77/2000 on Protection of Privacy as regards the Processing of Personal Data, as amended (the "**Data Protection Act**"), and the Competition Act. Also relevant to Arion Bank, in the context of a listing of the Shares, is Act No. 110/2007 on Stock Exchanges, as amended (the "**Stock Exchanges Act**").

Financial Undertakings Act

The Financial Undertakings Act, among other things, lists activities requiring an operating licence and sets forth the requirements applicable to obtaining and holding an operating licence as well as rules on qualifying holdings and large exposures. As a commercial bank, Arion Bank is licensed under the Financial Undertakings

Act to carry out specific authorised activities and provide other services and carry out ancillary activities naturally linked to its authorised activities. Similarly, Stefnir is licensed as an UCITS management company, Valitor hf. is licensed as a credit undertaking and Vördur is licensed as an insurance company.

Requirements of the Public Limited Companies Act with respect to the composition of the board of directors, governance and employees are supplemented by rules specific to financial undertakings set forth in the Financial Undertakings Act. Further rules relate to risk management, liquidity, equity requirements, accounting, financial reorganisation and sanctions for breaches of certain provisions of the Financial Undertakings Act.

European Union instruments that were implemented into national law through the enactment of the Financial Undertakings Act include Directive (2000/12/EC) relating to the taking up and pursuit of the business of credit institutions (the "**First Banking Consolidation Directive**"), Directive (93/6/EEC) on the capital adequacy of investments firms and credit institutions, Directive (93/22/EEC) on investment services in the securities field, Directive (86/635/EEC) on the annual accounts and consolidated accounts of banks and other financial institutions, Directive (107/2001/EC) amending Directive (85/611/EEC), Directive (95/26/EC) amending a number of directives with a view to reinforcing prudential supervision, Directive (2000/28/EC) amending the First Banking Consolidation Directive, Directive (2009/110/EC) on the taking-up, pursuit and prudential supervision of the business of electronic money institution, Directive 2007/64/EC on payment services in the internal market, Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and Regulation 575/2013/EU on prudential requirements for credit institutions and investment firms (CRD IV).

Among the amendments made, pursuant to Iceland's obligations under the EEA Agreement, to the Financial Undertakings Act since its enactment are the implementation of Directive (2002/87/EC) on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, Directive (2001/24/EC) on the reorganisation and winding up of credit institutions and Directive (2004/39/EC) on Markets in Financial Instruments ("**MiFID**"), as well as amendments to reflect the implementation of CRD IV. See "*—Capital Requirements Directive*". The timeframe for further implementation in Iceland has not yet been published, but as of the date of this Prospectus, work is underway at ministerial level on preparing proposed legislation covering what remains to be implemented of CRD IV as well as parts of the BRRD.

The BRRD provides for a member state of the EEA as a last resort, after having assessed and exploited the applicable resolution tools to the maximum extent possible while maintaining financial stability, to be able to provide extraordinary public financial support through additional financial stabilisation tools. These consist of the public equity support and temporary public ownership tools. Any such extraordinary financial support must be provided in accordance with the European Union state aid framework.

An institution will be considered as failing or likely to fail if (a) it is, or is likely in the near future to be, in breach of its requirements for continuing authorisation, (b) its assets are, or are likely in the near future to be, less than its liabilities, (c) it is, or is likely in the near future to be, unable to pay its debts as they become due or (d) it requires extraordinary public financial support (except in limited circumstances).

Secondary legislation in the form of regulations and rules enacted by the executive branch of government supplement the Financial Undertakings Act. See also "*Risk Factors—Risks Relating to the Offering and the Offer Securities—Recovery and resolution regimes may affect the rights and remedies of holders of the Offer Securities*".

Capital Requirements Directive

The Basel Committee on Banking Supervision issued the first version of the Basel III framework in December 2010 and a revised version in June 2012. The Basel III framework is the new international regulatory framework for banks, which includes requirements regarding regulatory capital, liquidity, leverage ratio and counterparty credit risk measurements. On 26 June 2013, the European Parliament and the European Council adopted CRD IV for the implementation of the Basel III framework in the European Union with the goal of strengthening the regulation of the banking sector. CRD IV replaces the current Capital Requirements Directives (2006/48/EC and 2006/49/EC) with a Directive (2013/36/EU) (the "**CRD IV Directive**") and the CRR.

The transposition of the CRD IV into Icelandic law is set to take place in separate amendments. The first amendment was introduced on 9 July 2015 by Act No. 57/2015, which amended the Financial Undertakings Act. This amendment includes CRD IV's provisions on capital buffers and adopts a regulation implementing the provisions of the CRR and related technical standards. The second amendment, which was introduced on 1 September 2016 by Act No. 96/2016 and further amended the Financial Undertakings Act, includes

CRD IV's provisions on operating licences, initial capital, information obligations, leverage ratios, supervisory review and evaluation process. The third amendment, introduced on 9 May 2017 by Act No. 23/2017, includes an obligation on financial undertakings to establish effective and reliable mechanisms to enable employees to report potential or actual breaches of laws or regulations applying to the institution.

The remainder of the CRR was transposed into Icelandic law by the entry into force of Regulation No. 233/2017 on 6 March 2017.

The timeframe for further implementation in Iceland has not yet been published. Two committees have been established as of the date of this Prospectus to draft a legislative bill covering what remains to be implemented of CRD IV. According to a recent list of upcoming legislative bills to be submitted to Parliament, issued by the Government, a bill concerning branch activities of financial undertakings and other financial services operating within the EEA, i.e. branch operations by EEA financial institutions as well as activities of branches by non-EEA financial institutions in Iceland, in line with CRD IV, is expected. This represents one of the final steps in CRD IV implementation. In addition, the proposed bill is expected to transpose BRRD into Icelandic law via amendments to the Financial Undertakings Act.

Liquidity Coverage Ratio

The Icelandic Central Bank has issued rules on LCR no. 266/2017 that became effective on 31 March 2017 (the "**LCR Rules**"). The LCR Rules replaced previous rules no. 1031/2014 and are based on liquidity standards introduced in the Basel III Accord, which began to be implemented in October 2015 on a global level. The objective of the LCR is to promote the short-term resilience of the liquidity risk profile of banks by ensuring that banks have an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet their liquidity needs for a 30 calendar day liquidity stress scenario. Accordingly, LCR is the balance between highly liquid assets and the expected net cash outflows of a bank in the following 30 day period under stressed conditions.

In accordance with the LCR methodology, bank assets are divided into different categories according to their liquidity. To qualify as highly liquid assets under the LCR Rules, assets must be non-pledged, liquid and easily priced on the market and not issued by a bank or its related entities. According to the rules established by the Icelandic Central Bank, Icelandic banks are required to maintain a minimum LCR requirement of 100%. Notwithstanding this requirement, a credit institution may convert liquid assets to cash to cover the net liquidity outflow during stress periods, although such use of liquid assets may temporarily lower the liquidity ratio down below 100%. A credit institution is also required to submit regular reports on its liquidity position to the Icelandic Central Bank.

In accordance with the LCR methodology, a bank's deposit base is split into different categories depending on customer type. A second categorisation is used where term deposits refer to deposits with a residual maturity longer than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the bank and the amount is covered by the Depositors' and Investors' Guarantee Fund, which is a fund established in Iceland pursuant to the provisions of the Deposit Guarantees Act and which guarantees a minimum level of protection to depositors in commercial and savings banks and to customers of companies engaging in securities trading pursuant to applicable law. A bank's deposit base is also divided into different categories. Deposits are considered "market stable" if they are made by a customer that has a business relationship with the bank and the amount is covered by the Depositors' and Investors' Guarantee Fund, which is a fund established in Iceland pursuant to the provisions of the Deposit Guarantees Act and which guarantees a minimum level of protection to depositors in commercial and savings banks and to customers of companies engaging in securities trading pursuant to applicable law. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions.

If the Bank's LCR falls short of the minimum LCR requirements or if reporting requirements are not met, the Icelandic Central Bank can apply daily fines to the shortfall amount in accordance with the LCR Rules.

Data Protection Act

The Data Protection Act implements Directive 95/46/EC. As protection of personal data falls under the EEA Agreement, the reform of data protection that the GDPR will entail will also be implemented in Iceland. It is expected that the date of adoption in Iceland will mirror that of the EU's date of entry into force, i.e. in May 2018, although this may be postponed.

Securities Transactions Act

The Securities Transactions Act regulates, among other things, the activities of financial institutions on the securities market, handling of insider information, price formation on a regulated market and public offering of securities not to be listed on a stock exchange or a regulated market. Furthermore, the Securities Transactions Act contains provisions on major holding announcements and takeover rules for Icelandic listed companies, which apply to Arion Bank by virtue of being an issuer of securities and the capital markets operations of its Investment Banking division or asset management operations through the Asset Management division or its subsidiary Stefnir.

Underlying the enactment of the Securities Transactions Act was the objective of transposing into national law MiFID, the Directive (2004/109/EC) on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (the "**Transparency Directive**"), the Directive (2003/6/EC) on insider dealing and market manipulation (market abuse) and the Directive (2004/25/EC) on takeover bids.

Work has commenced on the implementation of MAR, MiFID 2 and MiFIR. It is not yet clear when MiFID 2 and MiFIR will be transposed into national law, but it is not expected to be incorporated before 2019, whereas the legal framework took effect on 3 January 2018 in the European Union. These new rules are designed to take into account developments in the trading environment since the implementation of MiFID and, in light of the financial crisis, to improve the functioning of financial markets, making them more efficient, resilient and transparent. MiFID and MiFIR empower ESMA to develop technical standards.

Further legislative changes are expected to be made in the near future to bring Icelandic law in line with more recent developments in the European Union. See "*—Principal Governmental Authorities—FME*", "*Icelandic Securities Market—Transactions and Ownership Disclosure Requirements*" and "*Icelandic Securities Market—Mandatory Bids and Squeeze-Out Proceedings*". Secondary legislation in the form of regulations and rules enacted by the executive branch of government supplement the Securities Transactions Act.

Deposit Guarantees Act

Commercial banks, savings banks, companies providing investment services and other parties engaging in securities trading pursuant to Icelandic law and established in Iceland are members of the Depositors' and Investors' Guarantee Fund according to the Deposit Guarantees Act, which is based on Directive (1994/19/EC) on deposit-guarantee schemes. See "*Icelandic Securities Market—Compensation Scheme for Investors*". Directive (2014/49/EU) on deposit guarantee schemes is due to be implemented into national law. Its objective is to ensure a harmonised level of deposit protection by all recognised deposit-guarantee schemes, regardless of where the deposits are located in the European Union.

Payment Services Act

The Payment Services Act implemented into Icelandic law Directive (2007/64/EC) on payment services in the internal market (the "**Payment Services Directive**") and has been amended to take into account provisions of Directive (2009/110/EC) on the taking up, pursuit and prudential supervision of the business of electronic money institutions (the "**Electronic Money Directive**"). Among other things, the Payment Services Act establishes rules to ensure transparency of conditions and information requirements for payment services, rights and obligations in relation to the provision and use of payment services, surveillance, implementing measures, and sanctions.

Also, the Bank has taken steps to implement the Payment Services Directive 2, although it will not yet be implemented into Icelandic legislation when it enters into force in the European Union and is currently expected to be implemented in Iceland in 2019. The Payment Services Directive 2 sets out strict security requirements for electronic payments and the protection of consumers' financial data; increases the transparency of conditions and information requirements for payment services; and sets out rules concerning the rights and obligations of users and providers of payment services. The Payment Services Directive 2, furthermore, seeks to open up payment markets to new entrants, which is expected to lead to increased competition. The Payment Services Directive 2 is complemented by Regulation (2015/751) on interchange fees for card-based payment transactions, which puts caps on fees charged between banks for card-based transactions.

Insurance Activities Act

In September 2016, new legislation applicable to insurance activities, applicable to the operations of the Bank's subsidiary Vördur, was enacted that supersedes legislation previously applicable to such activities and transposes into national law the provisions of the Directive (2009/138/EC) on the taking-up and pursuit of the business of insurance and reinsurance (the "**Solvency II Directive**") as amended by Directive (2014/51/EU) amending the Prospectus Directive and the Solvency II Directive ("**Omnibus II Directive**"), except for provisions regarding the European Insurance and Occupational Pensions Authority's powers and consolidated insurance companies. According to a recent list of upcoming legislative bills, a bill has been submitted to Parliament to implement the rules on the European Insurance and Occupational Pensions Authority's powers into Icelandic law. The Solvency II Directive stipulates stricter requirements for the solvency and risk management of insurance companies, with a view to increasing the protection of insurance policyholders, and that the possibility of consumer losses or market interruptions will be reduced by the more stringent requirements.

Foreign Exchange Act

In response to the financial crisis, the Parliament of Iceland passed Act No. 134/2008 on 28 November 2008 relating to amendments to the Foreign Exchange Act, which granted the Icelandic Central Bank powers to intervene in the currency-market with the view of stabilising the foreign exchange rate of Icelandic Krona. The Icelandic Central Bank introduced the Capital Controls by implementing Rules No. 1082/2008, which were amended several times before the Capital Controls were enacted into primary legislation with the adoption of Act No. 127/2011, which amended the Foreign Exchange Act.

In March 2017, the Icelandic Central Bank announced new rules which provide for general exemptions to the majority of the Capital Controls, with restrictions remaining on (i) derivatives trading for purposes other than hedging; (ii) foreign exchange transactions carried out between residents and non-residents without the intermediation of a financial undertaking; (iii) in certain instances, lending by residents to non-residents; and (iv) certain other restrictions in relation to special reserve requirements due to new inflows of foreign currency in further specified cases. However, it is uncertain when and if the Capital Controls will be lifted in full, and if economic circumstances in Iceland were to change, there can be no assurance that the Icelandic Central Bank would not re-impose elements of the Capital Controls which have already been lifted.

Before the entry into force of the general exemption, the Capital Controls effectively prohibited the cross-border transfer of funds, except in the case of a payment for goods or services and transfers permitted under applicable statutory exemptions. As a result, all financial transactions leading to cross-border currency transactions, including lending and borrowing between resident and non-resident parties as well as currency-derivatives of any kind and the acquisition by domestic parties of financial instruments denominated in foreign currency, were prohibited unless expressly permitted. Furthermore, the Capital Controls made it compulsory for Icelanders and Icelandic companies to repatriate all of their foreign currency not subject to statutory exemptions.

The Bank is subject to the Capital Controls as an Icelandic resident entity but currently benefits from both general and specific exemptions. Accordingly, the Bank is subject to the restrictions on the cross-border transfer of currency and Icelandic Krona unless exemptions apply. The Capital Controls, if the exemptions no longer applied, could have a different impact on the Bank's operations depending on the type of cross-border activities the Bank engages in. Furthermore, the Capital Controls contain limitations on domestic transactions, such as currency transactions, derivatives transactions and lending in foreign exchange. Currently, financial institutions, including the Bank, enjoy a specific statutory exemption from the Capital Controls allowing unrestricted domestic interbank market trade in currencies when settled on a trade, using futures and swaps. The exemption also exempts financial institutions, including the Bank, from restrictions on cross-border borrowing and lending, provision of cross-border guarantees and obligation to remit foreign currency to Iceland. However, although specific terms of transactions may fall within exemptions, the overall transaction may nevertheless be restricted by the Capital Controls if it were not for the general exemption from March 2017. Finally, the exemption allows financial institutions, including the Bank, to accept money market deposits denominated in Icelandic Krona from non-resident entities.

Statutory Exemptions and Amendments

The Foreign Exchange Act provides for several statutory exemptions. For example, certain financial institutions are provided with an exemption from certain provisions of the Capital Controls. Accordingly, commercial banks, savings banks and credit institutions operating under a licence issued by the FME are, among other things, exempt from restrictions on borrowing and lending between resident and non-resident parties, the restriction on assuming liability for payments between resident and non-resident parties and the requirement to repatriate all foreign currency. In addition to the statutory exemptions, the Foreign Exchange Act sets forth the mechanics for obtaining specific exemptions from the Capital Controls, upon application to, and subject to the approval of, the Icelandic Central Bank.

However, in the case of the winding-up, bankruptcy or insolvency of a financial institution, the exemptions from the Capital Controls may not apply and, therefore, restrictions will be effected in respect of payments in foreign currency and cross-border transfer of funds, whether by reason of the Foreign Exchange Act, the Act on Bankruptcy No. 21/1991, as amended, or applicable provisions under the Financial Undertakings Act.

The amendments, implemented in March 2012 by Act No. 17/2012, imposed further restrictions on the outflow of foreign currency with respect to, among other things, the Capital Controls in response to a perceived increase in circumvention of the Capital Controls. Before such amendments were implemented, an investor could change its interests in the principal amortisation and indexation payments under a CPI-indexed annuity bond into foreign currency and transfer such payments out of Iceland. The amendments removed the previous exemption provided for such payments, with the result that such payments became subject to the Capital Controls, meaning that only interest payments remained within the exemption. Furthermore, the wide exemptions for payments by the winding-up committees of Kaupthing, Glitnir and Landsbanki to creditors were removed and became subject to approval by the Icelandic Central Bank.

Two additional amendments were made to the Foreign Exchange Act in March 2013. First, on 9 March 2013, Act No. 16/2013 was adopted, implementing certain changes to the currency control regime, including the removal of the expiration date from the Foreign Exchange Act. Such amendments also imposed limits on the exemptions which the Icelandic Central Bank can apply and the extent to which the exemptions may be subject to prior consultation with the relevant ministry. These limits primarily relate to financial institutions or legal entities under the control of the FME through winding-up proceedings or legal entities with a balance sheet exceeding ISK 400 billion and where the transaction may have a substantial effect on Iceland's debt position or affect ownership of a commercial bank. Second, on 26 March 2013, further amendments were adopted with Act No. 35/2013, primarily relating to general exemptions and enhanced authorisations for the Icelandic Central Bank. Such amendments enhanced the Icelandic Central Bank's surveillance of foreign exchanges, including in relation to payments of interest, indexation, dividends and contractual maturities. The Icelandic Central Bank also received authorisation to collect certain information, which may extend to any relevant third party, and to impose fines.

In May 2014, additional amendments to the Foreign Exchange Act were implemented with the adoption of Act No. 67/2014. The amendments sought to clarify Article 13 j. of the Foreign Exchange Act by further elaborating on what payments are classified as dividends under Article 13 j. (1). Article 16 a. of the Foreign Exchange Act was also amended to provide that fines may be imposed on institutions pursuant to the Foreign Exchange Act or applicable rules thereunder, irrespective of whether the relevant violation can be linked to the actions of such institution's representative or its employees.

Additional amendments to the Foreign Exchange Act were implemented in June 2015 and July 2015, primarily in connection with the conclusion of the winding-up proceedings of the estates of Glitnir, Landsbanki, Kaupthing and other smaller failed banks. With the adoption of Act No. 27/2015 in June 2015, several amendments were made restricting the operations of entities undergoing winding-up proceedings, entities that have concluded winding-up proceedings and entities that have been established in connection with the implementation of a composition agreement, and withdrawing the general exemption that previously applied. As a result of such amendments, the estates are prohibited from (a) purchasing foreign currency other than from domestic banks, (b) intra-group lending and borrowing and (c) granting intra-group guarantees unless the guarantee is granted in connection with the purchase and sale of goods and services or if the loan for which the guarantee is granted is otherwise exempt. Restrictions were also placed on repayments of loans. Investments in derivative contracts or in claims against the estates no longer qualify as new investments under the Icelandic Central Bank's new investment regime. Restrictions were also adopted on borrowing by domestic parties from non-domestic parties and purchase of foreign currency for repayment of loans advanced by domestic lenders. Further amendments were adopted with Act No. 60/2015 in July 2015 in relation to the levying of a so-called "stability-tax", which grants the estates exemption from some of the restrictions of the Foreign Exchange Act.

Easing of Capital Controls

On 25 March 2011, the Icelandic Central Bank announced a new strategy for the gradual easing of the remaining Capital Controls in phases, each of which is subject to certain conditions. The Icelandic government and the Icelandic Central Bank implemented further easing of the Capital Controls, which was aimed at individuals and the investments of legal entities, with the most recent changes occurring in October 2016, as described in greater detail below. No further announcements have been made by the Icelandic government or the Icelandic Central Bank regarding the easing of the remainder of the Capital Controls.

The Capital Controls constitute protective measures under Article 44 of the EEA Agreement and have as such been notified to the Standing Committee of the EFTA under the procedures provided for in Protocol 18 of the EEA Agreement as well as Protocol 2 of the Agreement between the EEA EFTA states on the Establishment of a Surveillance Authority and a Court of Justice (the "**Surveillance and Court Agreement**"). Following a referral by the District Court of Reykjavík, the Court of Justice of the EEA EFTA states (the "**EFTA Court**") issued a reasoned opinion on 14 December 2011, whereby the EFTA Court ruled that it had competence under the Capital Controls and the Surveillance and Court Agreement to review the Capital Controls, among other things, in light of the general principle of proportionality. The EFTA Court further declared that at the time in question the Capital Controls were proportionate. However, this ruling of the EFTA Court does not preclude further scrutiny of the Capital Controls by the relevant institutions of the EEA at any time.

In June 2015, the Icelandic government announced a plan towards easing of the Capital Controls. The plan was threefold: *first*, the estates of Glitnir, Landsbanki, Kaupthing and other smaller failed banks agreed to certain stability conditions, which have since been fulfilled by making contributions to the Icelandic Central Bank, after completing their respective winding-up proceedings by reaching composition agreements with their respective creditors, all of which have been confirmed by the District Court of Reykjavík; *second*, offshore holders of ISK-denominated deposits or government bonds will be offered a currency auction held by the Icelandic Central Bank; and, *third*, the Capital Controls will be gradually eased on the domestic market when conditions allow.

As of the date of this Prospectus, the first part of the plan has been completed. Each of the estates of Glitnir, Landsbanki and Kaupthing reached formal composition agreements approving a composition proposal through which they would exit winding-up proceedings with their creditors at creditors' meetings held on 20 November 2015, 23 November 2015 and 24 November 2015, respectively. The Glitnir composition agreement was approved by the District Court of Reykjavík on 7 December 2015 and became final and binding on 14 December 2015, the Landsbanki composition agreement was approved by the District Court of Reykjavík on 18 December 2015 and became final and binding on 25 December 2015 and the Kaupthing Composition Agreement was approved by the District Court of Reykjavík on 15 December 2015 and became final and binding on 23 December 2015. To allow each of Glitnir, Landsbanki and Kaupthing to implement their respective composition agreements, the Icelandic Central Bank has granted them certain exemptions from the Capital Controls on the basis that Glitnir, Landsbanki and Kaupthing, have, among other things, made a "stability contribution" to the Icelandic Central Bank. This stability contribution is intended to assist in maintaining stability in the Icelandic economy following the assumed negative impact of the composition agreements on the balance of payments and economic recovery programme for Iceland. The stability contribution varies between the estates, with the largest payment made by Glitnir, including the transfer of its shares in Íslandsbanki, and smaller payments made by Kaupthing and Landsbanki. Following the completion of the Kaupthing Composition Agreement, Kaupthing continued to hold 87% of the Bank's shares through its wholly owned subsidiary Kaupskil, which decreased to 57.9% with the sale of a 29.1% stake in the Bank through a private placement in March 2017, to 57.4% upon the exercise of certain options in September 2017 and to 55.6% through a further private placement in February 2018, each as described below under "*Principal and Selling Shareholders—Private Placements of Shares*". However, a profit-sharing agreement is in place whereby the proceeds from any future sale of the Bank will be divided between Kaupthing and the Icelandic government, in proportions which will vary depending on the proceeds of any such sale, and will form part of Kaupthing's stability contribution.

As part of the implementation of the second part of the plan, Act No. 37/2016 on the Treatment of Krona-denominated Assets Subject to Special Restrictions (the "**Krona Asset Act**") was enacted on 23 May 2016. The Krona Asset Act seeks to address the treatment of specified assets denominated in Icelandic Krona, defined as Offshore Krona Assets in article 2(1) of the Krona Asset Act. Offshore Krona Assets, which are currently subject to the Capital Controls and total over ISK 300 billion, include various assets and funds denominated in Icelandic Krona, owned or held by non-resident parties (as defined in the Foreign Exchange Act). They are considered by the Minister of Finance and Economic Affairs as assets likely to leave the Icelandic economy, with potentially negative consequences for financial stability. The aim of the Krona Asset Act, therefore, was for the Icelandic Central Bank to hold a foreign currency auction in which all owners of Offshore Krona Assets were given the option of exchanging these assets for euros at a particular exchange rate.

Any Offshore Krona Assets not exchanged in the foreign currency auction held are subject to restrictions, as further set out in the Krona Asset Act.

In October 2016, in the adoption of Act No. 105/2016, which took effect on 1 January 2017, further amendments were made to begin to implement the third part in the plan for easing of the Capital Controls.

Most recently, in March 2017, the Icelandic Central Bank announced new rules which provide for general exemptions to nearly all of the restrictions pursuant to the Foreign Exchange Act, with restrictions remaining on (i) derivatives trading for purposes other than hedging; (ii) foreign exchange transactions carried out between residents and non-residents without the intermediation of a financial undertaking; (iii) in certain instances, lending by residents to non-residents; and (iv) certain other restrictions in relation to special reserve requirements due to new inflows of foreign currency in further specified cases. However, it is uncertain when and if the Capital Controls will be lifted in full, and if economic circumstances in Iceland were to change, there can be no assurance that the Icelandic Central Bank would not re-impose elements of the Capital Controls which have already been lifted.

AML Act

Financial undertakings operating under a licence from the FME are covered by the AML Act which was based on and implemented into Icelandic law the Third Money Laundering Directive (2005/60/EC). The AML Act has since been amended with reference to the Payment Services Directive and the Electronic Money Directive. The objective of the AML Act is to prevent money laundering and terrorist financing by imposing on parties engaging in activities which may be used for the purposes of money laundering and terrorist financing the obligation to obtain knowledge of their customers and their business activities and report to the competent authorities any knowledge of such illegal activities.

According to a recent list of upcoming legislative bills to be submitted to Parliament, issued by the Government, a bill is expected which will transpose the Fourth Money Laundering Directive (2015/849/EU). The Directive reinforces the efficacy of the fight against money laundering and terrorist financing, and seeks to further align EU legal acts with the International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation, adopted by the Financial Action Task Force in February 2012. The Directive applies to credit and financial institutions, among others, and emphasises the use of a risk-based approach to identify, understand and mitigate the risks of money laundering and terrorist financing. Member States were obliged to bring the Directive into force by 26 June 2017.

Competition Act

All commercial activities whose effect, or intended effect, is in Iceland fall under the scope of application of the Competition Act. To a significant extent the Competition Act is based on Regulation (1/2003/EC) on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty and Regulation (139/2004) on the control of concentrations between undertakings. The objective of the Competition Act is to promote effective competition and thereby increase the efficiency of the factors of production of society. This objective shall be achieved by (i) preventing unreasonable barriers and restrictions on freedom of economic operation, (ii) preventing harmful oligopoly and restriction of competition and (iii) facilitating the entry of new competitors into the market.

Stock Exchanges Act

NASDAQ Iceland operates under the Stock Exchanges Act, which sets forth the conditions that have to be satisfied by a stock exchange to obtain a licence to operate. In addition to setting forth rules on the establishment and functions of stock exchanges, the Stock Exchanges Act governs the rules applicable to membership of a regulated market, admission of financial instruments to trading, transparency in a regulated market, surveillance and sanctions. See "*Icelandic Securities Market*".

EU Interchange Fee Regulation

The EU Interchange Fee Regulation governs permissible levels of interchange fees for card-based payment transactions and how this has been implemented in Icelandic law. Under the EU Interchange Fee Regulation, interchange fees in the European Union have been capped at 0.3% of transaction value for credit cards and the lesser amount of 0.2% or €0.05 per transaction for debit cards, although individual EU member states are free to mandate even lower caps. The EU Interchange Fee Regulation has not been implemented in Iceland yet, but according to information from the Ministry of Finance, it is expected to be implemented in Iceland in the course of 2018. Implementation in Iceland will not generally affect debit card fee levels as the cap is already set at that level in Iceland for certain institutions due to a settlement with the ICA for cards acquired by Valitor and Borgun, but it is expected to have an impact on Arion Bank's revenue from domestic credit card turnover. The domestic interchange rate fee cap in Iceland applicable to the Group is now set at 0.6% but is expected to be set at 0.3% resulting in a degree of revenue loss, which Arion Bank has budgeted for.

Principal Governmental Authorities

The primary regulatory and inspection bodies active in the Icelandic financial system are described below.

FME

The FME is responsible for the supervision of the whole range of financial institutions as well as insurance companies and pension funds. The FME supervises the activities of Arion Bank as a commercial bank, Stefnir as an UCITS management company, Valitor hf. as a credit undertaking and Vördur as an insurance company. Iceland has implemented a number of European Union instruments regarding financial institutions and, accordingly, the FME has extensive authority over such entities.

In addition to the proposed legislative amendments summarised in "*—Principal Legislation and Regulations*", the FME has been working with the Icelandic government on the transposition of further European Union instruments into Icelandic law and regulations. This includes Directive (2014/17/EU) on credit agreements for consumers relating to residential immovable property ("**MCR**"), which was transposed into legislation with Act No 118/2016 and entered into force on 1 April 2017, and Regulation (236/2012) on short selling and certain aspects of credit default swaps ("**SSR**"), which was transposed into legislation with Act No 55/2017 and entered into force on 1 July 2017, and Regulation (648/2012) on over-the-counter derivatives, central counterparties and trade repositories ("**EMIR**"), which was transposed into legislation with Act No. 15/2018 and will enter into force on 1 October 2018. Other instruments expected to be relevant to the Group include the following:

- Regulation (909/2014) on improving securities settlement in the European Union and on central securities depositories ("**CSDR**");
- Regulation (596/2014) on market abuse ("**MAR**"); and
- Directive (2014/57/EU) on criminal sanctions for insider dealing and market manipulation ("**CSMAD**").

Once the piecemeal transposition of the above instruments has concluded, a wholesale review of changes to the regulatory framework of financial services is due to take place with a view to assessing whether a new consolidated Financial Undertakings Act should be enacted.

The activities of the FME are primarily governed by the Financial Activities Supervision Act No.87/1998 and Act No. 99/1999 on the Payment of Costs for Public Supervision of Financial Activities, as amended. A wholesale revision of these acts is anticipated once pending implementation of European Union instruments has been completed. The bill has not yet been submitted to the Icelandic Parliament.

Icelandic Central Bank

The Icelandic Central Bank is responsible for implementing a monetary policy consistent with the goal of maintaining price stability and foreign exchange reserves as well as promoting a sound and efficient financial system, including domestic and cross-border payment systems. The activities of the Icelandic Central Bank are primarily governed by Act No. 36/2001 on the Central Bank. The Icelandic Central Bank imposes a reserve requirement on all commercial banks and savings banks. The purpose of this requirement is to ensure that such credit institutions are able to meet fluctuations in their liquidity positions. The Icelandic Central Bank also oversees surveillance of the Capital Controls and is responsible for granting specific exemptions upon application. See "*Risk Factors—Risks Relating to Business and Industry—The Capital Controls restrict the manner in which the Bank conducts its business and may result in abnormal pricing and financial bubbles in Iceland*".

ICA

One of the responsibilities of the ICA is enforcing the requirements and prohibitions of the Competition Act and, as applicable, Articles 53 and 54 of the EEA Agreement. This includes providing exemptions on the basis of the Competition Act, deciding on measures to be taken against anti-competitive behaviour of undertakings, monitoring the development of competition and trade practices in individual market sectors in Iceland and investigating the management and ownership relations between institutions.

The supervisory work of the ICA extends to all forms of business activities, regardless of whether such activities are conducted by individuals, companies, public entities or other parties. Financial markets have been the subject of particular scrutiny by the ICA and, in 2011 and 2013, the ICA published reports on the then current state of financial services in Iceland with a particular focus on Arion Bank, Íslandsbanki and Landsbankinn.

Fines imposed by the ICA for violations of the Competition Act may amount to up to 10% of an entity's total turnover of the prior business year of any undertaking or association of undertakings involved in a violation. In determining the amount of fines, the ICA is obliged to take account of the nature and extent of the violations, as well as their duration and whether repeated violations are involved. Fines may be waived or reduced if an undertaking has taken the initiative in providing information or documents to the ICA concerning violations. A decision to impose a fine may further be waived if a violation is regarded as insignificant.

SELECTED CONSOLIDATED FINANCIAL, OPERATING AND OTHER INFORMATION

The selected consolidated financial information of the Bank as of and for the years ended 31 December 2017, 2016 and 2015 has, unless otherwise stated, been derived from the Annual Financial Statements included elsewhere in this Prospectus.

In order to present information on a consistent basis with the presentation adopted in the consolidated financial statements of the Bank for the year ended 31 December 2017, certain information in the consolidated financial statements as of and for the years ended 31 December 2016 and 31 December 2015 included in "*Summary*", "*Selected Consolidated Financial, Operating and Other Information*" and "*Operating and Financial Review*" has been reclassified as described in "*Presentation of Financial and Other Information—Presentation of Financial Information*".

As such, the selected consolidated financial information for the year ended 31 December 2016 has been derived from the comparative information included in Arion's Bank audited consolidated financial statements for the year ended 31 December 2017 that reflect those line item reclassifications. Similarly, the selected financial information for the year ended 31 December 2015 has been derived from the comparative information included in Arion Bank's audited consolidated financial statements for the year ended 31 December 2016 that reflect those line item reclassifications or from the accounting records. Therefore, in respect of these line items, the consolidated statements of comprehensive income for the year ended 31 December 2016 and for the year ended 31 December 2015 differ from the respective audited Annual Financials Statements included herein.

The selected condensed consolidated interim financial information of the Bank as of and for the three months ended 31 March 2018 has, unless otherwise stated, been derived from the Bank's unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018.

On 1 January 2018, the Group adopted IFRS 9, Financial Instruments ("**IFRS 9**") and, as permitted by the transition provisions of IFRS 9, the comparative period was not restated; accordingly, all comparative period information presented in this Prospectus is presented in accordance with International Accounting Standard 39, Financial Instruments: Recognition and Measurement ("**IAS 39**"). The Group also elected, as a policy choice permitted under IFRS 9, to continue to apply hedge accounting under IAS 39. The impact of the adoption of the new standard of ISK 942 million has been recognised directly in retained earnings on 1 January 2018.

In addition, on 1 January 2018 the Group also adopted IFRS 15, Revenue from Contracts with Customers ("**IFRS 15**"). IFRS 15 was applied using the modified retrospective method, with the effect of initial application recognised on the date of initial application and without restatement of the comparative periods. The adoption of IFRS 15 did not, in the Bank's view, have a material impact on the Consolidated Statement of Comprehensive Income.

The audited consolidated financial statements as of and for the years ended 31 December 2017, 2016 and 2015 do not reflect the changes from the application of IFRS 9 and IFRS 15. Those audited consolidated financial statements applied International Accounting Standard ("**IAS**") 39, Financial Instruments: Recognition and Measurement ("**IAS 39**") and IAS 18, Revenue ("**IAS 18**"), which were the accounting standards in effect at the time for each period. Therefore, due to the adoption of the new accounting standards, the consolidated financial statements as of and for the years ended 31 December 2017, 2016 and 2015 and the comparative figures as of and for the three months period ended 31 March 2017, are not directly comparable with the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018.

The selected consolidated financial information set forth below should be read in conjunction with, and is qualified by reference to, "*Operating and Financial Review*" and "*Consolidated Financial Statements*". The results of operations for any period are not necessarily indicative of the results to be expected for any future period.

Consolidated Statement of Comprehensive Income

	Three months ended 31 March		Year ended 31 December		
	2018	2017	2017	2016	2015
	(ISK in millions)				
Interest income	14,162	13,723	57,089	61,655	54,546
Interest expense	(7,254)	(6,563)	(27,254)	(31,755)	(27,554)
Net interest income	**6,908**	**7,160**	**29,835**	**29,900**	**26,992**
Fee and commission income	8,197	6,091	29,777	23,887	21,234
Fee and commission expense	(4,655)	(2,761)	(14,420)	(9,909)	(6,750)
Net fee and commission income	**3,542**	**3,330**	**15,357**	**13,978**	**14,484**
Net financial income	1,340	1,230	4,091	5,162	12,844
Net insurance income	143	447	2,093	1,395	760
Share of profit of associates and net impairment	(18)	(34)	(925)	908	29,466
Other operating income	269	564	2,927	3,203	2,074
Operating income	**12,184**	**12,697**	**53,378**	**54,546**	**86,620**
Salaries and related expense	(4,636)	(4,222)	(17,189)	(16,659)	(14,892)
Other operating expenses	(3,996)	(3,834)	(12,772)	(13,881)	(12,919)
Bank Levy	(804)	(797)	(3,172)	(2,872)	(2,818)
Net impairment	(99)	880	186	7,236	(3,087)
Earnings before tax	**2,649**	**4,724**	**20,431**	**28,370**	**52,904**
Income tax expense	(818)	(1,371)	(5,806)	(6,631)	(3,225)
Net earnings from continuing operations	**1,831**	**3,353**	**14,625**	**21,739**	**49,679**
Discontinued operations, net of tax	118	—	(206)	—	—
Net earnings	**1,949**	**3,353**	**14,419**	**21,739**	**49,679**
Other comprehensive income					
Net gain on financial assets carried at fair value through OCI, net of tax	30	—	—	—	—
Realised net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement	(97)	—	—	—	—
Net gain on AFS financial assets, net of tax	—	—	—	(2,903)	2,903
Exchange difference on translating foreign subsidiaries	59	44	(5)	182	13
Total comprehensive income	**1,823**	**3,397**	**14,414**	**19,018**	**52,595**
Shareholders of Arion Bank	1,823	3,396	14,395	18,426	44,884
Non-controlling interest	—	1	19	592	7,711

Consolidated Statement of Financial Position

	As of 31 March	As of 31 December		
	2018	2017	2016	2015
		(ISK in millions)		
Assets				
Cash and balances with Central Bank	97,934	139,819	87,634	48,102
Loans to credit institutions	94,961	86,609	80,116	87,491
Loans to customers	782,255	765,101	712,422	680,350
Financial instruments	106,415	109,450	117,456	133,191
Investment property	6,749	6,613	5,358	7,542
Investments in associates	743	760	839	27,299
Intangible assets	13,498	13,848	11,057	9,285
Tax assets	611	450	288	205
Non-current assets and disposal groups held for sale	8,496	8,138	4,418	5,082
Other assets	20,107	16,966	16,436	12,496
Total assets	**1,131,769**	**1,147,754**	**1,036,024**	**1,011,043**
Liabilities				
Due to credit institutions and Central Bank	7,880	7,370	7,987	11,387
Deposits	453,059	462,161	412,064	469,347
Financial liabilities at fair value	3,130	3,601	3,726	7,609
Tax liabilities	6,885	6,828	7,293	4,922
Other liabilities	55,715	57,062	54,094	49,461
Borrowings	400,855	384,998	339,476	256,058
Subordinated liabilities	—	—	—	10,365
Total liabilities	**927,524**	**922,020**	**824,640**	**809,149**
Equity				
Share capital and share premium	58,722	75,861	75,861	75,861
Other reserves	14,880	16,774	19,761	4,548
Retained earnings	130,515	132,971	115,590	112,377
Total shareholders' equity	**204,117**	**225,606**	**211,212**	**192,786**
Non-controlling interest	128	128	172	9,108
Total equity	**204,245**	**225,734**	**211,384**	**201,894**
Total liabilities and equity	**1,131,769**	**1,147,754**	**1,036,024**	**1,011,043**

Consolidated Statement of Cash Flows

	Three months ended 31 March		Year ended 31 December		
	2018	2017	2017	2016	2015
	(ISK in millions)				
Operating activities					
Net earnings	1,949	3,353	14,419	21,739	49,679
Non-cash items included in net earnings and other adjustments	(5,987)	(6,776)	(25,372)	(30,516)	(51,720)
Changes in operating assets and liabilities	(12,894)	91,860	47,923	(3,404)	16,109
Interest received	13,113	10,467	60,428	61,335	41,178
Interest paid[(1)]	(4,776)	(3,896)	(28,623)	(30,926)	(22,108)
Dividend received	95	84	320	2,280	7,954
Income tax paid	(1,158)	(515)	(6,432)	(3,032)	(4,499)
Net cash from operating activities	**(9,658)**	**94,577**	**62,663**	**17,476**	**36,593**
Investing activities					
Acquisition of associates	—	(54)	(961)	(76)	(262)
Acquisition of subsidiary	—	—	(2,123)	(5,300)	—
Cash and cash equivalents acquired through business combinations	—	—	127	1,068	—
Proceeds from sale of associates	—	—	41	27,291	17,148
Dividend received from associates	—	41	74	153	611
Disposal of subsidiary	—	—	—	293	—
Acquisition of intangible assets	(436)	(324)	(1,657)	(1,247)	(790)
Acquisition of property and equipment	(187)	(262)	(776)	(1,040)	(711)
Proceeds from sale of property and equipment	—	67	239	224	30
Net cash (used in) from investing activities	**(623)**	**(532)**	**(5,036)**	**21,366**	**16,026**
Financing activities					
Payment of subordinated liabilities	—	—	—	(8,785)	(19,883)
Dividend paid to shareholders of Arion Bank	(24,254)	—	—	—	(12,809)
Disbursement of share capital and dividend to non-controlling interest	—	—	(63)	(9,386)	—
Acquisition of non-controlling interest	—	—	—	—	(118)
Net cash used in financing activities	**(24,254)**	**—**	**(63)**	**(18,171)**	**(32,810)**
Net increase (decrease) in cash and cash equivalents	(34,535)	94,045	57,564	20,671	19,809
Cash and cash equivalents at beginning of the period	181,898	123,933	123,933	110,000	91,715
Effect of exchange rate changes on cash and cash equivalents	(1,047)	439	401	(6,738)	(1,524)
Cash and cash equivalents at the end of the period	**146,316**	**218,417**	**181,898**	**123,933**	**110,000**
Non-cash investing transactions					
Assets acquired through foreclosure on collateral from customers with view to resale	319	286	835	1,830	2,768
Settlement of loans through foreclosure on collateral from customers with view to resale	(319)	(286)	(835)	(1,830)	(2,768)
Non-cash changes due to acquisition of United Silicon					
Non-current assets and disposal groups held for sale	—	—	4,537	—	—
Borrowings	—	—	(4,537)	—	—
Non-cash changes due to funding agreement with Kaupthing					
Deposits	—	—	—	41,409	—
Borrowings	—	—	—	(41,109)	—

	Three months ended 31 March		Year ended 31 December		
	2018	2017	2017	2016	2015
	(ISK in millions)				
Non-cash items included in net earnings					
Net interest income	(6,908)	(7,160)	(29,837)	(29,900)	(26,992)
Net impairment	99	(880)	(186)	(7,236)	3,087
Income tax expense	818	1,371	5,806	6,631	3,135
Bank Levy	804	797	3,172	2,872	2,818
Net foreign exchange loss (gain)	208	32	(122)	1,253	182
Net gain on financial instruments	(1,332)	(1,178)	(3,649)	(4,135)	(5,072)
Depreciation and amortisation	560	508	2,132	1,842	1,656
Share of profit of associates and net impairment	18	34	925	(908)	(29,466)
Investment property, fair value change	(136)	(93)	(1,036)	(290)	(422)
Revised Depositors' and Investors' Guarantee Fund expense	—	—	(2,669)	—	—
Discontinued operations, net of tax	(118)	—	206	—	(360)
Other changes	—	(23)	(114)	(645)	(286)
Non-cash items included in net earnings	**(5,987)**	**(6,592)**	**(25,372)**	**(30,516)**	**(51,720)**
Changes in operating assets and liabilities					
Mandatory reserve with Central Bank	(170)	366	108	3,303	(3,700)
Loans to credit institutions, excluding bank accounts	(3,187)	15,156	(2,879)	(22,769)	13,637
Loans to customers	(19,780)	(2,837)	(59,413)	(46,537)	(29,588)
Financial instruments and financial liabilities at fair value	3,307	8,268	15,512	11,854	(23,655)
Investment property	—	(460)	(204)	1,440	54
Other assets	(1,203)	46	993	481	2,660
Due to credit institutions and Central Bank	517	1,621	(702)	(3,151)	(11,266)
Deposits	(9,007)	60,792	50,653	(9,586)	19,704
Borrowings	19,625	13,163	42,071	68,016	53,070
Other liabilities	(2,996)	(4,439)	1,784	(6,455)	(4,807)
Changes in operating assets and liabilities	**(12,894)**	**91,676**	**47,923**	**(3,404)**	**16,109**
Cash and cash equivalents					
Cash and balances with Central Bank	97,934	178,593	139,819	87,634	48,102
Bank accounts	57,776	48,790	51,303	45,631	74,533
Mandatory reserve deposit with Central Bank	(9,394)	(8,966)	(9,224)	(9,332)	(12,635)
Cash and cash equivalents	**146,316**	**218,417**	**181,898**	**123,933**	**110,000**

(1) Interest paid includes interest credited to deposit accounts at the end of the period.

Reconciliation of Consolidated Statement of Financial Position, transition from IAS 39 to IFRS 9 as of 1 January 2018

	IAS 39 as of 31 December 2017	Impact of classification and measurement	Impact of impairment[1]	Total impact	IFRS 9 as of 1 January 2018
			(ISK in millions)		
Assets					
Cash and balances with Central Bank	139,819	—	(7)	(7)	139,812
Loans to credit institutions	86,609	—	(3)	(3)	86,606
Loans to customers	765,101	486	930	1,416	766,517
Financial instruments	109,450	—	—	—	109,450
Investment property	6,613	—	—	—	6,613
Investments in associates	760	—	—	—	760
Intangible assets	13,848	—	—	—	13,848
Tax assets	450	—	—	—	450
Non-current assets and disposal groups held for sale	8,138	—	—	—	8,138
Other assets	16,966	—	—	—	16,966
Total assets	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**
Liabilities					
Due to credit institutions and Central Bank	7,370	—	—	—	7,370
Deposits	462,161	—	—	—	462,161
Financial liabilities at fair value	3,601	—	—	—	3,601
Tax liabilities	6,828	97	138	235	7,063
Other liabilities	57,062	—	229	229	57,291
Borrowings	384,998	—	—	—	384,998
Total liabilities	**922,020**	**97**	**367**	**464**	**922,484**
Equity					
Share capital and share premium	75,861	—	—	—	75,861
Other reserves	16,774	—	3	3	16,777
Retained earnings	132,971	389	550	939	133,910
Total shareholders' equity	**225,606**	**389**	**553**	**942**	**226,548**
Non-controlling interest	128	—	—	—	128
Total equity	**225,734**	**389**	**553**	**942**	**226,676**
Total liabilities and equity	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**

(1) Impact of impairment arises not from a specific asset or assets but rather from the application of the new "expected credit loss" impairment models.

Certain Other Financial Information

The table below and the table under the heading "—*Adjusted Income Statement Information*" set forth the other financial information and Non-IFRS Information and KPIs as of and for the periods indicated, along with explanatory notes. This section should be read in conjunction with "*Presentation of Financial and Other Information—Presentation of Financial Information—KPIs and Non-IFRS information*". The Non-IFRS Information does not constitute measurements of performance or liquidity under IFRS or any other generally accepted accounting principles. Investors should not place undue reliance on this Non-IFRS Information and KPIs and should not consider these measures as: (a) an alternative to profit from operating activities or profit as determined in accordance with IFRS, or as measures of operating performance; (b) an alternative to cash flows from operating, investing or financing activities, as determined in accordance with IFRS, or a measure of the Group's ability to meet cash needs; or (c) an alternative to any other measures of performance under IFRS. These measures are not indicative of the Group's historical operating results, nor are they meant to be predictive of future results. Arion Bank has presented these supplemental measures because they are used by the Bank to monitor the underlying performance of its business and operations. Since all companies do not calculate these measures in an identical manner, the Group's presentation may not be consistent with similar measures used by other companies.

See "—*Adjusted Income Statement Information*" below for descriptions of the adjusted metrics and the rationale for presenting adjusted figures as an alternative measure of performance.

	As of and for the three months ended 31 March		As of and for the year ended 31 December		
	2018	2017	2017	2016	2015
	(%, unless otherwise indicated)				
Return on equity(1)	3.6	6.3	6.6	10.5	28.1
* Adjusted return on equity(2)	2.6	3.9	4.8	4.7	8.7
Return on assets(3)	0.7	1.2	1.3	2.1	5.0
Return on risk-weighted assets(4)	1.0	1.8	1.9	2.9	6.7
Net interest margin on interest-earning assets(5)	2.6	2.8	2.9	3.1	3.0
* Adjusted net interest margin on interest-earning assets(6)	2.6	2.9	2.9	3.2	3.2
Net interest margin on total assets(7)	2.4	2.7	2.7	2.9	2.7
* Adjusted net interest margin on total assets(8)	2.4	2.7	2.7	3.0	2.9
Cost-to-income ratio(9)	70.8	63.5	56.1	56.0	32.4
* Adjusted cost-to-income ratio(10)	68.9	61.9	58.9	57.6	53.3
Cost-to-total assets ratio(11)	3.0	3.0	2.7	3.0	2.9
Coverage ratio(12)	n/a	72.4	80.5	77.4	75.8
Share of stage 3 loans(13)	3.2	n/a	n/a	n/a	n/a
Cost of risk (in bps)(14)	5.0	(49.1)	(2.5)	(103.0)	46.5
* Adjusted cost of risk (in bps)(15)	58.0	58.0	58.0	58.0	58.0

* Non-IFRS Information

(1) Return on equity is net earnings for the period as a percentage of average total equity, which is calculated as the average of the opening, quarter-end and closing balances for the applicable period. The Bank's return on equity excluding Valitor for the year ended 31 December 2017 would have been 6.6% (compared to 7.5% for the year ended 31 December 2016 and 29.6% for the year ended 31 December 2015). Valitor's profitability under this period has been significantly impacted by gains related to the sale of Visa Europe during 2016 and mark-to-market changes on Valitor's equity holding in Visa Inc. during 2017, as described in "*Operating and Financial Review—Financial Position and Results of Operations—Results of Operations for the years ended 31 December 2017, 2016 and 2015*". The return on equity excluding Valitor is Non-IFRS Information which the Bank considers in light of a possible disposal of Valitor and is calculated on the basis that transactions and balances between Valitor and the rest of the Group are treated on a third-party basis and are not eliminated upon consolidation. Excluding the effects of the Bank Levy and additional income taxes payable by the Bank as a financial institution, the Bank's return on equity would have been 8.2% in 2017 (2016: 12.6%). The return on equity excluding the effects of the Bank Levy and additional income taxes is Non-IFRS Information and is calculated by excluding the impact of the Bank Levy and the additional 6% tax on financial undertakings from net earnings, as a percentage of average total equity.

(2) Adjusted return on equity is Non-IFRS Information and is calculated as adjusted net earnings for the period as a percentage of average adjusted total equity. Average adjusted total equity represents the average of the opening balance and the closing balance plus adjusted net earnings less dividend payments for the applicable period.

(3) Return on assets is net earnings for the period as a percentage of average total assets. Average total assets are calculated as the average of the opening, quarter-end and closing balances for the applicable period.

(4) Return on risk-weighted assets is net earnings for the period as a percentage of average risk-weighted assets. Average risk-weighted assets are calculated as the average of the opening, quarter-end and closing balances for the applicable period. Risk-weighted assets represent a prudential measure by which the assets of the Bank are adjusted to give different weight to certain risk based considerations as a means to assess those assets relative to such risks. For additional information on the calculation of risk-weighted assets, see "*Operating and Financial Review—Capital Position*".

(5) Net interest margin on interest-earning assets is net interest income on interest-earning assets for the period less interest expense on interest-bearing liabilities as a percentage of average interest-earning assets. Average interest-earning assets are calculated as the average of the opening, quarter-end and closing balances for the applicable period. The table below sets forth the average interest-earning assets for the periods indicated.

	Three months ended 31 March		Year ended 31 December		
	2018	2017	2017	2016	2015
	(ISK in millions)				
Cash and balances with Central Bank	118,876	133,113	137,943	73,741	47,844
Loans to credit institutions	90,785	74,133	81,473	82,628	103,813
Loans to customers	773,678	716,310	736,463	703,164	664,577
Bonds and debt instruments	54,226	67,525	68,704	75,385	69,890
Derivatives	7,637	5,096	6,351	3,583	1,914
Interest-bearing securities used for economic hedging	6,587	7,832	7,090	3,932	2,594
Other interest-earning assets	9,769	8,815	11,290	7,480	7,033
Average interest-earning assets	**1,061,558**	**1,012,823**	**1,049,314**	**949,913**	**897,665**

See the note titled "*Financial assets and financial liabilities*" in the Annual Financial Statements. Net interest margin on interest-earning assets is a measure of the difference in the interest income generated by the Bank's interest-earning assets and its interest expense by reference to the average interest-earning assets for the relevant period. The higher this figure, the greater the returns from the Bank's interest-earning assets for such period.

(6) Adjusted net interest margin on interest-earning assets is Non-IFRS Information and is calculated using adjusted interest income on interest-earning assets and adjusted interest expense for the period. See note (5) above.

(7) Net interest margin on total assets is net interest income for the period as a percentage of average total assets, which is calculated as the average of the opening, quarter-end and closing balances for the applicable period. Net interest margin on total assets is a measure of the difference in the interest income generated by the Bank's total assets and its interest expense by reference to the average total assets for the relevant period. The higher this figure, the greater the returns from the Bank's total assets for that period.

(8) Adjusted net interest margin on total assets is Non-IFRS Information and is calculated using adjusted net interest income for the period. See note (7) above.

(9) With respect to cost-to-income ratio, "cost" means salaries and related expense and other operating expense for the period. "Income" means operating income for the period. Cost-to-income ratio is a measure of the Bank's costs as compared with its income. The lower this figure, the lower the Bank's costs relative to its income. The Bank's cost-to-income ratio excluding Valitor for the year ended 31 December 2017 would have been 50.6% (compared to 59.3% for the year ended 31 December 2016 and 28.2% for the year ended 31 December 2015). The cost-to-income ratio excluding Valitor is Non-IFRS Information which the Bank considers in light of a possible disposal of Valitor and is calculated on the basis that transactions and balances between Valitor and the rest of the Group are treated on a third-party basis and are not eliminated upon consolidation.

(10) Adjusted cost-to-income ratio is Non-IFRS Information and is calculated using adjusted operating expense and adjusted operating income for the period. See note (9) above.

(11) With respect to cost-to-total assets ratio, "cost" means salaries and related expense and other operating expense for the period. "Total assets" are calculated as the average of the opening, quarter-end and closing balances for the applicable period. Cost-to-total assets ratio is a measure of the Bank's costs as compared with its total assets. The lower this figure, the lower the Bank's costs relative to its total assets.

(12) Coverage ratio is a measure of the provision for losses on loans to customers at the end of the period as a percentage of the gross carrying amount of impaired loans to customers at the end of the period. The coverage ratio represents the portion of the face value of problem loans for which the Bank has made provisions. The Bank may not make a provision for the entire face value of the problem loan, if the Bank holds collateral or has information indicating that a provision for entire face value of the problem loan is not required. The higher this ratio, the more conservative is the Bank's valuation of the customer loan portfolio for the relevant period. Following the implementation of IFRS 9 as of 1 January 2018, the Bank now uses other measurements for loan quality, such as share of loans with specific provision.

(13) Share of stage 3 loans, gross is the measure of stage 3 classified loans of the total loan portfolio. Stage 3 loans consists of loans in default as defined by the Bank's definition of default, even if there is no specific provision needed due to collateral coverage.

(14) Cost of risk is calculated using the net impairment charges for the period as a percentage of average loans to customers which is calculated as the average of the opening, quarter-end and closing balances for the applicable period. Because the Bank's loan portfolio is comprised largely of loans that have been acquired, the Bank believes that cost of risk does not present a reliable measure of the cost of risk for the Bank for the periods under review, but rather reflects the price that the Bank paid for the loans.

(15) Adjusted cost of risk is Non-IFRS Information and is calculated using the adjusted impairment due to credit quality for the period as a percentage of average loans to customers for the period.

Adjusted Income Statement Information

The Bank does not as a matter of course make public projections as to future income, earnings, expenses or other results. However, the management of the Bank has prepared the financial information (described as "Adjusted") set forth below to remove the impact of the results of operations attributable to non-core assets, which consist of legacy equity holdings of non-core subsidiaries and other assets, such as investment property, which the Group had acquired as a result of restructuring of its loan portfolio following the financial crisis in 2008. The accompanying adjusted financial information was not prepared with a view toward public disclosure for any registration statement filed with the U.S. Securities and Exchange Commission or with a view toward complying with the guidelines established by the American Institute of Certified Public Accountants with respect to prospective financial information, but, in the view of the Bank's management, was prepared on a reasonable basis, reflects the best currently available estimates and judgements, and presents, to the best of management's knowledge and belief, the expected course of action and the expected future financial performance of the Bank. However, this information is not fact and should not be relied upon as being necessarily indicative of future results, and readers of this Prospectus are cautioned not to place undue reliance on the Adjusted financial information.

Neither the Bank's independent auditors, nor any other independent accountants, have compiled, examined, or performed any procedures with respect to the Adjusted financial information contained herein, nor have they expressed any opinion or any other form of assurance on such information or its achievability, and assume no responsibility for, and disclaim any association with, the Adjusted financial information.

The table below sets forth this Adjusted income statement information, which is presented as an alternative measure to provide an analysis of the Group's results of operations, which the Board of Directors believes is more comparable to what the results of the Group will be going forward, as its remaining non-core assets are divested. Additional detail on such adjustments appears in the footnotes below.

	Three months ended 31 March		Year ended 31 December		
	2018	**2017**	**2017**	**2016**	**2015**
	(ISK in millions)				
Net interest income	6,908	7,160	29,835	29,900	26,992
Adjustments(1)	—	66	17	530	1,347
Adjusted net interest income	6,908	7,226	29,852	30,430	28,339
Net fee and commission income	3,542	3,330	15,357	13,978	14,484
Adjustments(2)	—	—	—	81	7
Adjusted net fee and commission income	3,542	3,330	15,357	14,059	14,491
Net financial income	1,340	1,230	4,091	5,162	12,844
Adjustments(3)	—	(64)	—	(4,240)	(7,513)
Adjusted net financial income	1,166	1,166	4,091	922	5,331
Net insurance income	143	447	2,093	1,395	792
Share of profit of associates and net impairment and other operating income	251	530	2,002	4,111	31,540
Adjustments(4)	—	—	—	(1,020)	(29,579)
Adjusted share of profit of associates and net impairment and other operating income	251	530	2,002	3,091	1,961
Operating income	12,184	12,697	53,378	54,546	86,620
Cumulative adjustments to income(5)	—	2	17	(4,648)	(35,706)
Adjusted operating income	**12,184**	**12,699**	**53,395**	**49,898**	**50,914**
Salaries and related expense and other operating expense	(8,632)	(8,056)	(29,961)	(30,540)	(27,811)
Adjustments(6)	239	201	(1,490)	1,794	698
Adjusted salaries and related expense and other operating expense	(8,393)	(7,855)	(31,451)	(28,746)	(27,113)
Bank levy	(804)	(797)	(3,172)	(2,872)	(2,818)
Net impairment	(99)	880	186	7,236	(3,087)
Adjustments(7)	(1,023)	(1,919)	(4,071)	(11,275)	(764)
Adjusted net impairment	(1,122)	(1,039)	(3,885)	(4,039)	(3,851)
Income tax expense	(818)	(1,371)	(5,806)	(6,631)	(3,225)
Adjustments(8)	204	429	1,501	2,130	221
Adjusted income tax expense	(614)	(942)	(4,305)	(4,501)	(3,004)
Discontinued operations, net of tax	118	—	(206)	—	—
Net earnings	1,831	3,353	14,419	21,739	49,679
Total adjustments(9)	(580)	(1,287)	(4,043)	(11,999)	(35,672)
Adjusted net earnings	**1,369**	**2,066**	**10,376**	**9,740**	**14,097**

(1) Adjustments to net interest income represent calculated net interest income earned by the Bank, had the Bank not held non-core assets at the time and instead held the equivalent value in interest-bearing accounts, and interest income and expenses attributable to non-core subsidiaries. Non-core subsidiaries comprise BG12 slhf., which held the Group's interest in Bakkavor; EAB 1 ehf., a holding company controlled by the Group, which holds an indirect interest in European drink manufacturer Refresco; Eignabjarg, a holding company which had been responsible for managing and selling shareholdings in companies which the Bank has acquired through debt restructurings or other enforcement procedures and which was liquidated in 2015; and Landfestar, which managed all commercial real estate that the Bank acquired in the restructuring of its customer loan portfolio and which merged with Eik fasteignafélag hf. ("**Eik**") in 2014.

(2) Adjustments to net fee and commission income represent net fee and commission income attributable to non-core subsidiaries.

(3) Adjustments to net financial income represent changes in valuation and gain on sale of certain non-core subsidiaries. The table below sets forth the specific adjustments to net financial income for the periods indicated.

	Three months ended 31 March		Year ended 31 December		
	2018	2017	2017	2016	2015
	(ISK in millions)				
Change in valuation and profit from sale of Refresco	—	—	—	388	(3,377)
Gain on sale of Eik	—	—	—	—	(667)
Net financial income from subsidiaries	—	—	—	(25)	423
Change in valuation of and dividend from Stodir hf.	—	—	—	328	(3,892)
Gain on sale of Visa Europe	—	—	—	(5,291)	—
Other adjustments	—	—	—	361	—
Adjustments to net financial income	—	—	—	**(4,240)**	**(7,513)**

Any remaining non-core subsidiaries listed on a stock exchange and still held by the Group at each period end are excluded from the above adjustments, as holding equity interests in listed companies is a part of the normal business of the Bank.

(4) Adjustments to share of profit of associates and net impairment and other income, comprising share of profit of associates and net impairment and other operating income, represent changes in valuation and gain on sale of equity holdings held by the Group and adjustments for share of profit of associates and net impairment. The table below sets forth adjustments to other income for the periods indicated.

	Three months ended 31 March		Year ended 31 December		
	2018	2017	2017	2016	2015
	(ISK in millions)				
Changes in valuation and profit from sale of Reitir	—	—	—	—	(4,224)
Revised impairment and gain on sale of Bakkavor	—	—	—	(733)	(20,845)
Change in valuation and gain on sale of Síminn	—	—	—	—	(4,185)
Gain on sale of Kolufell	—	—	—	(227)	—
Other adjustments	—	—	—	(60)	(325)
Adjustments to other income	—	—	—	**(1,020)**	**(29,579)**

See "*Operating and Financial Review—Key Factors Affecting the Group's Business, Financial Position and Results of Operations—Acquisitions and Disposals*".

(5) Cumulative adjustments to operating income represent the sum of the adjustments in notes (1) to (4).

(6) Adjustments to salaries and related expense and other operating expense represent fines from ICA, expenses relating to branch restructuring, expenses relating to the non-core assets and the estimated expenses of 30 FTEs for the period, which management estimates as relating to non-recurring projects. Included in the numbers are also redundancy costs for 46 FTEs in 2016 and expenses in connection with the Offering. At the end of June 2017 Arion Bank received a confirmation from the Depositors' and Investors' Guarantee Investor Fund that a liability of ISK 2,669 million, relating to an old division within the fund, would not be collected. Therefore, a reversal has been reflected in the year ended 31 December 2017.

(7) Adjustments to net impairment represent all value changes on loans to customers for the period, which have been removed with an estimated impairment of 0.58% per annum calculated on the average book value of loans to customers, which represents management's best estimate of the impairment during the period. The table below sets forth adjustments to net impairment for the periods indicated.

	Three months ended 31 March		Year ended 31 December		
	2018	2017	2017	2016	2015
	(ISK in millions)				
Increase in value of loans	385	(673)	(1,856)	(11,980)	(4,696)
Impairment of loans	(484)	(207)	1,667	4,735	7,756
Impairment of other assets	—	—	3	9	27
Calculated impairment on loans of 0.58%	(1,023)	(1,505)	(3,885)	(4,039)	(3,581)
Adjustments to net impairment	**(1,122)**	**(1,039)**	**(4,071)**	**(11,275)**	**(764)**

(8) Adjustments to income tax expense represent the assumption of a 26.0% tax rate on relevant adjustments, as corporate tax rate amounted to 20.0% with additional 6.0% tax rate on net earnings above ISK 1.0 billion.

(9) Total adjustments to net earnings represent the sum of the adjustments in notes (5) to (9).

OPERATING AND FINANCIAL REVIEW

The following discussion of the financial condition and results of operations of Arion Bank should be read in conjunction with the Annual Financial Statements, together with the notes thereto, and with the information relating to the business of Arion Bank included elsewhere in this Prospectus. In particular, this section should be read in conjunction with the financial information of the Group as set forth in "Consolidated Financial Statements" and the other financial information contained elsewhere in this Prospectus, including under "Selected Consolidated Financial, Operating and Other Information" and "Selected Statistical Information".

In order to present information on a consistent basis with the presentation adopted in the consolidated financial statements of Arion Bank for the year ended 31 December 2017, certain information in the consolidated financial statements for the years ended 31 December 2016 and 31 December 2015 included in "Summary", "Selected Consolidated Financial, Operating and Other Information" and this Operating and Financial Review has been reclassified as described in "Presentation of Financial and Other Information—Forward-Looking Statements".

The following discussion includes forward-looking statements that reflect the current view of Arion Bank's management and involve risks and uncertainties. The actual results of Arion Bank could differ materially from those contained in any forward-looking statements as a result of factors discussed below and elsewhere in this Prospectus, particularly in "Risk Factors" and "Presentation of Financial and Other Information—Forward-Looking Statements". Prospective investors should read this Prospectus in its entirety and not just rely upon summarised information set forth in this Operating and Financial Review.

Overview

Arion Bank is a leading, privately owned universal relationship bank in Iceland with a differentiated and innovative approach. Arion Bank has established itself as a broad and well-balanced bank that provides products and services which meet the needs of Icelandic households and companies. Arion Bank's diversified and balanced approach to its business also means that it has a broad revenue base and a balanced and diverse loan portfolio with a moderate risk profile serving individuals and companies. For the years ended 31 December 2017, 2016 and 2015, respectively, Arion Bank's net interest income was ISK 29,835 million, ISK 29,900 million and ISK 26,992 million, its net fee and commission income was ISK 15,357 million, ISK 13,978 million and ISK 14,484 million, its operating income was ISK 53,378 million, ISK 53,546 million and ISK 86,620 million, and its net earnings were ISK 14,419 million ISK 21,739 million and ISK 49,679 million. As of 31 December 2017, Arion Bank's total assets were ISK 1,147,754 million.

Key Factors Affecting the Group's Business, Financial Position and Results of Operations

The Group's business, financial position and results of operations are affected by a number of factors, some of which are beyond its control. This section, which should be read in conjunction with "*Risk Factors*", sets forth certain key factors which have affected the Group's business, financial position and results of operations during the periods under review and could affect the Group in the future.

Macroeconomic Environment in Iceland

The macroeconomic environment in Iceland affects the Group's financial position and results of operations, in particular with respect to the housing and deposits markets, exchange rates, interest rates and specific regulatory actions related to the economy. In addition, the Group is subject to the conditions and trends of the Icelandic labour market, including with respect to levels of salaries and related expense in Iceland, which have been increasing during the periods under review. Since 2011, Icelandic GDP has experienced year-on-year growth with a strong outlook, while government debt as a percentage of GDP has been in decline, which is expected to continue *(source: Statistics Iceland, IMF)*.

The overall performance of the Icelandic economy drives economic activity, employment levels, housing prices and levels of personal wealth and disposable income, which affect the Group's performance. Unemployment affects the amount of defaults experienced by the Group in the Retail Banking division. Unemployment has been declining in the aftermath of the global financial crisis and, as of 31 December 2017, the unemployment rate was 2.9%, with a twelve-month moving average rate of unemployment of 2.8% *(source: Statistics Iceland)*. The principal source of recent growth in jobs in Iceland has been tourism related activities, such as accommodation and food services, transportation, storage and travel agencies and booking services.

Housing prices, which affect the Group's mortgage loans business, are broadly correlated with economic growth and have been increasing since 2011 *(source: Icelandic Central Bank, Statistics Iceland, Registers*

Iceland). The Group anticipates that housing prices in Iceland will continue to rise in the medium term, as disposable income is expected to increase and household debt is expected to continue to decrease, which in turn is expected to lead to increasing rates of homeownership *(source: Arion Bank Research subdivision)*. These developments reflect the increase in Icelandic GDP since 2011, which has supported the Group's performance during the periods under review.

Along with GDP, exchange rates and interest rates have a significant impact on the Group's performance. The appreciation of Icelandic Krona during the periods under review has had a negative impact on net interest income and the value of the Group's customer loan portfolio, as a significant proportion of the customer loan portfolio is denominated in currencies other than Icelandic Krona (19% as of 31 December 2017). In addition, inflation can have a significant impact on the Group's performance, as a proportion of its assets are linked to the Icelandic CPI. See "*—Net Interest Income, Net Interest Margin and Funding Mix*".

The continuing low interest rate environment experienced after the global financial crisis in 2008 has led to the correspondingly low pricing of the Group's customer assets and liabilities, especially with respect to mortgage and other loans and savings rates. The low interest rate environment and consequent lower rates on mortgage loans have made it easier for borrowers to service their debt. Low interest rates have also affected savers significantly, as savers have been offered in recent years lower savings rates on all but the longest-term savings products. The Bank believes that potential future increases in interest rates will tend to reverse these trends in the longer term, although it does not expect any such increases in interest rates in the medium term.

Proportion of Net Fee and Commission Income

The Group targets to increase the proportion of its operating income attributable to net fee and commission income across each of its operating segments. During the periods under review, the Asset Management segment and Valitor were the two largest contributors to fee and commission income, and this trend is expected to continue, as the easing of the Capital Controls can offer new possibilities for fees and commissions for transactions at Valitor, particularly given its intended international expansion, and in the asset management operations of Arion Bank. Net fee and commission income increased by 6.0% between 2015 and 2017, mainly due to increased activities in asset management and international operations in card and payment solutions at subsidiary Valitor, partly due to the acquisition of new subsidiaries, along with increased fee and commission income from the Retail Banking division.

Net fee and commission income is primarily driven by transaction volumes, particularly for credit and debit cards, but also for asset management services (including portfolio management and investment advice) and, to a lesser degree, investment banking services, including corporate finance advisory and brokerage services, collection and payment services, fees for the provision of loans and guarantees and other services. Net fee and commission income is also impacted by economic developments in general (*i.e.*, fewer payments and fewer fees overall as a result of lower economic activity) and the performance of capital markets in particular (lower number and volume of transactions resulting in decreased transaction and asset management fees). Transaction fees also benefit from volatility, even if markets go down.

Net Interest Income, Net Interest Margin and Funding Mix

The Group's ability to increase net interest income for a given period is influenced by the margins it can generate on its lending. Margins are driven by rates the Group charges on its lending relative to the cost of funding. The Group's principal lending activities are loans to customers (mortgage loans and other secured and unsecured loans to individual and corporate customers, credit cards and overdraft facilities) and to credit institutions (primarily bank accounts, but also money market and other loans). Its principal funding activities occur through deposits and other sources, including issuances of the Statutory Covered Bonds, issuances under its EMTN Programme and equity funding.

The Group calculates its net interest margin as its net interest income for a given period divided by its average interest-earning assets over such period, based on quarterly averages. The Group's net interest income (and consequently net interest margin) depends on, among other things, the interest income that the Group earns on its lending, which in turn depends on the rates it charges on its loans and the upfront fees it charges to its borrowers, which are included in interest income. Net interest margin has remained stable during the periods under review, amounting to 2.9%, 3.1% and 3.0% for the years ended 31 December 2017, 2016 and 2015, respectively. This slight compression in the Bank's net interest margin was partially due to low inflation and higher borrowing costs resulting from the Bank's liquidity in relatively high levels of liquid assets held in foreign currency during the year. The Bank's net interest margin as a percentage of average interest-bearing assets was 2.6% during the first quarter of 2018, compared with 2.8% for the same period in 2017, which decrease is partly due to the Bank holding relatively high amounts of cash and cash equivalents in foreign currency, which bear low interest rates, and to pressure on the Banks' interest rates in a highly competitive environment with decreasing interest rates, both for corporate and retail customers. Increased inflation, a more normalised liquidity position and improved funding rates are expected to contribute to net interest margin going forward; however, the Bank believes that other factors, such as increased competition in the lending market, as well as increased interest costs from the issuance of any AT1 or Tier 2 capital instruments, would likely offset any such increases in net interest margin, and therefore expects further slight reductions in net interest margin from 2017 levels.

The cost of the Group's liabilities depends on the rate of interest paid on its sources of funding. Changes in the cost of deposits or other borrowings could have a significant impact on the Group's net interest income, net interest margin and profitability. The composition of the Group's funding has changed significantly over the last few years, as the Capital Controls have been gradually eased and deposits from financial entities being wound up with low interest rates have been paid off and replaced with long-term funding denominated in Icelandic Krona and foreign currencies with a higher yield. The Group's strategy is to seek to increase the maturity profile of its liabilities and to strengthen the Group's liquidity reserve. As of 31 December 2009, over 90% of the Group's deposits were on demand, as compared to 71.8% as of 31 December 2017. A large proportion of the Group's lending is linked to CPI in Iceland and, as such, the spread between deposit rates and the Group's CPI-linked and other assets will affect the Group's net interest margin. As inflation has been low in Iceland since 2013, this has generally had a negative effect on the Group's net interest margin, as the Group has more CPI-linked assets than liabilities. See "—*Funding*".

The Bank has significant CPI-linked assets and liabilities. As of 31 December 2017, CPI-linked assets amounted to ISK 363,791 million and CPI-linked liabilities amounted to ISK 230,851 million. Accordingly, after netting out the CPI-linked assets against the CPI-linked liabilities, the CPI-linked balance amounted to net assets of ISK 132,940 million as of 31 December 2017, as compared to ISK 115,960 million as of 31 December 2016. The impact of such imbalance between the CPI-linked assets and liabilities on the financial statements of the Group depends on the level of inflation in Iceland and changes in the CPI. The impact is reflected in net interest income in the Group's consolidated statement of comprehensive income. In general, an increase of 1.0% in the rate of inflation in Iceland results in a corresponding increase of 1.0% of the net imbalance reflected in net interest income.

Cost and Efficiency Management

During the periods under review, the Bank has sought to reduce its operating expenses, mainly through automation and further optimisation in both back office functions and the Bank's branch network. The Bank has optimised its branch network, for example in its business premises, changes in opening hours and sharing of services and other measures which increase operational synergies, and reduced the total size of its branch network by approximately 2,771 m^2 in the last five years (equivalent to approximately 9% of the size of its current operations). In March 2018, the Bank announced plans to merge certain branches and focus on optimising its branch network by reducing square metres occupied and to have digital branches, resulting in closing three branches. In September 2016, the Bank laid off approximately 6% of its workforce in connection with efficiency measures. The layoffs came from all divisions of the Bank and did not affect other companies in the Group. In the periods under review, the total number of employees at the Bank has remained relatively static, even though the Bank has undertaken a number of additional initiatives in the period, including opening of the branch at the Keflavík international airport and increased IT and marketing initiatives, including digital banking.

The Bank has invested heavily in the introduction of a lean banking system, which is designed to ensure efficiency throughout the Group with the ultimate goal of strengthening relationships and improving the level of service to customers. These cost efficiency measures have helped to drive improvements in the Group's cost-to-income ratio, which have been temporarily offset by growth initiatives at Valitor and at the initiatives described above, as well as salary increases under wage agreements and lower revenues derived from other sources, with the objective to implement cost efficiency measures to achieve improvements in the cost-to-income ratio going forward. According to the wage agreement applicable to the financial sector in Iceland, the salaries of all of the Bank's employees increased by 5% in May 2017 and will increase by 5% in May 2018, which is expected to have a corresponding impact on salaries and related expense.

Regulatory Developments

The Group is subject to regulation at both local and international levels. Regulations are subject to constant change and this environment has affected, and will continue to affect, the Group's results of operations in a number of ways. Principal European regulations which have had or could have an impact on the Group's results of operations include the Basel III framework, implemented through the CRD IV Directive and the CRR, the BRRD and MiFID 2. Although over time, the Group expects that there will be convergence between Iceland and the rest of Europe on the implementation of these measures, in some circumstances the Icelandic implementation could be more onerous than expected or than is otherwise imposed in other European countries, which could lead to pricing disadvantages for the Group. Moreover, given the Group's small size relative to other financial services providers in Europe, its compliance costs relative to the size of its overall operations could be high.

See "*Regulatory Overview*", "*Risk Factors—Risks Relating to Business and Industry—There are regulatory and legal risks inherent in the Bank's businesses*", "*Risk Factors—Risks Relating to Business and Industry—The Bank is involved in a number of ongoing legal proceedings and is subject to investigations by governmental authorities*", "*Risk Factors—Risks Relating to Business and Industry—Changes to the Capital Requirements Directives could adversely affect the Bank's results*" and "*Risk Factors—Risks Relating to the Offering and the Offer Securities—Recovery and resolution regimes may affect the rights and remedies of holders of the Offer Securities*".

As an Icelandic financial services provider, the key regulatory developments relating to the Group's financial position and results of operations during the periods under review are summarised below.

Bank Levy

The Bank Levy is an annual levy mandated by Icelandic law, under which the Group must currently pay a tax on total liabilities (excluding tax liabilities) in excess of ISK 50.0 billion. Therefore, as the Group's funding liabilities increase, the impact of the Bank Levy increases correspondingly, which affects the Group's earnings before tax. Non-financial subsidiaries of the Group are exempt from this tax. Although the Bank Levy was intended as a temporary measure when it was first instituted in December 2010, there is currently no indication of when it will be eliminated, although the latest budget from the Icelandic government indicates that the Bank Levy could be reduced in the medium term. The Bank Levy remained at the level of 0.376% of total liabilities (excluding tax liabilities) in excess of ISK 50.0 billion for each of the years ended 31 December 2017, 2016 and 2015. See "*Risk Factors—Risks Relating to Business and Industry—The Bank is subject to additional taxes beyond corporate income tax, which impose costs and competitive disadvantages*".

Easing of the Capital Controls

As a result of the financial crisis in 2008, the Icelandic Central Bank introduced the Capital Controls in November 2008, which are in the process of being eased and, as of the date of this Prospectus, have been largely lifted. The Capital Controls resulted in a large number of deposits of foreign investors being forced to stay within Iceland, which supported the Bank's lending and afforded it high levels of liquidity, although this was balanced by the perception that, upon easing of the Capital Controls, such deposits would quickly leave Iceland and, in turn, led to higher funding costs for the Bank in the international capital markets. As the Capital Controls are eased, it is expected that funding costs will decrease despite this perception of deposit flight. Other than deposits in respect of entities being wound up, which the Bank had already accounted for, the Bank has not experienced a significant deposit outflow nor any material changes in deposit pricing as a result of the easing of the Capital Controls to date.

In addition, the Capital Controls increased the regulatory and compliance burdens on the Group when undertaking transactions in foreign currency, which particularly impacted the Investment Banking division and the asset management operations of Arion Bank relating to foreign securities, where trading volumes, and consequently net fee and commission income, had diminished. It is expected that the easing of the Capital Controls will have a positive impact on the Group's ability to engage in these operations again, although there can be no assurance that volumes will increase as a result.

For more information on the Capital Controls, see "*Regulatory Overview—Principal Legislation and Regulations—Foreign Exchange Act—Capital Controls*" and "*Risk Factors—Risks Relating to Business and Industry—The Capital Controls restrict the manner in which the Bank conducts its business and may result in abnormal pricing and financial bubbles in Iceland*".

Acquisitions and Disposals

As a result of the financial crisis in 2008 and the loan restructuring process which resulted from it, the Group acquired significant shareholdings in troubled companies following a restructuring of its loan portfolio and also acquired or absorbed operations (including assets and liabilities) of other financial institutions in Iceland. These acquisitions and, in the case of the shareholdings in troubled companies, any related disposals had a significant impact on the Group's business, financial position and results of operations during the periods under review, particularly in terms of their impact on operating income through the line item share of profit of associates and net impairment, which has consequently experienced significant variation during the periods under review. However, the disposals have now been substantially concluded and are therefore not expected to have a significant impact on the Group's business going forward. For additional information on such disposals and their impact on the Group's reported results of operations, see "*Business Overview—Business—Asset Portfolio Disposals*" and "*Selected Consolidated Financial, Operating and Other Information—Certain Other Financial Information—Adjusted Income Statement Information*".

In addition, in 2017 the Group acquired United Silicon, which is noted below, as a result of a loan restructuring process.

United Silicon

Arion Bank was primary lender to United Silicon, whose primary operations comprised a silicon production plant which commenced operations in November 2016. As of 31 December 2016, the Bank held a loan of ISK 6,277 million against United Silicon, collateralised with shares in the company and other assets. The Bank also had a 6% equity interest in United Silicon and an unsecured bond extended to United Silicon in the total amount of ISK 877 million.

In the second quarter of 2017, Arion Bank invested a further ISK 907 million in United Silicon, obtaining an equity interest of 16.3%, with voting rights of 23.9%, and thus United Silicon became an associate of the Bank, accounted for according to the equity method, less impairment. The purpose of the investment was to support the company in operating difficulties following repeated shutdowns of production at the plant. Due to continued operating difficulties, the Bank fully provisioned for its equity interest in United Silicon in an amount of ISK 1,164 million at the end of the second quarter of 2017, of which ISK 907 million was recognised through share of profit of associates and ISK 257 million through net financial income in the consolidated statement of comprehensive income.

As a result of these continued operating difficulties, United Silicon was granted a moratorium on payments on 14 August 2017. United Silicon used the moratorium period to analyse the reasons for the operating difficulties at its plant and to attempt to negotiate terms of a composition agreement with its creditors whereby payments would be deferred or converted into equity.

In September 2017, the Bank foreclosed on its collateral and took possession of the collateralised shares in United Silicon and became the largest shareholder of the company, with an interest ownership of 66.58% and voting rights of 66.68%, while remaining United Silicon's primary lender as well. With this transaction, the Bank acquired control of United Silicon and thus the company became a subsidiary of the Group. The fair value calculation of the underlying assets at the time of the foreclosure resulted in a provision on loans of ISK 2,962 million recognised in net impairment as well as fair value loss of the unsecured bond of ISK 708 million recognised in net financial income of the consolidated statement of comprehensive income. Including the impact of the calculated income tax effect, the total impact of United Silicon on the Group's results of operations for 2017 amounted to a reduction of the Group's net earnings in the amount of ISK 4,068 million.

As of 31 December 2017, the book value of assets of United Silicon held by the Group was ISK 5,219 million. As United Silicon was acquired exclusively with a view to resale, it has been classified as an asset held for sale and as a discontinued operation as of 31 December 2017 in accordance with IFRS 5.

The effects on the consolidated statement of financial position at the end of September 2017 when United Silicon became a subsidiary of the Group were a decrease in loans to customers of ISK 4,535 million (representing the fair value of the loans the Bank had extended to United Silicon), an increase in non-current assets and disposal groups held for sale of ISK 4,479 million (representing the fair value of the United Silicon assets) and an increase in deposits of ISK 56 million (representing United Silicon's bank account).

During the moratorium period, in order to analyse the operating difficulties at the plant, Icelandic and international specialists were hired to evaluate, as far as possible, whether and how much additional investment is needed to bring the plant up to full production capacity, both in terms of the quantity and quality of the products. The Bank monitored this analysis and in its assessment of fair value at the time of the foreclosure assumed that the plant would continue to operate, following additional investment. In light of this information, the Bank believed that the basis for running the plants operation was viable. However, in January 2018 it became clear that the Icelandic Environmental Agency did not fully agree with the remedial action proposed by the company following the evaluation. The Icelandic Environmental Agency found that limited further remedial actions would need to be undertaken in addition to what had been proposed, some of which was likely to require an additional environmental impact study which, in turn, was likely to postpone the recommissioning of the plant by 18-20 months. Against this backdrop and without funds to sustain operations for this period, the board of directors of United Silicon declared the company bankrupt on 22 January 2018.

As United Silicon's primary lender, the Bank has asserted a first lien position against all the operational assets of the company. In its capacity as such, the Bank has also demanded the transfer of these assets and accompanying rights to a newly established subsidiary of the Bank, Eignabjarg, established for this purpose. This transfer occurred in March 2018, in spite of protests by a limited number of United Silicon's unsecured creditors. The Bank has since experienced notable interest by investors in acquiring the new legal entity which holds the operational assets and, on that basis, intends to either find buyers for this new subsidiary in its current form or, alternatively, proceed with the necessary remedial action and divest the plant thereafter. The Bank estimates that it would cost approximately EUR 6 million to make the plant operational and a total of approximately EUR 25 million to bring it to optimal condition. Anticipated additional investments over the next 12 to 18 months are expected to be low, since they relate principally to the environmental impact study noted above. The anticipated investment period once all permits have been obtained is approximately six months.

The development of this project during 2017 had a significant effect on the Bank's net earnings. This effect is only partly included in the 2017 adjusted financial information included in this Prospectus, through the changes in the impairment calculation. If the effect of these provisions for its equity and bond investment had been included in the calculation of the adjusted financial information included in this Prospectus, it would have increased the Bank's adjusted return on equity for 2017 from 4.8% to 5.5%.

Vördur Acquisition

In September 2016, the Bank acquired all shares in Vördur, following the approval of the ICA, for a total consideration, including cash paid and liabilities assumed, of ISK 14,483 million. The results of operations of Vördur have been consolidated with the results of the Group since 1 October 2016.

Sale of Bakkavor

In January 2016, the Bank‘s subsidiary BG12 slhf. sold its entire shareholding in the subsidiary Bakkavor Group Ltd. The profit from the sale was ISK 498 million and was recognised in the statement of comprehensive income in 2016.

See "*Risk Factors—Risks Relating to Business and Industry—The Bank could incur unforeseen liabilities from prior and future acquisitions and disposals*".

Growth of Customer Loan Portfolio and Impairment Losses

The Group's ability to increase the volume of loans it extends to customers has been an important factor contributing to growth in net interest income during the periods under review. The Group's customer loan portfolio has increased from ISK 680,350 million as of 31 December 2015 to ISK 712,422 million as of 31 December 2016 and ISK 765,101 million as of 31 December 2017. This has been driven in part by an increase in lending in various industry sectors, such as real estate and tourism-related businesses and, to a lesser extent, increased lending to individuals, including mortgage lending, where Arion Bank was the first of the three large Icelandic banks to return to mortgage lending after the financial crisis in 2008. Mortgage lending is expected to be a main driver in lending volumes in the medium term, in line with expected growth in private consumption generally. Although mortgage lending by pension funds has increased in the periods under review, the Bank views such lending as a temporary phenomenon. Additionally, general infrastructure growth in Iceland is expected to result in an increase in demand for corporate lending in the medium term.

The customer loan portfolio covers lending in both the Retail Banking division (to individuals and SMEs) and the Corporate Banking division (to larger corporates), with the Retail Banking division accounting for 65.4% of the customer loan portfolio (including 47.7% of loans to individuals) and the Corporate Banking division accounting for 34.2% of the customer loan portfolio as of 31 December 2017. Geographically, as of 31 December 2017, 96.8% of the loans related to Icelandic customers and 3.2% related to international customers. In terms of collateral, as of 31 December 2017, 85.1% of the customer loan portfolio was collateralised and 91.7% of loans to individuals were collateralised. The customer loan portfolio is also highly concentrated in Icelandic borrowers, albeit spread almost relatively evenly across individuals and companies and, with respect to companies, with a diverse spread across a range of industry sectors.

Defaults by the Group's customers on their loan payment obligations could adversely affect the Group's financial position and results of operations. The Bank believes that the Group has a high quality financial position and that the Group's robust asset quality has been maintained during the periods under review, as problem loans, defined as (i) loans (based on book value) more than 90 days past due but not impaired plus (ii) other problem (*i.e.*, individually impaired) loans, have decreased and provisioning for impaired loans has improved, which the Bank expects to continue in the short to medium term.

Arion Bank has used two main indicators for the quality of its customer loan portfolio: (i) the ratio of problem loans over the Bank's total loans to customers and (ii) the ratio of loans which have been impaired over the Bank's total loans to customers. Following the implementation of IFRS 9 as of 1 January 2018, the Bank no longer uses coverage ratio as a measurement for loan quality.

Net impairment on loans since the establishment of the Bank has been very volatile, primarily because a large part of the loan portfolios acquired by the Bank were distressed, following the financial crisis in 2008. Despite the fact that the loans were acquired at a deep discount to nominal value, from 2009 to 2014, the Bank restructured a large portion of its loan portfolio in cooperation with its customers, in some cases with positive results for the Bank and in others with negative results for the Bank, which were reflected in the release of discount (which resulted in income) and increased impairment and write-offs on loans (which resulted in expense), respectively. Since 2015, there has been stabilisation of the portfolio, but at the same time interest rates and the competitive environment have changed, resulting in an unusually high number of prepayments and refinancing of loans. The repayment of loans acquired following the 2008 financial crisis, given their deep discounts, resulted in overall positive net impairment during the periods under review; however, the Bank expects the effect of the release of these discounts to diminish as the loans acquired at such a deep discount have now largely been repaid, and these are not expected to have a material impact on the Group's results of operations going forward.

On 1 January 2018, the Bank implemented IFRS 9. IFRS 9 replaced the "incurred credit loss" model used under IAS 39 with an "expected credit loss" ("**ECL**") model. The new "expected credit" impairment models apply to financial assets that are debt instruments (including loans to customers) measured at amortised cost or fair value reported in other comprehensive income ("**FVOCI**"), lease receivables, loan commitments and financial guarantee contracts. Equity instruments are not subject to impairment. The implementation of new models caused a decrease in the overall loss allowance. Excepted loss allowance for loan commitments and financial guarantees are presented under Other liabilities.

The changes from incurred to expected credit losses requires professional judgement over various factors used in the calculation of ECLs, such as how macroeconomic scenarios affect the ECL calculation. The calculation of impairments under IFRS 9 is split into three stages. Stage 1 calculates twelve month expected credit loss for exposures not in default and with no significant increase in credit risk. Stage 2 calculates lifetime expected credit loss for exposures not in default with significant increase in credit risk (as defined by the Bank). Stage 3 calculates lifetime expected credit losses for exposures in default (as defined by the Bank). The application of the IFRS 9 impairment requirements could increase volatility in profit and loss of the Group.

As of 31 December 2017, 1.0% of the customer loan portfolio was classified as problem loans (1.6% as of 31 December 2016 and 2.5% as of 31 December 2015), and the Group's provisions on its customer loan portfolio amounted to 1.7% (2.2% as of 31 December 2016 and 4.3% as of 31 December 2015) of the total gross amount of the portfolio and 1.6% (3.2% as of 31 December 2016 and 4.7% as of 31 December 2015) of the aggregate amount of customer loans outstanding had been wholly or partially impaired. As of 31 December 2017, the value of collateral that the Group holds relating to loans individually determined to be impaired amounted to ISK 2,491 million, or 19.5%, of the aggregate carrying amount of the problem loans (ISK 5,349 million as of 31 December 2016 (22.6%) and ISK 8,086 million as of 31 December 2015 (24.2%)).

In particular, credit quality within the mortgage loans portfolio has improved, through amortisation and increasing housing prices, while overall mortgage lending volumes have increased, with mortgage loans rising from ISK 284,784 million as of 31 December 2015 to ISK 302,082 million as of 31 December 2016 and ISK 331,139 million as of 31 December 2017. The percentage of mortgage loans more than 90 days in default has decreased from 3.5% as of 31 December 2015 to 1.8% as of 31 December 2016 and 1.1% as of 31 December 2017, and mortgage loan-to-value ratios have generally decreased over the same period. The vast majority (72% as of 31 December 2016) of the mortgage loan portfolio relates to properties in Reykjavík, with

10% relating to properties in the south of Iceland, 10% in the north of Iceland, 7% in the west of Iceland and 2% in the east of Iceland.

The Bank had historically not considered cost of risk to be a relevant indicator for the quality of the customer loan portfolio, because the Bank's legacy customer loan portfolio was acquired at a deep discount from 2008 to 2013, and provisions and write-offs since acquisition have been a validation of the negotiated purchase price, rather than a strict measure of credit quality. However, Arion Bank has focused on reducing its cost of risk, since the remaining unrealised discounts are largely complete, and the vast majority of Arion Bank's current outstanding loan book has been originated by Arion Bank itself, based on rules and processes made by the Bank.

Based on current credit models, the expected credit loss (the expected loss for the next 12 months) was calculated 0.39% as of 31 December 2017, a decrease from 0.56% as of 31 December 2016 and 0.68% as of 31 December 2015. The focus for the Bank is to reduce this ratio toward the level of its Nordic peers but will most likely by slightly higher, based on the higher interest rate environment and more unstable currency in comparison in Iceland. The Bank's focus in mitigating these Iceland-specific issues will be on maintaining adequate collateralisation and close relationships with customers, allowing improved lending practices and early intervention, should customers face financial challenges.

Recent Developments

The Group's trading performance since 31 March 2018 has, in the Bank's view, progressed favourably. Net interest income improved in April, partly due to higher inflation, which positively affects the Bank's interest margin as it has more inflation-linked assets than liabilities. Net interest income was also positively affected by a repayment of a bond issue with a relatively high coupon in the first quarter of 2018, reducing interest expense. The Bank's loan book has grown in line with the first quarter, with continued growth in mortgages, SMEs and corporate lending. There has been improvement in the Group's insurance business after a difficult first quarter. The cost base has followed trends observed in the three months ended 31 March 2018, and no significant developments on loan impairments have occurred since the end of the first quarter. The pipeline for new lending and projects in corporate advisory remains healthy.

Other than as described above, there has been no significant change in the financial or trading position of the Group since 31 March 2018, the end of the last financial period for which financial information was prepared.

Financial Position and Results of Operations

Consolidated Statement of Financial Position

	As of 31 March 2018	As of 31 December 2017	2016	2015
		(ISK in millions)		
Assets				
Cash and balances with Central Bank	97,934	139,819	87,634	48,102
Loans to credit institutions	94,961	86,609	80,116	87,491
Loans to customers	782,255	765,101	712,422	680,350
Financial instruments	106,415	109,450	117,456	133,191
Investment property	6,749	6,613	5,358	7,542
Investments in associates	743	760	839	27,299
Intangible assets	13,498	13,848	11,057	9,285
Tax assets	611	450	288	205
Non-current assets and disposal groups held for sale	8,496	8,138	4,418	5,082
Other assets	20,107	16,966	16,436	12,496
Total assets	**1,131,769**	**1,147,754**	**1,036,024**	**1,011,043**
Liabilities				
Due to credit institutions and the Central Bank	7,880	7,370	7,987	11,387
Deposits	453,059	462,161	412,064	469,347
Financial liabilities at fair value	3,130	3,601	3,726	7,609
Tax liabilities	6,885	6,828	7,293	4,922
Other liabilities	55,715	57,062	54,094	49,461
Borrowings	400,855	384,998	339,476	256,058
Subordinated liabilities	—	—	—	10,365
Total liabilities	**927,524**	**922,020**	**824,640**	**809,149**
Equity				
Share capital and share premium	58,722	75,861	75,861	75,861
Other reserves	14,880	16,774	19,761	4,548
Retained earnings	130,515	132,971	115,590	112,377
Total shareholders' equity	**204,117**	**225,606**	**211,212**	**192,786**
Non-controlling interest	128	128	172	9,108
Total equity	**204,245**	**225,734**	**212,384**	**201,894**
Total liabilities and equity	**1,131,769**	**1,147,754**	**1,036,024**	**1,011,043**

Explanation of Selected Line Items from the Consolidated Statement of Financial Position

Cash and Balances with Central Bank

Cash and balances include balances held with the Icelandic Central Bank with less than three months' maturity, including cash and balances held for statutory reserve purposes.

Loans to Credit Institutions

Loans to credit institutions include bank accounts, money market and other loans and other non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, the recoverability of which is based solely on the credit risk of the counterparty and with respect to which the Group has no intention of trading the loan. These assets are initially recognised at fair value, including direct and incremental transaction costs. Subsequent recognition is at amortised cost using the effective interest rate method, less any provision for impairment.

Loans to Customers

Loans to customers include overdrafts, credit card advances and mortgage loans and other loans and are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, with respect to which the Group has no intention of trading the loan or receivable. Loans to customers comprise loans to both individuals and corporates and represent the substantial majority of the Group's assets.

Within loans to customers, other loans are mainly loans to corporates, including leases, revolving credit facilities, factoring and other traditional loans. For additional information on the Group's loan portfolio, see "*Selected Statistical Information—Loan Portfolio*".

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as an increase in value of loans in profit or loss when recalculation results in an increase in carrying amount and impairment when there is a decrease in carrying amount.

Financial Instruments

The Group's financial instruments include bond and debt instruments, shares and equity instruments with variable income, derivatives and securities used for economic hedging. The Group uses derivatives to reduce exposure to various risks and not for trading purposes. The Group undertakes the following types of derivative financial instruments transactions: (i) forward contracts for foreign exchange, securities (equities and bonds) and commodities, (ii) foreign exchange and interest rate swaps and (iii) options for foreign exchange, securities (equities and bonds) and commodities. The Group's financial instruments transactions are entered into for the purpose of eliminating risk from potential movements in interest rates, foreign exchange rates, equity exposures and indexation exposures inherent in the Group's assets, liabilities and positions.

Investment Property

Investment property is a property held either to earn rental income or for capital appreciation, or both.

Investments in Associates

Associates are those entities over which the Group has significant influence, *i.e.*, the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Group holds 20.0% or more of the voting power, including potential voting rights, unless it can be clearly demonstrated that this is not the case. The considerations made in determining significant influence are similar to those necessary to determine control over subsidiaries. Investments in associates are initially recognised at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss. Historically, investments in associates have included non-core assets, which the Group had acquired through restructuring of its loan portfolio following the financial crisis in 2008, but since the disposal of the remainder of the Group's interest in Bakkavor in 2016, this includes only shares in small associates that are related to the Bank's operations.

For information on the Group's interest in its principal associates as of 31 December 2016, see "*Legal Considerations and Supplementary Information—Significant Subsidiaries and Principal Associates*".

Deposits

Deposits include deposits from individuals, businesses and financial institutions. For additional information on the Group's deposits, see "*—Funding—Deposit Funding*".

Borrowings

Borrowings include senior secured debt securities issued to third parties in the form of Structured Covered Bonds, Statutory Covered Bonds, EMTN Bonds (senior unsecured bonds), secured borrowings from the Icelandic Central Bank denominated in various currencies and bills. For additional information on the Group's borrowings, see "*—Funding—Borrowings*".

Key Changes to Financial Position as of 31 March 2018

Cash and balances with the Icelandic Central Bank decreased by ISK 41,885 million, or 30.0%, to ISK 97,934 million as of 31 March 2018 from ISK 139,819 million as of 31 December 2017. This decrease was primarily due to the payment of the First Monetisation Dividend and the related buy-back of Shares. For more information, see "*Shares and Share Capital—Dividends and Dividend Policy—Dividends Paid*" and "*Shares and Share Capital—Share Capital Information—Buyback of Shares*".

Loans to customers increased by ISK 17,154 million, or 2.2%, to ISK 782,255 million as of 31 March 2018 from ISK 765,101 million as of 31 December 2017. This increase was primarily due to increases in the mortgage portfolio driven by new digital solutions and a strong housing market in Iceland (despite strong competition), as well as growth in the corporate loan portfolio. New lending to corporates was mainly in real estate activities and construction. Due to the implementation of IFRS 9, the classification and impairment requirements have been updated. As a result, a small portion of the loan portfolio was reclassified from amortised cost to fair value through profit and loss. The classification into impairment stages is presented below, itemised by accounting treatment in the condensed consolidated interim financial statements as of 31 March 2018.

	As of 31 March 2018 (ISK millions)				
	Stage 1	**Stage 2**	**Stage 3**	**POCI**	**Total**
Loans to customers					
Risk class 1—(Grades A+ to BBB−)	336,262	83	—	—	336,345
Risk class 2—(Grades BB+ to BB−)	243,618	19,137	—	—	262,755
Risk class 3—(Grades B+ to B−)	111,791	12,564	—	50	124,404
Risk class 4—(Grades CCC+ to CCC−)	18,901	11,784	—	2	30,687
Risk class 5—(Grade DD)	—	—	24,532	1,453	25,985
Unrated	7,537	326	350	—	8,214
Gross carrying amount	718,109	43,894	24,882	1,505	788,391
Loss allowance	(1,489)	(706)	(9,991)	(289)	(12,475)
Loans to customers at amortised cost	**716,620**	**43,188**	**14,891**	**1,216**	**775,916**
Loans to customers at fair value					6,339
Loans to customers					**782,255**

The Bank's distribution of loans between individuals and companies was largely unchanged (47.9% to individuals as of 31 March 2018 compared to 47.7% as of 31 December 2017).

Financial instruments decreased by ISK 3,035 million, or 2.8%, to ISK 106,415 million as of 31 March 2018 from ISK 109,450 million as of 31 December 2017. This decrease is primarily due to sale of listed equity holdings, especially in Skeljungur hf. during the period, and other changes related to the Bank's liquidity management. As previously mentioned, due to IFRS 9, a portion of financial instruments were reclassified from fair value through profit and loss into fair value through other comprehensive income (OCI). Assets were presented in the interim financial statements as of 31 March 2018 as follows:

	As of 31 March 2018 (ISK in millions)
Bonds and debt instruments at fair value through P/L	14,556
Bonds and debt instruments at fair value through OCI	42,142
Shares and equity instruments with variable income	20,333
Bond funds with variable income	3,887
Derivatives	7,650
Securities used for economic hedging	17,847
Financial instruments	**106,415**

Deposits decreased by ISK 9,102 million, or 2.0%, to ISK 453,059 million as of 31 March 2018 from ISK 462,161 million as of 31 December 2017. These changes in deposits are minimal and within normal seasonal changes within the year.

Borrowings increased by ISK 15,857 million, or 4.1%, to ISK 400,855 million as of 31 March 2018 from ISK 384,998 million as of 31 December 2017. For more information, see "*—Funding—Borrowings*".

Changes in Assets as of 31 December 2017, 2016 and 2015

Loans to Credit Institutions

The table below sets forth the components of the loans to credit institutions as of the dates indicated.

	As of 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Bank accounts	51,303	45,631	74,533
Money market loans	32,309	32,267	7,976
Other loans	2,997	2,218	4,982
Loans to credit institutions	**86,609**	**80,116**	**87,491**

Loans to credit institutions increased by ISK 6,493 million, or 8.1%, to ISK 86,609 million as of 31 December 2017 from ISK 80,116 million as of 31 December 2016. This increase was primarily due to changes in the Bank's liquidity management.

Loans to credit institutions decreased by ISK 7,375 million, or 8.4%, to ISK 80,116 million as of 31 December 2016 from ISK 87,491 million as of 31 December 2015. This decrease was primarily due to changes in the Bank's liquidity management assets on the respective balance sheet dates, as well as increased focus on net interest margin.

Loans to Customers

The table below sets forth the Group's loans to customers for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Overdrafts	30,942	31,011	37,220
Credit cards	12,040	12,250	11,557
Mortgage loans	329,735	298,971	280,649
Other loans	392,384	370,190	350,924
Loans to customers	**765,101**	**712,422**	**680,350**

Loans to customers increased by ISK 52,679 million, or 7.4%, to ISK 765,101 million as of 31 December 2017 from ISK 712,422 million as of 31 December 2016. This increase was primarily in line with increased activity in the Icelandic economy and was attributable to an increase in loans to corporates in the amount of ISK 24,808 million and individuals, especially mortgage loans, in the amount of ISK 27,871 million. New lending to corporates was mainly in the real estate and transportation sectors.

Loans to customers increased by ISK 32,072 million, or 4.7%, to ISK 712,422 million as of 31 December 2016 from ISK 680,350 million as of 31 December 2015. This increase was primarily due to increased activity in the Icelandic economy and was mainly attributable to an increase in loans to corporates in the amount of ISK 19,275 million. New lending to corporates was mainly in the real estate and industry, energy and manufacturing sectors. Loans to individuals also increased in the amount of ISK 12,797 million.

Financial Instruments

The table below sets forth the components of the financial instruments as of the dates indicated.

	As of 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Bonds and debt instruments	51,755	69,565	78,794
Shares and equity instruments with variable income	18,757	24,001	34,192
Bond funds with variable income	17,433	3,034	1,312
Derivatives	7,624	5,159	2,401
Securities used for economic hedging	13,881	15,697	16,492
Financial instruments	**109,450**	**117,456**	**133,191**

Financial instruments decreased by ISK 8,006 million, or 7.3%, to ISK 109,450 million as of 31 December 2017 from ISK 117,456 million as of 31 December 2016. This decrease is primarily due to the sale of listed equity holdings during the year and decreased activity in asset swaps, resulting in a decrease in securities used for economic hedging. The decrease in bonds and debt instruments and the increase in bond funds with variable income result from liquidity management activities aimed at increasing income from liquid assets.

Financial instruments decreased by ISK 15,735 million, or 11.8%, to ISK 117,456 million as of 31 December 2016 from ISK 133,191 million as of 31 December 2015. This decrease is partially due to the sale of Valitor's shareholding in Visa Europe in 2016, with book value of ISK 5,853 million, which resulted in an impact of ISK 5,291 million. In general, the Icelandic stock market underperformed during the year, with the OMX Iceland 8 Index decreasing by 9.0%.

Investment Property

Investment property increased by ISK 1,255 million, or 23.4%, to ISK 6,613 million as of 31 December 2017 from ISK 5,358 million as of 31 December 2016. This increase was primarily due to valuation changes on investment properties during the year.

Investment property decreased by ISK 2,184 million, or 29.0%, to ISK 5,358 million as of 31 December 2016 from ISK 7,542 million as of 31 December 2015. This decrease was primarily due to the sale of land held by the Bank's subsidiary Kolufell in early 2016.

Investments in Associates

The table below sets forth the components of the investments in associates as of the dates indicated.

	As of 31 December		
	2017	2016	2015
	(ISK in millions)		
Carrying amount at the beginning of the year	839	27,299	21,966
Acquisitions	961	76	262
Dividend received	(41)	(153)	(611)
Transfers	—	—	(6,458)
Disposals	(74)	(27,291)	(17,148)
Exchange difference	—	—	(178)
Share of profit of associates and net impairment	(925)	908	29,466
Investments in associates	**760**	**839**	**27,299**

Investments in associates decreased by ISK 79 million, or 9.4%, to ISK 760 million as of 31 December 2017 from ISK 839 million as of 31 December 2016. This decrease was primarily due to the sale by the Bank's subsidiary Landey of its shareholding in an associated company, Urridaland ehf. The share of profit of associates and net impairment is primarily due to impairment of investment in United Silicon during 2017, amounting to ISK 907 million. As of the date of this Prospectus, the Bank only holds shares in small associates that are related to the Bank's operations.

Investments in associates decreased by ISK 26,460 million, or 96.9%, to ISK 839 million as of 31 December 2016 from ISK 27,299 million as of 31 December 2015. This decrease was primarily due to the sale of Bakkavor held by the Bank's subsidiary BG 12 slhf.

Changes in Liabilities as of 31 December 2017, 2016 and 2015

Deposits

Deposits increased by ISK 50,097 million, or 12.2%, to ISK 462,161 million as of 31 December 2017 from ISK 412,064 million as of 31 December 2016. This increase was primarily due to an increase in deposits from individuals and SMEs in Retail Banking due to favourable developments in the Icelandic economy.

Deposits decreased by ISK 57,283 million, or 12.2%, to ISK 412,064 million as of 31 December 2016 from ISK 469,347 million as of 31 December 2015. This decrease was primarily due to a funding arrangement with Kaupthing entered into in January 2016, as a result of which Kaupthing's deposits denominated in foreign currency held at Arion Bank (approximately ISK 41 billion as of 31 December 2015) were offset against the issuance of the Resettable Notes (see "—*Borrowings*").

Borrowings

Borrowings increased by ISK 45,522 million, or 13.4%, to ISK 384,998 million as of 31 December 2017 from ISK 339,476 million as of 31 December 2016. This increase was primarily due to a new issue of covered bonds in the Icelandic market of ISK 29.9 billion and the issuance of two EMTN bonds totalling EUR 500 million (ISK 63 billion). The Resettable Notes issued to Kaupthing were repaid in full in 2017, and the Group was fully market funded (excluding deposits) as of 31 December 2017.

Borrowings increased by ISK 83,418 million, or 32.6%, to ISK 339,476 million as of 31 December 2016 from ISK 256,058 million as of 31 December 2015. In January 2016, Arion Bank issued the Resettable Notes to Kaupthing in the amount of USD 747.8 million (ISK 97 billion), which were used to offset the loan from the Icelandic Central Bank from 2010 in the amount of ISK 56 billion and Kaupthing's deposits denominated in foreign currency held at Arion Bank. See "*Principal and Selling Shareholders—Kaupthing*". The issuance of the Resettable Notes to Kaupthing represented substantially all of the increase in the Bank's borrowings. The Resettable Notes were repaid in full as of 30 June 2017.

Consolidated Statement of Comprehensive Income

	Three months ended 31 March		Year ended 31 December		
	2018	**2017**	**2017**	**2016**	**2015**
	(ISK in millions)				
Interest income	14,162	13,723	57,089	61,655	54,546
Interest expense	(7,254)	(6,563)	(27,254)	(31,755)	(27,554)
Net interest income	**6,908**	**7,160**	**29,835**	**29,900**	**26,992**
Fee and commission income	8,197	6,091	29,777	23,887	21,234
Fee and commission expense	(4,655)	(2,761)	(14,420)	(9,909)	(6,750)
Net fee and commission income	**3,542**	**3,330**	**15,357**	**13,978**	**14,484**
Net financial income	1,340	1,230	4,091	5,162	12,844
Net insurance income	143	447	2,093	1,395	760
Share of profit of associates and net impairment	(18)	(34)	(925)	908	29,466
Other operating income	269	564	2,927	3,203	2,074
Operating income	**12,184**	**12,697**	**53,378**	**54,546**	**86,620**
Salaries and related expense	(4,636)	(4,222)	(17,189)	(16,659)	(14,892)
Other operating expenses	(3,996)	(3,834)	(12,772)	(13,881)	(12,919)
Bank Levy	(804)	(797)	(3,172)	(2,872)	(2,818)
Net impairment	(99)	880	186	7,236	(3,087)
Earnings before tax	**2,649**	**4,724**	**20,431**	**28,370**	**52,904**
Income tax expense	(818)	(1,371)	(5,806)	(6,631)	(3,225)
Net earnings from continuing operations	**1,831**	**3,353**	**14,625**	**21,739**	**49,679**
Discontinued operations, net of tax	118	—	(206)	—	—
Net earnings	**1,949**	**3,353**	**14,419**	**21,739**	**49,679**
Other comprehensive income					
Net gain on financial assets carried at fair value through OCI, net of tax	30	—	—	—	—
Realised net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement	(97)	—	—	—	—
Net gain on AFS financial assets, net of tax	—	—	—	(2,903)	2,903
Exchange difference on translating foreign subsidiaries	(59)	44	(5)	182	13
Total comprehensive income	**1,823**	**3,397**	**14,414**	**19,018**	**52,595**
Shareholders of Arion Bank	1,823	3,396	14,395	18,426	44,884
Non-controlling interest	—	1	19	592	7,711

Explanation of Selected Line Items from the Consolidated Statement of Comprehensive Income

Interest Income and Interest Expense

Interest income includes interest on cash and balances with the Icelandic Central Bank, interest on loans to customers as well as interest on loans to credit institutions, interest on securities and other interest. The Group earns interest income on assets, such as its customer loan portfolio, its securities portfolio and other assets. Interest expense includes interest on deposits, interest on borrowings, interest on subordinated liabilities and other interest. The Group incurs interest expense on its liabilities to depositors and other creditors. Net interest income is the difference between interest income and interest expense.

Interest income and interest expense are recognised using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and financial liability and is not revised subsequently. The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and interest expense presented in the Statement of Comprehensive Income include:

- interest on financial assets and liabilities at amortised cost on an effective interest rate basis;
- interest on financial assets and liabilities held for trading; and
- interest on financial assets designated at fair value through profit or loss.

Fee and Commission Income and Expense

The Group provides various services to its customers and earns income from such services, such as income from asset management, cards and payment solutions (including the results of operations of Valitor), collection and payment services, investment banking, lending and guarantees as well as other services. Fees earned from services that are provided over a certain period of time are recognised as the services are provided. Fees earned from transaction type services are recognised when the service has been completed. Fees that are performance linked are recognised when the performance criteria are fulfilled. The profitability of fee- and commission-based businesses depends on the levels of fees and commissions charged to customers relative to the related fee and commission expenses incurred by the Group, which the Group refers to as net fee and commission income.

Fee and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

Net Financial Income

Net financial income includes dividend income received by the Group in respect of its equities and interest payments in respect of its bond portfolios, net gain or loss on financial assets and financial liabilities classified as held for trading, net gain or loss on financial assets and financial liabilities at fair value and net foreign exchange gain or loss.

Dividend income is recognised when the right to receive dividend is established, which is usually the ex-dividend date for equity securities.

Net gain or loss on financial assets and financial liabilities at fair value includes all realised and unrealised fair value changes in trading portfolio and assets and liabilities designated at fair value through profit or loss, except for interest (which is included in interest income and interest expense) and foreign exchange gain or loss (which are included in net foreign exchange gain or loss as described below).

Net foreign exchange gain or loss includes all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the period or in the financial statements for previous periods. Net foreign exchange gain or loss also includes foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognised in profit or loss.

Net Insurance Income

Net insurance income includes earned premiums and claims incurred. Premiums recognised as income comprise the premiums contracted during the fiscal year including premiums transferred from the previous year but excluding premiums from subsequent periods, which are recognised as provision for unearned premiums. Claims represent the period's claims including increases or decreases due to claims from previous fiscal years. With the acquisition of Vördur at the end of September 2016 the net insurance income of the Group increased.

Share of Profit of Associates and Net Impairment

Share of profit of associates and net impairment reflects the Group's interest in any profit from its associates, which are primarily the remaining shareholdings of companies acquired as a result of financial restructurings following the financial crisis in 2008. Share of profit of associates and net impairment includes gain or loss recognised by the Group from the sale of its shareholdings in the associates during a reporting period, which accounts for the significant variation in percentage contribution to operating income for the periods under review. Following the sale of Bakkavor, a non-core asset, the Bank only holds shares in small associates that are related to the Bank's operations. As of 31 December 2017, the Group's total investment in associates amounted to ISK 760 million.

Other Operating Income

Other operating income includes rental income from investment property, fair value changes on investment property, realised gain on investment property, net gain on non-current assets held for sale and other income. Net gain on non-current assets held for sale consists mainly of net income from real estates that have been acquired as the result of foreclosures on companies and individuals. Other operating income is primarily due to selling assets and income from Valitor for rental of points of sale.

Salaries and Related Expense

Salaries and related expense include salaries, payments for defined contribution payment plans and salaries and related expense, such as social security tax, special tax on salaries expense of financial institutions and holiday allowance.

For information on remuneration paid to members of the Board of Directors and the Executive Committee, see "*Board of Directors, Executive Committee, Auditor and Corporate Governance—Remuneration of Members of the Board of Directors and Executive Committee*".

Other Operating Expense

The majority of other operating expenses relate to administration expense, which includes, among others, IT costs, costs relating to properties, professional services and marketing costs, as well as depreciation of property and equipment, amortisation of intangible assets, payments in respect of the Depositors' and Investors' Guarantee Fund and expenses related to investment properties. The Group's relatively large fixed operating costs bear little to no direct relationship to its business volumes, so that an increase in business volumes may not be fully translated into expense growth, and *vice versa*. For additional information, see "*—Key Factors Affecting the Group's Business, Financial Position and Results of Operations—Cost and Efficiency Management*".

Bank Levy

The Bank Levy amounts to 0.376% on total debt excluding tax liabilities, in excess of ISK 50.0 billion for the periods under review. Non-financial subsidiaries are exempt from the Bank Levy. The Bank Levy is assessed on financial institutions to meet the funding of a special index and interest relief provided to individual taxpayers.

Net Impairment

Impairment charges result from changes in the quality of assets, in particular in respect of loans to individuals and companies. The quality of assets is impacted by the economic developments in general and the housing market in particular. Impairment charges on loans and other receivables are closely related to the interest-based business, as it is based on credit risk, and compensation for credit risk is charged to the customer as part of the margin on interest-earning assets.

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

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

The Group considers evidence of impairment for loans at both a borrower-specific and a collective level. For additional information, see note 54 titled "*Financial assets and financial liabilities*" in "*Significant Accounting Policies*" in the 2017 Annual Financial Statements.

Impairment losses are recognised in profit or loss and reflected in an allowance account against loans. When an event occurring after the impairment was recognised causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised in profit or loss as increase in value of loans via net impairment when recalculation results in an increase in carrying amount and impairment when decrease in carrying amount.

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

Income Tax Expense

Income tax expense includes current tax and deferred tax. Income tax for the period has been calculated and recognised in the Group's consolidated statement of comprehensive income for the respective period. Current tax is the expected tax payable on the taxable income for the period, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous periods.

The rate of corporate income tax in Iceland has been 20.0% for each of the years ended 31 December 2017, 2016 and 2015 and, in addition, there has been a 6.0% tax on financial institutions in respect of taxable profit exceeding ISK 1.0 billion. Based on the composition of the Group's operating income, its effective tax rate can be higher or lower than the rate of corporate income tax, and in the short to medium term the Group expects an effective tax rate between 18% and 24%.

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities and the realisation of foreign exchange gain or loss for financial reporting purposes and the amounts used for taxation purposes. Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantively enacted at the reporting date. Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Key Changes to Results of Operations for the Three Months Ended 31 March 2018 and 2017

Interest income increased by ISK 439 million, or 3.2%, to ISK 14,162 million for the three months ended 31 March 2018 from 13,723 million for the three months ended 31 March 2017. This increase was primarily due to higher inflation compared to the same period in 2017 and increased loans to customers.

Interest expense increased by ISK 691 million, or 10.5%, to ISK 7,254 million for the three months ended 31 March 2018 from ISK 6,563 million for the three months ended 31 March 2017. This increase was primarily due to higher inflation compared to the same period in 2017.

Fee and commission income increased by ISK 2,106 million, or 34.6%, to ISK 8,197 million for the three months ended 31 March 2018 from ISK 6,091 million for the three months ended 31 March 2017. This increase was primarily due to increased activity in the international market at the subsidiary Valitor, in card and payment solutions.

Fee and commission expense increased by ISK 1,894 million, or 68.6%, to ISK 4,655 million for the three months ended 31 March 2018 from ISK 2,761 million for the three months ended 31 March 2017. This increase was primarily due to increased activity in the international market at the subsidiary Valitor, in card and payment solutions.

Net financial income increased by ISK 110 million, or 8.9%, to ISK 1,340 million for the three months ended 31 March 2018 from ISK 1,230 million for the three months ended 31 March 2017. Positive market changes in equity holdings were the main reason for the growth in net financial income in both periods.

Net insurance income decreased by ISK 304 million, or 68.0%, to ISK 143 million for the three months ended 31 March 2018 from ISK 447 million for the three months ended 31 March 2017. This decrease was primarily due to unusually high levels of car insurance claims in the three months ended 31 March 2018. The average claim has increased as a result of a newer car fleet and higher wage levels, resulting in higher claims.

Other operating income decreased by ISK 295 million, or 52.3%, to ISK 269 million for the three months ended 31 March 2018 from ISK 564 million for the three months ended 31 March 2017. This decrease was primarily due to profit from the sale of assets during the first quarter of 2017.

Salaries and related expense increased by ISK 414 million, or 9.8%, to ISK 4,636 million for the three months ended 31 March 2018 from ISK 4,222 million for the three months ended 31 March 2017. This increase was primarily due to an increase of FTEs at Valitor, from 265 FTEs as of 31 March 2017 to 361 FTEs as of 31 March 2018, and a contractual wage increase of 5% from 1 May 2017 in Iceland.

Other operating expense increased by ISK 162 million, or 4.2%, to ISK 3,996 million for the three months ended 31 March 2018 from ISK 3,834 million for the three months ended 31 March 2017. This increase was primarily due to higher IT and professional services expenses.

Net impairment increased by ISK 979 million, or 111.3%, to ISK 99 million for the three months ended 31 March 2018 from a positive net impairment of ISK 880 million for the three months ended 31 March 2017. The increase in net impairment was in particular due to prepayments of mortgage loans, composition payments from corporate customers and final loan payments from bankrupt entities, which had previously been impaired, and resulted in a positive net impairment during the first quarter 2017, with less effect from such transactions during the first three months of 2018. From 1 January 2018, IFRS 9 was implemented, resulting in significant changes to impairment calculation methods. The main changes are in relation to the new requirements of IFRS 9 to calculate expected future credit losses instead of incurred credit losses as previously done under IAS 39. Therefore, the amounts disclosed in the first quarter of 2018 are not comparable with the first quarter of 2017. However, the main changes between the first quarter of 2018 and the first quarter of 2017 are due to other items than change in accounting methods.

Income tax expense decreased by ISK 553 million, or 40.3%, to ISK 818 million for the three months ended 31 March 2018 from ISK 1,371 million for the three months ended 31 March 2017. Income tax comprises 20.0% income tax on earnings and the Special Financial Activity Tax. The effective income tax rate was 30.9% during the three months ended 31 March 2018, as compared to 29.0% during the three months ended 31 March 2017.

Results of Operations for the years ended 31 December 2017, 2016 and 2015

Interest Income

The table below sets forth the components of the interest income for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Cash and balances with Central Bank	6,449	4,584	2,757
Loans	47,832	51,910	47,393
Securities	1,964	4,347	3,532
Other	844	814	864
Interest income	**57,089**	**61,655**	**54,546**

Interest income decreased by ISK 4,566 million, or 7.4%, to ISK 57,089 million for the year ended 31 December 2017 from 61,655 million for the year ended 31 December 2016. This decrease was partly due to a decrease in the CPI which resulted in lower interest income from CPI-linked assets (loans and securities), decreased interest rates on foreign currency linked loans and ISK loans as interest rate had been decreasing during the year.

Interest income increased by ISK 7,109 million, or 13.0%, to ISK 61,655 million for the year ended 31 December 2016 from 54,546 million for the year ended 31 December 2015. This increase was primarily due to an increase in interest-earning assets, both as a result of new lending and of more liquid assets being held in cash and bonds.

Interest Expense

The table below sets forth the components of the interest expense for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Deposits	(12,725)	(16,278)	(15,453)
Borrowings	(14,449)	(14,858)	(11,344)
Subordinated liabilities	—	(529)	(701)
Other	(80)	(90)	(56)
Interest expense	**(27,254)**	**(31,755)**	**(27,554)**

Interest expense decreased by ISK 4,501 million, or 14.2%, to ISK 27,254 million for the year ended 31 December 2017 from ISK 31,755 million for the year ended 31 December 2016. This decrease was primarily due to a decrease in the CPI which resulted in lower interest expense on CPI-linked liabilities. The CPI decreased from 2.1% in 2016 to 1.7% in 2017, resulting in a decrease in interest expense, as the Group held approximately ISK 231 billion in CPI-linked-liabilities as of 31 December 2017, particularly borrowings (covered bonds) and deposits. Borrowing has increased significantly but interest expense on borrowings has not increased in connection to that, mainly related to decreased interest rates in the market.

Interest expense increased by ISK 4,201 million, or 15.2%, to ISK 31,755 million for the year ended 31 December 2016 from ISK 27,554 million for the year ended 31 December 2015. This increase was primarily due to a change in the funding profile, as a greater proportion of the Bank's funding was comprised of borrowings (as compared to deposits).

Fee and Commission Income

The table below sets forth the components of the fee and commission income for the periods indicated.

	Year ended 31 December		
	2017	2016	2015
	(ISK in millions)		
Asset management[(1)]	4,529	4,225	4,463
Cards and payment solutions	19,309	14,268	11,532
Collection and payment services	1,563	1,478	1,349
Investment banking	808	1,039	1,740
Lending and guarantees	2,198	1,685	1,431
Other	1,370	1,192	719
Fee and commission income	**29,777**	**23,887**	**21,234**

(1) 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.

Fee and commission income increased by ISK 5,890 million, or 24.7%, to ISK 29,777 million for the year ended 31 December 2017 from ISK 23,887 million for the year ended 31 December 2016. This increase was primarily due to an increase of income of ISK 5,041 million from cards and payment solutions following increasing volume of international operations at Valitor, partly through acquisitions of subsidiaries.

Fee and commission income increased by ISK 2,653 million, or 12.5%, to ISK 23,887 million for the year ended 31 December 2016 from ISK 21,234 million for the year ended 31 December 2015. This increase was primarily due to an increase of income of ISK 2,736 million from cards and payment solutions following increasing volume of international operations at Valitor. Commission income from the Investment Banking division decreased by ISK 701 million due to less income from initial public offerings during the year ended 31 December 2016.

Fee and Commission Expense

The table below sets forth the components of the fee and commission expense for the periods indicated.

	Year ended 31 December		
	2017	2016	2015
	(ISK in millions)		
Asset management	(366)	(245)	(218)
Cards and payment solutions	(13,177)	(8,975)	(5,945)
Collection and payment services	(94)	(80)	(93)
Investment banking	(43)	(46)	(56)
Other	(740)	(563)	(438)
Fee and commission expense	**(14,420)**	**(9,909)**	**(6,750)**

Fee and commission expense increased by ISK 4,511 million, or 45.2%, to ISK 14,420 million for the year ended 31 December 2017 from ISK 9,909 million for the year ended 31 December 2016. This increase was primarily due to higher expense in the amount of ISK 4,202 million from cards and payment solutions attributable to increased volumes of international operations at Valitor, partly through acquisitions of subsidiaries.

Fee and commission expense increased by ISK 3,159 million, or 46.8%, to ISK 9,909 million for the year ended 31 December 2016 from ISK 6,750 million for the year ended 31 December 2015. This increase was primarily due to higher expense in the amount of ISK 3,030 million from cards and payment solutions attributable to increased volumes of international operations at Valitor.

Net Financial Income

The table below sets forth the components of the net financial income for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Dividend income	320	2,280	7,954
Net gain (loss) on financial assets and financial liabilities classified as held for trading	155	363	1,157
Net gain on fair value hedge of interest rate swap	336	—	—
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	3,158	(1,519)	3,915
Realised gain on financial assets available for sale	—	5,291	—
Net foreign exchange gain (loss)	122	(1,253)	(182)
Net financial income	**4,091**	**5,162**	**12,844**

Net financial income decreased by ISK 1,071 million, or 20.7%, to ISK 4,091 million for the year ended 31 December 2017 from ISK 5,162 million for the year ended 31 December 2016. This decrease was primarily due to a one-off realised gain on financial assets in 2016 from the sale of Valitor's shareholding in Visa Europe to Visa Inc. of ISK 5,291 million, partly offset in 2017 by a net gain on financial assets and financial liabilities designated at fair value through profit or loss amounting to ISK 3,158 million (compared with loss in 2016 of ISK 1,519 million), as a result of equity markets being more favourable during 2017. The decrease in dividend income is mainly related to the reduction in the Bank's direct and indirect holding in Refresco, as between 2015 and 2016.

Net financial income decreased by ISK 7,682 million, or 59.8%, to ISK 5,162 million for the year ended 31 December 2016 from ISK 12,844 million for the year ended 31 December 2015. This decrease was primarily due to significant non-recurring valuation changes and earnings from the sale of shareholdings during the year ended 31 December 2015. Partly offsetting this decrease was a realised gain on the sale of Valitor's shareholding in Visa Europe to Visa Inc. during the year ended 31 December 2016, which amounted to ISK 5,291 million in the first half of 2016. Net financial income from other financial assets was satisfactory during the second half of 2016 and partly offset the loss generated in the first half of 2016 due to challenging market conditions, particularly on equities. The appreciation of the Icelandic Krona resulted in a foreign exchange loss of ISK 1,253 million in 2016, particularly attributable to subsidiaries. The decrease in dividend income from 2015 is mainly related to the reduction in the Bank's direct and indirect holding in Refresco.

Net Insurance Income

The table below sets forth the components of the net insurance income for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Earned premiums, net of reinsurers' share			
Premiums written	10,407	2,927	1,134
Premiums written, reinsurers' share	(428)	(196)	(139)
Change in provision for unearned premiums	(810)	330	(30)
Change in provision for unearned premiums, reinsurers' share	1	1	—
Earned premiums, net of reinsurers' share	**9,169**	**3,061**	**1,145**
Claims incurred, net of reinsurers' share			
Claims paid	(6,115)	(1,762)	(383)
Claims paid, reinsurers' share	142	66	67
Change in provision for claims	(1,057)	33	(59)
Change in provision for claims, reinsurers' share	(46)	(3)	(10)
Claims incurred, net of reinsurers' share	**(7,076)**	**(1,666)**	**(385)**
Net insurance income	**2,093**	**1,395**	**760**

Net insurance income increased by ISK 698 million, or 50.0%, to ISK 2,093 million for the year ended 31 December 2017 from ISK 1,395 million for the year ended 31 December 2016. This increase was primarily due to the inclusion of a full year of results of Vördur, whose acquisition occurred at the end of September

2016. The full year results of Vördur in 2017 were the main driver for the increased levels of both earned premiums and claims incurred, as shown in the table above.

Net insurance income increased by ISK 635 million, or 83.5%, to ISK 1,395 million for the year ended 31 December 2016 from ISK 760 million for the year ended 31 December 2015. This increase was primarily due to the acquisition of Vördur at the end of September 2016.

Share of Profit of Associates and Net Impairment

Share of profit of associates and net impairment decreased by ISK 1,833 million, or 201.9%, to a net impairment of ISK 908 million for the year ended 31 December 2017 from a profit of ISK 908 million for the year ended 31 December 2016. This decrease was primarily due to loss from investment in United Silicon, which was classified as an associated company from April to September 2017, following an equity investment by the Bank. In 2016 the profit from sale of the Group's shareholding in Bakkavor of ISK 685 million was the main contributor of profit of associates.

Share of profit of associates and net impairment decreased by ISK 28,558 million, or 96.9%, to ISK 908 million for the year ended 31 December 2016 from ISK 29,466 million for the year ended 31 December 2015. This decrease was primarily due to the valuation increase in the Group's shareholding in Bakkavor in 2015, as described in "*Business Overview—Business—Asset Portfolio Disposals*". In early 2016, the Group's shareholding in Bakkavor was sold with a profit amounting to ISK 685 million.

Other Operating Income

The table below sets forth the components of the other operating income for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Fair value changes on investment property	1,036	290	422
Realised gain on investment property	15	400	286
Net gain on non-current assets held for sale	958	1,107	450
Other income	918	1,406	916
Other operating income	**2,927**	**3,203**	**2,074**

Other operating income decreased by ISK 276 million, or 8.6%, to ISK 2,927 million for the year ended 31 December 2017 from ISK 3,203 million for the year ended 31 December 2016. This decrease was primarily due to a decrease in profit from sale of assets, included in Other income, in 2016 and a decrease in income from non-current assets held for sale. These changes were partly offset by higher fair value change on investment property during the year.

Other operating income increased by ISK 1,129 million, or 54.4%, to ISK 3,203 million for the year ended 31 December 2016 from ISK 2,074 million for the year ended 31 December 2015. This increase was primarily due to a higher level of net gain from the sale of receivable during the year.

Salaries and Related Expense

The table below sets forth the components of the salaries and related expense for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Salaries	13,424	12,890	11,522
Defined contribution pension plans	1,963	1,885	1,637
Salary related expense	1,802	1,884	1,733
Salaries and related expense	**17,189**	**16,659**	**14,892**

Salaries and related expense increased by ISK 530 million, or 3.2%, to ISK 17,189 million for the year ended 31 December 2017 from ISK 16,659 million for the year ended 31 December 2016. This increase was mainly a result of renewed wage agreements and a rise in the number of employees partly related to the acquisition of two new subsidiaries of Valitor. The average salary per employee decreased by 0.9% from 2016, but at the same time the salary index rose by 7.0%. The reasons for this disparity include changes in the composition of employees with the arrival of new subsidiaries, and the strengthening of the ISK against foreign currencies, as

Valitor, the Bank's largest subsidiary, maintains operations outside of Iceland. Full-time equivalent positions at the end of 2017 totalled 1,284 for the Group, 45 more than at the end of 2016. The increase was largely a result of investments in new business opportunities in Iceland and abroad. Most significant in this respect was the growth of Valitor internationally through two acquisitions in 2017.

Salaries and related expense increased by ISK 1,767 million, or 11.9%, to ISK 16,659 million for the year ended 31 December 2016 from ISK 14,892 million for the year ended 31 December 2015. This increase was mainly a result of renewed wage agreements and a rise in the number of employees partly related to the acquisition of Vördur, as well as expenses in relation to the redundancy of 46 employees at the end of September 2016. The average salary per employee increased by 7.1% from 2015, but at the same time the salary index rose by 11.3%. Full-time equivalent positions at the end of 2016 totalled 1,239 for the Group, 92 more than at the end of 2015. The increase was largely a result of investments in new business opportunities in Iceland and abroad. Most significant in this respect were the acquisition of Vördur, the growth of Valitor internationally and the opening of a new branch at Keflavík international airport.

Other Operating Expense

The table below sets forth the components of the other operating expense for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Administration expense	12,388	11,186	10,330
Depositors' and Investors' Guarantee Fund	(1,829)	804	836
Depreciation of property and equipment	816	865	849
Amortisation of intangible assets	1,316	977	807
Direct operating expense derived from investment properties	81	49	97
Other operating expense	**12,772**	**13,881**	**12,919**

Other operating expense decreased by ISK 1,109 million, or 8.0%, to ISK 12,772 million for the year ended 31 December 2017 from ISK 13,881 million for the year ended 31 December 2016. This decrease was primarily due to the reversal of a previously expensed contribution to the Depositors' and Investors' Guarantee Fund, amounting to ISK 2,669 million, which represents the Bank's calculated liability in respect of this contribution. The Bank reversed this contribution because it received confirmation from the Depositors' and Investors' Guarantee Fund that the contribution would not be collected. Partly offsetting this decrease was a rise in administrative expense, resulting from increased activity at Valitor and full year inclusion of subsidiary Vördur.

Other operating expense increased by ISK 962 million, or 7.4%, to ISK 13,881 million for the year ended 31 December 2016 from ISK 12,919 million for the year ended 31 December 2015. This increase was primarily due to higher administrative expense (primarily from professional services expenses) in 2016.

Net Impairment

The table below sets forth the components of the net impairment for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Increase in book value of loans to corporates	364	2,990	2,488
Increase in book value of loans to individuals	1,492	8,990	2,208
Net change in impairment of loans to corporates	(3,197)	(2,914)	(3,818)
Net change in impairment of loans to individuals	168	(2,248)	(3,421)
Net change in collective impairment on loans	1,362	427	(517)
Other impairment	(3)	(9)	(27)
Net impairment	**186**	**7,236**	**(3,087)**

Net impairment decreased by ISK 7,050 million, or 97.4%, to a positive net impairment of ISK 186 million for the year ended 31 December 2017 from a positive net impairment of ISK 7,236 million for the year ended 31 December 2016. The decrease in positive net impairment was in particular due to revaluation of acquired mortgages in 2016, resulting in a significantly lower increase in book value of loans to individuals in 2017. The positive movement in net change in collective impairments on loans in 2017 is mainly due to prepayments of acquired mortgages with discount from prior years, improved models in calculation of collective impairment on loans and a favourable environment regarding loans to individuals. Higher impairment on loans to corporates is primarily related to United Silicon.

Net impairment decreased by ISK 10,323 million, or 344.4%, to ISK 7,236 million for the year ended 31 December 2016 from ISK (3,087) million for the year ended 31 December 2015. The positive net impairment was in particular due to the revaluation of acquired mortgages in the third quarter of 2016, but continued fluctuation was related to the restructuring and additional recovery of loans. The revaluation of the acquired mortgages was based on the positive development in the macroeconomic environment from the time of the purchase of those loans and the fact that the acquired credit impairment was no longer relevant.

Income Tax Expense

The table below sets forth the components of the income tax expense for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Current tax expense	6,132	6,784	1,749
Deferred tax expense	(326)	(153)	1,476
Income tax expense	**5,806**	**6,631**	**3,225**

Income tax expense decreased by ISK 825 million, or 12.4%, to ISK 5,806 million for the year ended 31 December 2017 from ISK 6,631 million for the year ended 31 December 2016. Fluctuation in the effective tax rate is mainly due to the combination of taxable income and non-exempt income. Income tax comprises 20.0% income tax on earnings and the Special Financial Activity Tax. The effective income tax rate was 28.4% during the year ended 31 December 2017, as compared to 23.4% during the year ended 31 December 2016.

Income tax expense increased by ISK 3,406 million, or 105.6%, to ISK 6,631 million for the year ended 31 December 2016 from ISK 3,225 million for the year ended 31 December 2015. Income tax comprises 20.0% income tax on earnings and the Special Financial Activity Tax. The effective income tax rate was 23.4% during the year ended 31 December 2016, as compared to 6.1% during the year ended 31 December 2015. The unusually low effective income tax rate during the year ended 31 December 2015 was mainly explained by tax exempt earnings of corporates relating to valuation changes and profits on equity positions.

To calculate the effective income tax rate for the Group (28.4%, 23.4% and 6.1% for the years ended 31 December 2017, 2016 and 2015, respectively), it is necessary to factor into earnings before tax any non-deductible expenses and taxes, tax-exempt revenue and other applicable changes, the calculation of which is set forth in the note titled "*Income tax expense*" in the Annual Financial Statements. The historically lower effective income tax rate for the Group was primarily driven by tax-exempt income relating to the equity positions held by the Group.

Segmental Analysis

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. Operating segments pay and receive interest to and from Treasury on an arm's length basis to reflect the allocation of capital, funding cost and relevant risk premium. The tables below set forth certain information with respect to the Group's operating segments for the periods indicated.

	Year Ended 31 December 2017							
	Asset management(1)	Corporate banking	Investment banking	Retail banking(2)	Treasury	Other divisions and subsidiaries(3)	Headquarters and elimination(4)	Total
				(ISK in millions)				
Net interest income	502	6,002	240	15,502	6,536	1,269	(216)	29,835
Net fee and commission income	4,011	1,171	1,298	4,703	(312)	4,213	273	15,357
Net financial income	145	224	(71)	19	(13)	4,052	(265)	4,091
Net insurance income	—	—	—	—	—	2,224	(131)	2,093
Share of profit of associates and net impairment	—	—	—	—	—	15	(940)	(925)
Other operating income	19	1,146	—	927	5	478	352	2,927
Operating income (loss)	**4,677**	**8,543**	**1,467**	**21,151**	**6,216**	**12,251**	**(927)**	**53,378**
Operating expense	(1,138)	(357)	(780)	(5,134)	161	(9,317)	(13,396)	(29,961)
Allocated expense	(1,019)	(2,424)	(652)	(5,905)	(887)	(15)	10,902	—
Bank Levy	(182)	(671)	(39)	(1,097)	(1,183)	—	—	(3,172)
Net impairment	—	(1,794)	(53)	2,489	70	(527)	1	186
Earnings (loss) before tax	**2,338**	**3,297**	**(57)**	**11,504**	**4,377**	**2,392**	**(3,420)**	**20,431**
Net segment revenue from external customers	2,638	15,689	1,003	30,765	(9,044)	12,948	(621)	53,378
Net segment revenue from other segments	2,039	(7,146)	464	(9,614)	15,260	(697)	(306)	—
Operating income (loss)	**4,677**	**8,543**	**1,467**	**21,151**	**6,216**	**12,251**	**(927)**	**53,378**
Depreciation and amortisation	1	—	—	359	—	974	798	2,132

(1) Includes Stefnir.

(2) Includes ABMIIF.

(3) Includes Market Making and subsidiaries Valitor, Landey and Vördur (including what was formerly Okkar Life Insurance). The operating income of Valitor and Vördur was ISK 7,401 million and ISK 3,139 million, respectively, the earnings before tax of Valitor and Vördur were ISK 206 million and ISK 1,164 million, respectively, and total assets of Valitor and Vördur were ISK 50,313 million and ISK 19,980 million, respectively.

(4) "Headquarters and elimination" includes the netting out of intragroup accounts, dividends paid in respect of the Bank's holdings in listed equity and valuation changes. "Headquarters" include overhead and the following support divisions: Risk Management, Finance (excluding Treasury and Market Making), Legal, IT and Operations.

	Year Ended 31 December 2016							
	Asset management(1)	Corporate banking	Investment banking	Retail banking(2)	Treasury	Other divisions and subsidiaries(3)	Headquarters and elimination(4)	Total
				(ISK in millions)				
Net interest income	535	6,436	1,104	14,992	6,093	1,233	(493)	29,990
Net fee and commission income	3,863	1,082	1,808	3,537	(345)	3,885	148	13,978
Net financial income	(67)	(12)	(100)	115	332	4,617	277	5,162
Net insurance income	—	—	—	—	—	1,395	—	1,395
Share of profit of associates and net impairment	—	—	613	—	—	275	20	908
Other operating income	14	368	321	1,058	80	905	457	3,203
Operating income	4,345	7,874	3,746	19,702	6,160	12,310	409	54,546
Operating expense	(1,422)	(605)	(939)	(6,134)	(189)	(7,061)	(14,190)	(30,540)
Allocated expense	(882)	(2,386)	(827)	(6,149)	(876)	(20)	11,140	—
Bank Levy	(209)	(609)	(41)	(980)	(1,033)	—	—	(2,872)
Net impairment	—	33	1,704	5,557	7	(65)	—	7,236
Earnings (loss) before tax	**1,832**	**4,307**	**3,643**	**11,996**	**4,069**	**5,164**	**(2,641)**	**28,370**
Net segment revenue from external customers	1,908	15,919	3,225	31,064	(11,647)	12,875	1,202	54,546
Net segment revenue from other segments	2,437	(8,121)	521	(11,287)	17,807	(565)	(792)	—
Operating income	**4,345**	**7,798**	**3,746**	**19,777**	**6,160**	**12,310**	**410**	**54,546**
Depreciation and amortisation	—	1	—	336	—	727	778	1,842

(1) Includes Stefnir.

(2) Includes ABMIIF.

(3) Includes Market Making and subsidiaries Valitor, Okkar Life Insurance, Landey and Vördur. The operating income of Valitor, Okkar Life Insurance and Vördur was ISK 9,428 million, ISK 850 million and ISK 847 million, respectively, the earnings before tax of Valitor, Okkar Life Insurance and Vördur were ISK 3,590 million, ISK 195 million and ISK 454 million, respectively, and total assets of Valitor, Okkar Life Insurance and Vördur were ISK 38,588 million, ISK 4,554 million and ISK 12,436 million, respectively.

(4) "Headquarters and elimination" includes the netting out of intragroup accounts, dividends paid in respect of the Bank's holdings in listed equity and valuation changes. "Headquarters" include overhead and the following support divisions: Risk Management, Finance (excluding Treasury and Market Making), Legal, IT and Operations.

	Year Ended 31 December 2015							
	Asset management[1]	**Corporate banking**	**Investment banking[2]**	**Retail banking[3]**	**Treasury**	**Other divisions and subsidiaries[4]**	**Headquarters and elimination[5]**	**Total**
	(ISK in millions)							
Net interest income	462	6,023	101	13,877	5,803	708	18	26,992
Net fee and commission income	4,183	1,059	2,153	2,656	(313)	4,106	640	14,484
Net financial income	226	(37)	8,304	158	872	814	2,507	12,844
Net insurance income	—	—	—	—	—	792	(32)	760
Share of profit of associates and net impairment	—	—	25,436	—	—	6	4,024	29,466
Other operating income	11	(26)	440	196	396	834	224	2,074
Operating income	**4,882**	**7,019**	**36,434**	**16,887**	**6,758**	**7,260**	**7,381**	**86,620**
Operating expense	(1,451)	(547)	(1,152)	(6,011)	(256)	(5,616)	(12,778)	(27,811)
Allocated expense	(728)	(2,009)	(809)	(5,666)	(1,009)	(38)	(10,259)	
Bank Levy	(213)	(587)	(128)	(893)	(997)	—	—	(2,818)
Net impairment	—	(3,074)	3,030	(2,262)	11	(868)	75	(3,087)
Earnings before tax	**2,490**	**802**	**37,375**	**2,055**	**4,507**	**738**	**4,937**	**52,904**
Net segment revenue from external customers	2,589	14,252	37,119	27,488	(9,809)	7,647	7,335	86,620
Net segment revenue from other segments	2,293	(7,233)	(685)	(10,601)	16,567	(387)	46	—
Operating income	**4,882**	**7,019**	**36,434**	**16,887**	**6,758**	**7,260**	**7,381**	**86,620**
Depreciation and amortisation	—	—	—	287	—	576	793	1,656

(1) Includes Stefnir.

(2) Includes BG12 slhf., EAB 1 ehf. and Kolufell, in which the Bank sold a majority of its shareholding in July 2016.

(3) Includes ABMIIF and AFL, a savings bank which was merged into the Bank in October 2015.

(4) Includes Market Making and subsidiaries Valitor, Okkar Life Insurance, Landey and Eignabjarg, a wholly owned subsidiary of the Bank which was liquidated in 2015. The operating income of Valitor and Okkar Life Insurance was ISK 5,157 million and ISK 1,012 million, respectively, the earnings before tax of Valitor and Okkar Life Insurance were ISK 131 million and ISK 459 million, respectively, and total assets of Valitor and Okkar Life Insurance were ISK 39,134 million and ISK 4,663 million, respectively.

(5) "Headquarters and elimination" includes the netting out of intragroup accounts, dividends paid in respect of the Bank's holdings in listed equity and valuation changes. "Headquarters" include overhead and the following support divisions: Risk Management, Finance (excluding Treasury and Market Making), Legal, IT and Operations.

Asset Management

Operating income for Asset Management segment increased by ISK 332 million, or 7.6%, to ISK 4,677 million for the year ended 31 December 2017 from ISK 4,345 million for the year ended 31 December 2016. This increase was primarily due to an increase in net fee and commission income as a result of an increase in performance based fees and favourable market conditions compared to 2016, driven by performance at Stefnir.

Operating income for Asset Management segment decreased by ISK 537 million, or 11.0%, to ISK 4,345 million for the year ended 31 December 2016 from ISK 4,882 million for the year ended 31 December 2015. This decrease was primarily due to less favourable market conditions compared to 2015, as part of the fee and commission income is performance based. Stefnir also held some financial assets, particularly its private equity funds, which did not perform as well in the year ended 31 December 2016 compared to 2015.

The table below sets forth the assets under management and assets under custody which the Group manages or holds on behalf of its customers as of the dates indicated.

	As of 31 December		
	2017	2016	2015
	(ISK in millions)		
Assets under management[(1)]	984,653	1,054,759	996,648
Assets under custody[(2)]	1,620,355	1,532,860	1,427,269

(1) Assets under management represent the total market value of the financial assets which the Group manages on behalf of its customers.

(2) Assets under custody represent those assets for which the Group, acting as custodian, is responsible for safeguarding a firm's or individual's financial assets, holding safekeeping securities such as stocks, bonds and securities funds, arranging the settlement of trades and movements of securities, processes corporate actions such as income on bonds and dividends on shares, and pricing on securities.

The increase in assets under management during the periods under review primarily reflects increased activity in the market and new customers at the Asset Management division. Movements in assets under custody during the periods under review reflect changes in the customer base of the Bank.

Corporate Banking

Operating income for the Corporate Banking segment increased by ISK 669 million, or 8.5%, to ISK 8,543 million for the year ended 31 December 2017 from ISK 7,874 million for the year ended 31 December 2016. This increase was primarily due to increased activities in the loan book during the year. There was pressure on the net interest margin on loans, and with lower interest rates in the market the net interest income decreased between years.

Operating income for Corporate Banking segment increased by ISK 855 million, or 12.2%, to ISK 7,874 million for the year ended 31 December 2016 from ISK 7,019 million for the year ended 31 December 2015. This increase was primarily due to an increased loan book during the year.

Investment Banking

Operating income for Investment Banking segment decreased by ISK 2,279 million, or 60.8%, to ISK 1,467 million for the year ended 31 December 2017 from ISK 3,746 million for the year ended 31 December 2016. This decrease was primarily due to (i) a decrease in net fee and commission income as a result of internal and long-term projects in the Corporate Finance subdivision and (ii) a decrease in net interest income due to the transfer of some bond holdings from Investment Banking to the CEO office (reflected in Headquarters and elimination) and a decrease in the interest rate in the environment, despite the Capital Markets subdivision performing well.

Operating income for Investment Banking segment decreased by ISK 32,688 million, or 89.7%, to ISK 3,746 million for the year ended 31 December 2016 from ISK 36,434 million for the year ended 31 December 2015. This decrease was primarily due to significant income from valuation change and sale of equity holdings during the year ended 31 December 2015, but fee and commission income also decreased in the year ended 31 December 2016 due to less income from initial public offerings during 2016.

The table below sets forth certain financial information for the Investment Banking division, extracted from the standalone (rather than consolidated) financial statements of the Bank, for the periods indicated.

	Year ended 31 December		
	2017	**2016**	**2015**
	(ISK in millions)		
Net interest income	240	526	510
Net fee and commission income	1,298	1,872	2,160
Net financial income	(71)	21	5,425
Share of profit of associates and subsidiaries	—	115	19,085
Other operating income	—	115	—
Operating income	**1,467**	**2,649**	**27,180**
Operating expense	(780)	(780)	(809)
Allocated expense	(652)	(827)	(809)
Bank Levy	(39)	(41)	(128)
Net impairment	(53)	1,704	4,652
Earnings before tax	**(57)**	**2,705**	**31,023**

Until the first quarter of 2016, non-core assets were classified as a part of the Investment Banking segment, as the Corporate Finance subdivision largely had the institutional knowledge of such non-core assets. Because such non-core assets have either been sold or are in the late stages of selling process, it was decided to transfer the responsibility for such non-core assets to the CEO office. The effect of such non-core assets is mainly on the financial income, share of profit of associates and subsidiaries and net impairment. For the year ended 31 December 2015, the difference between the consolidated and standalone earnings before tax resulted primarily from a change from a valuation according to the equity method (less impairment) to the sales value (less cost of sale) in anticipation of the disposal of Bakkavor.

Retail Banking

Operating income for Retail Banking segment increased by ISK 1,449 million, or 7.4%, to ISK 21,151 million for the year ended 31 December 2017 from ISK 19,702 million for the year ended 31 December 2016. This increase was primarily due to growth in net interest income from increased volumes of loans to customers driven by loan growth to individuals and SMEs, despite strong competition and increased fee and commission income.

Operating income for Retail Banking segment increased by ISK 2,815 million, or 16.7%, to ISK 19,702 million for the year ended 31 December 2016 from ISK 16,887 million for the year ended 31 December 2015. This increase was primarily due to an increased loan portfolio with higher net interest income and increased fee and commission income, partly related to the new branch opened at Keflavík international airport in May 2016.

Treasury

Operating income for Treasury segment increased by ISK 56 million, or 0.9%, to ISK 6,216 million for the year ended 31 December 2017 from ISK 6,160 million for the year ended 31 December 2016. This increase was primarily due to higher net interest income from increased interest-bearing assets as no dividend was paid during 2017.

Operating income for Treasury segment decreased by ISK 598 million, or 8.8%, to ISK 6,160 million for the year ended 31 December 2016 from ISK 6,758 million for the year ended 31 December 2015. This decrease was primarily due to higher funding costs following increased borrowings instead of deposits and an unfavourable currency market.

Other Divisions and Subsidiaries

Operating income for Other Divisions and Subsidiaries segment decreased by ISK 59 million, or 0.5%, to ISK 12,251 million for the year ended 31 December 2017 from ISK 12,310 million for the year ended 31 December 2016. From 2016 to 2017, the operating income of Valitor decreased by 21.5% (see below) but was offset in part by the operating income of the new subsidiary Vördur, which was included in the results of operations of the Group from its acquisition in the fourth quarter of 2016.

Operating income for Other Divisions and Subsidiaries segment increased by ISK 5,049 million, or 69.5%, to ISK 12,310 million for the year ended 31 December 2016 from ISK 7,260 million for the year ended

31 December 2015. This increase was primarily due to profit from sale of equity holdings in Visa Europe to Visa Inc. held by Valitor and increased net insurance income primarily from Vördur, which was acquired at the end of September 2016.

The results of operations of Valitor are consolidated with the Other Divisions and Subsidiaries reportable segment in the tables above. The table below sets forth certain financial information for Valitor, extracted from its own consolidated financial statements (rather than the Bank's), for the periods indicated.

	Year ended 31 December		
	2017	2016	2015
	(ISK in millions)		
Net interest income	1,008	1,024	513
Net fee and commission income	4,510	4,059	4,292
Net financial income	1,471	4,004	(108)
Share of profit of associates	2	11	0
Other operating income	410	330	459
Operating income	**7,401**	**9,428**	**5,157**
Operating expense	(7,069)	(5,773)	(4,853)
Bank Levy	—	—	—
Net impairment	(126)	(65)	(173)
Earnings before tax	**206**	**3,590**	**131**

In 2017, products sold through the partner channel accounted for approximately two-thirds Valitor's revenue, whilst SME products accounted for approximately one-fourth, and the remainder was attributable to omni-channel activities (solutions for handling payments across multiple channels, including in-store, online and mobile). The Bank and Valitor believe that there are substantial growth opportunities for SME and omni-channel. In terms of the split between channels, the partner channel accounted for approximately two-thirds of Valitor's revenue in 2017 and the direct channel accounted for the remainder. In 2017, Valitor's gross revenue split as follows: 41% from the United Kingdom; 25% from Iceland; 13% from the Nordics excluding Iceland; and 21% from the rest of Europe.

The decrease of operating income of Valitor by ISK 2,027 million, or 21.5%, from 2016 to 2017 was mainly due to a decrease in net financial income, as profit from the sale of Visa Europe in 2016 was significantly higher than the net financial income attributable to the mark-to-market changes on Valitor's equity holding in Visa Inc. during 2017. The increase in net fee and commission income was mainly due to the UK operating companies, Chip and Pin Solutions Ltd. and International Payment Services Ltd., which Valitor acquired during 2017, and increased international operations by Valitor. Other than these factors, the Bank believes that the financial information presented for Valitor is reflective of its organic growth, as the acquisitions referred to did not otherwise have a material impact on its results of operations.

The increase of operating income of Valitor by 82.8% from 2015 to 2016 was mainly due to profit from the sale of Valitor's equity holding in Visa Europe to Visa Inc. of ISK 5,291 million. The increase in net interest income was related to changes made in 2015 following a settlement with the ICA, and the decrease in net fee and commission income was mainly due to the competitive environment in the foreign operations of Valitor and the appreciation of the Icelandic Krona against foreign currency from 2015 to 2016. The increase in operating expense was primarily due to the expansion of Valitor's international operations.

Headquarters and Elimination

Operating income for Headquarters and Elimination decreased by ISK 1,336 million, or 326.7%, to a loss of ISK 927 million for the year ended 31 December 2017 from a gain of ISK 409 million for the year ended 31 December 2016. This decrease was primarily due to unfavourable market conditions in Iceland during 2016, since listed equity holdings are held in this segment.

Operating income for Headquarters and Elimination decreased by ISK 6,972 million, or 94.5%, to ISK 409 million for the year ended 31 December 2016 from ISK 7,381 million for the year ended 31 December 2015. This decrease was primarily due to unfavourable market conditions in Iceland during 2016, since listed equity holdings are held in this segment.

Cash Flows

The table below sets forth the Group's cash flows for the periods indicated.

	Year ended 31 December		
	2017	2016	2015
	(ISK in millions)		
Net cash from operating activities	62,663	17,476	36,593
Net cash from (used in) investing activities	(5,036)	21,366	16,026
Net cash used in financing activities	(63)	(18,171)	(32,810)
Net increase (decrease) in cash and cash equivalents	**57,564**	**20,671**	**19,809**
Cash and cash equivalents at beginning of the period	123,933	110,000	91,715
Effect of exchange rate changes on cash and cash equivalents	401	(6,738)	(1,524)
Cash and cash equivalents at the end of the period	**181,898**	**123,933**	**110,000**

Net cash from operating activities

Net cash from operating activities increased by ISK 45,187 million, or 258.6%, to ISK 62,663 million for the year ended 31 December 2017 from ISK 17,476 million for the year ended 31 December 2016. The increase was primarily due to an increase in deposits and borrowings.

Net cash from operating activities decreased by ISK 19,117 million, or 52.2%, to ISK 17,476 million for the year ended 31 December 2016 from ISK 36,593 million for the year ended 31 December 2015. The decrease was primarily due to increased lending during the year.

Net cash from (used in) investing activities

Net cash from investing activities decreased by ISK 26,402 million, or 123.6%, to ISK 5,036 million used in investing activities for the year ended 31 December 2017 from ISK 21,366 million from investing activities for the year ended 31 December 2016. The decrease was primarily due to the sale of the associated company Bakkavor, partly offset by the acquisition of Vördur in 2016. The subsidiary Valitor invested in the subsidiaries IPS—International Payment Services Ltd. and Chip and Pin Solutions Ltd. in 2017 in 2016.

Net cash from investing activities increased by ISK 4,272 million, or 26.7%, to ISK 21,366 million from investing activities for the year ended 31 December 2016 from ISK 16,026 million for the year ended 31 December 2015. The increase was primarily due to the sale of the associated company Bakkavor, partly offset by the acquisition of Vördur in 2016.

Net cash used in financing activities

Net cash used in financing activities decreased by ISK 18,108 million, or 99.7%, to ISK 63 million for the year ended 31 December 2017 from ISK 18,171 million for the year ended 31 December 2016. The decrease was primarily due to payment of a subordinated loan of ISK 8,785 million and disbursement of share capital and dividend to a non-controlling interest in 2016 of ISK 9,386 million.

Net cash used in financing activities decreased by ISK 14,639 million, or 44.6%, to ISK 18,171 million for the year ended 31 December 2016 from ISK 32,810 million for the year ended 31 December 2015. The decrease was primarily due to payments on subordinated liabilities in the amount of ISK 8,785 million as well as disbursement of share capital and a dividend payment to a non-controlling interest of the subsidiary BG12 slhf., amounting to ISK 9,386 million.

Funding

The funding policy of the Group is to seek stable funding at low cost, which provides the Group with a competitive advantage in the Icelandic banking market to service its retail and corporate customers. The Group's funding profile is strong and supports the Group's liquidity profile, helps to withstand stress scenarios for an extended period of time and does not rely on volatile funding or external support. The funding policy also helps to support the franchise value of Arion Bank, as it aims to be a leading issuer of debt in Iceland by having good investor relations, disclosure and credit ratings.

The Group is focused on maintaining a large and stable deposit base originated from its customers. Deposits are expected to continue to form the core of the Group's funding profile in the future. However, there are external factors that might affect the Group's deposit base in the short to medium term, such as the increased availability of other investment opportunities for investors who currently hold deposits with the Group. Relative to Íslandsbanki and Landsbankinn, the Group has a relatively low proportion of deposit funding to overall funding, which has an impact on the Group's cost of funding.

In addition to deposits, the Group's other funding comprises senior unsecured bonds issued under the EMTN Programme and its covered bonds, bills issued and other loans and equity, and the Group intends to continue diversifying its funding profile by issuing bonds in the domestic and international bond market when conditions permit. The Group's other funding as of 31 March 2018 was in the form of covered bonds in the amount of ISK 173,442 million, senior unsecured bonds issued under the EMTN Programme in the amount of ISK 209,452 million, bills issued/other loans of ISK 17,961 million and equity in the amount of ISK 204,245 million.

Deposit Funding

The Group is partially funded with domestic deposits. Its total deposit base as of 31 March 2018 was ISK 453,059 million, or 48.8% of its total liabilities, representing deposits across Retail Banking, Asset Management, Corporate Banking and Treasury. As of 31 March 2018, the aggregate amount of the Group's 10 largest deposits equalled 17% of the aggregate amount of the Group's total deposits as of such date. In the periods under review, the Group has experienced a reduced concentration of demand deposits, while average deposit yields increased from 3.2% for the year ended 31 December 2015 to 3.7% for the year ended 31 December 2016, due to the return to Kaupthing of certain foreign-currency denominated deposits (which had carried very low interest rates) which had been held by the Bank for the account of Kaupthing. For the year ended 31 December 2017, the rate was 2.9%, and the decrease was mainly due to the lowered interest rate environment in Iceland and increased liquidity at the Bank, with less need for higher yielding institutional investor deposits.

The table below sets for the composition of the Group's deposits as of the dates indicated.

	As of 31 March	As of 31 December		
	2018	2017	2016	2015
		(ISK in millions)		
Individuals	229,265	231,281	206,185	187,030
Corporates and SMEs	105,248	116,905	109,405	88,207
Other	118,262	113,976	96,474	193,610
Total	**453,059**	**462,161**	**412,064**	**469,347**

Although the Group has a stable deposit base which it expects to grow over time, it continues to diversify its funding profile to reduce asset and liability mismatches and have a balanced maturity profile in order to manage its liquidity risk. For additional information on the Group's deposits, see "*Risk Management—Liquidity and Funding Risk*".

Borrowings

The table below sets forth the Group's non-deposit borrowings (including subordinated liabilities) as of the dates indicated.

Instrument, Currency, Original Nominal Value	Issued	Maturity	Maturity Type	Terms of Interest	As of 31 March 2018	As of 31 December 2017	2016	2015
						(ISK in millions)		
ARION CB 1 (ISK 21,877 million)	2006	2033	Amortising	Fixed, CPI linked, 3.75%	—	—	16,734	17,108
ARION CB 4 (ISK 15,500 million)	2008	2045	Amortising	Fixed, CPI linked, 4.00%	—	—	6,199	6,182
ARION CB 2 (ISK 51,125 million)	2006	2048	Amortising	Fixed, CPI linked, 3.75%	78,538	78,267	78,239	77,916
Total Structured Covered Bonds					**78,538**	**78,267**	**101,172**	**101,206**
ARION CBI 19 (ISK 4,500 million)	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,596	4,586	4,502	4,483
ARION CB 19 (ISK 2,740 million)	2016	2019	At maturity	Fixed, 5.50%	1,813	1,789	580	—
ARION CBI 21 (ISK 10,220 million)	2014	2021	At maturity	Fixed, CPI linked, 3.50%	9,839	9,729	9,696	5,096
ARION CB 22 (ISK 23,660 million)	2015	2022	At maturity	Fixed, 6.50%	25,176	23,339	19,596	7,737
ARION CBI 25 (ISK 23,080 million)	2017	2025	At maturity	Fixed, CPI linked, 3.00%	24,369	22,875	—	—
ARION CBI 29 (ISK 25,220 million)	2014	2029	At maturity	Fixed, CPI linked, 3.50%	26,658	26,243	23,524	15,279
ARION CBI 34 (ISK 2,500 million)	2012	2034	Amortising	Fixed, CPI linked, 3.60%	—	2,152	2,207	2,249
ARION CBI 48 (ISK 3,500 million)	2018	2048	Amortising	Fixed, CPI linked, 2.50%	2,453	—	—	—
Total Statutory Covered Bonds					**94,904**	**90,713**	**60,105**	**34,844**
Total Structured Covered Bonds and Statutory Covered Bonds					**173,442**	**168,980**	**161,277**	**136,050**
NOK 500 million	2013	2016	At maturity	Floating, NIBOR+5.00%	—	—	—	1,547
USD 30 million	2016	2017	At maturity	Floating, 3-month LIBOR+1.93%	—	—	3,406	—
EUR 21 million	2009	2018	Amortising	Floating, EURIBOR+1.00%	346	348	662	1,177
ISK 3,835 million	2010	2018	Amortising	Floating, REIBOR+1.00%	544	531	1,063	1,600
EUR 300 million	2015	2018	At maturity	Fixed, 3.125%	—	25,461	36,610	43,350
SEK 500 million	2016	2018	At maturity	Floating, 3-month STIBOR+1.09%	5,921	6,348	3,113	—
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	37,270	37,957	36,307	—
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	920	966	951	—
SEK 275 million	2016	2019	At maturity	Floating, 3-month STIBOR+2.65%	3,252	3,485	3,422	—
SEK 100 million	2017	2019	At maturity	Fixed, 0.29%	1,184	1,268	—	—
NOK 800 million	2015	2020	At maturity	Floating, NIBOR+2.95%	10,153	10,236	10,617	11,900
NOK 320 million	2016	2020	At maturity	Floating, NIBOR+1.95%	4,052	4,087	2,902	—
EUR 300 million[(1)]	2017	2020	At maturity	Fixed, 0.75%	36,529	37,356	—	—
SEK 300 million	2017	2020	At maturity	Floating, 3-month STIBOR+1.35%	3,556	3,811	—	—

Instrument, Currency, Original Nominal Value	Issued	Maturity	Maturity Type	Terms of Interest	As of 31 March 2018	As of 31 December 2017	2016	2015
					(ISK in millions)			
SEK 250 million	2017	2020	At maturity	Floating, 3-month STIBOR+0.75%	2,960	3,173	—	—
EUR 500 million[(1)]	2016	2021	At maturity	Fixed, 1.625%	60,052	61,341	35,639	—
USD 747 million (Resettable Notes)	2016	2023	At maturity	Floating, 3-month LIBOR +2.60%	—	—	29,317	—
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,230	3,231	—	—
EUR 300 million	2018	2023	At maturity	Fixed, 1.0%	36,242	—	—	—
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,241	3,240	—	—
Total Senior Unsecured Bonds (issued under the EMTN Programme)					**209,452**	**202,839**	**164,009**	**59,574**
Icelandic Central Bank, secured	2010	2022	At maturity	Floating, LIBOR+3.00%	—	—	—	56,024
Bills issued (including commercial paper)					16,248	10,794	13,854	4,081
Other					1,713	2,385	336	329
Other loans/bills					**17,961**	**13,179**	**14,190**	**60,434**
Total borrowings					**400,855**	**384,998**	**339,476**	**256,058**

(1) The Group applies hedge accounting to these issuances and uses certain foreign-currency denominated interest rate swaps as hedging instruments. See Note 22 in the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018 in "*Consolidated Financial Statements*". The interest rate swaps are used to hedge the exposure of the Group's changes in the fair value of these fixed-rate foreign-currency denominated bonds arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. As of 31 March 2018, the total carrying amount of these issuances was ISK 96,581 million and included in the amount were fair value changes related to interest rate risk amounting to ISK 27 million. See Note 7 in the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018 in "*Consolidated Financial Statements*".

Structured Covered Bonds

The Group's funding profile changed significantly at the end of 2011, when the Bank acquired a mortgage portfolio from Kaupthing and assumed all liabilities and obligations of Kaupthing (past, present and future, other than Kaupthing's liabilities and obligations relating to withholding tax payments) in respect of each of the outstanding series of the covered bonds issued from 2006 to 2008 by Kaupthing to finance its mortgage loans (the "**Structured Covered Bonds**") under the covered bond programme established by Kaupthing on 30 March 2006. The Structured Covered Bond series have all been prepaid except for one outstanding series. The outstanding series is not rated, CPI-linked, has a final maturity date of 2048 and had an aggregate face value of ISK 78.3 million as of 31 December 2017, and which is included as borrowings in the Bank's consolidated statement of financial position. In addition, as of 31 December 2017, the Structured Covered Bonds covered 6,031 loans with an asset balance of ISK 93.7 billion, a pool loan-to-value ratio of 55.0% and over-collateralisation of 19.7%.

Statutory Covered Bonds

The Bank has established a statutory covered bond programme, under which it issues covered bonds on a regular basis to finance its residential mortgage lending (the "**Statutory Covered Bonds**"). The Statutory Covered Bonds may be either rated or unrated, have either fixed or floating interest rate and may be linked to a currency or CPI. As of 31 December 2017, the Statutory Covered Bonds covered 8,132 loans with an asset balance of ISK 108.7 billion, a pool loan-to-value ratio of 60.6% and over-collateralisation of 11.6%. The Bank expects a majority of Statutory Covered Bonds issued in the short to medium term to be CPI linked given the preference of the Icelandic pension funds who purchase them and to match a majority issuance of CPI linked mortgage loans, due to their lower debt servicing costs.

EMTN Programme

The Bank established the EMTN Programme, under which the Bank may issue from time to time senior unsecured notes at either fixed or floating rates, denominated in any currency and either rated or unrated (each, an "**EMTN Bond**"). EMTN Bonds issued under the EMTN Programme are subject to terms and conditions customary for such instruments. The Bank expects that its issuances under the EMTN Programme will predominantly be denominated in foreign currencies and used for lending mainly to Icelandic companies which are export-driven and do not have a great need for ISK funding.

In January 2016, the Bank issued Resettable Notes due 2023 in the amount of USD 747,481,000 (ISK 97 billion) to Kaupthing (the "**Resettable Notes**") under the EMTN Programme. See "*Principal and Selling Shareholders—Kaupthing*". The Resettable Notes are seven-year instruments, callable on interest payment dates during the first two years and are subject to a mandatory prepayment clause in the event that the Bank (or a special purpose vehicle subsidiary of the Bank set up for the purpose of issuing debt securities) issues debt securities with a nominal amount greater than or equal to USD 165.0 million or such equivalent amount in a currency other than ISK from date of issue until 11 January 2018 (with exceptions for debt issued to redeem debt securities denominated in a currency other than ISK which were outstanding as of 11 January 2016 and had an originally scheduled maturity date not later than 30 months thereafter). Subject to certain exceptions, the amount of such mandatory prepayment is equal to 75% of the proceeds of the bond issue which triggered the mandatory prepayment and must be paid not less than 20 but not more than 45 days following the mandatory prepayment event. The Resettable Notes were repaid in full as of 30 June 2017.

Liquidity

The Group's strategy is to always maintain sufficient liquidity by sustaining a high ratio of liquid assets and available funding to near-term liabilities and expected payment outflows. The Board of Directors believes that uncertainties in respect of the availability of liquidity in relation to the Capital Controls have been significantly reduced by diversifying the funding profile of the Group, in particular by establishing access to domestic and international debt markets and by attempting to prudently manage the maturity profile of its liabilities. See "*Risk Factors—Risks Relating to Business and Industry—The Bank is exposed to significant liquidity risk*". In addition, the Group has made significant progress, over the course of its existence, in converting its demand deposits to term deposits. For additional information on the composition of the Group's funding and deposit base, see "*—Funding*" and "*Risk Management—Liquidity Risk*".

The LCR Rules applicable to the Group are based on the liquidity standards introduced in the Basel III Accord, which began to be implemented in 2015 internationally. The LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions. The LCR is defined as the quotient of the weighted liquid assets divided by the difference between the weighted cash outflows and the weighted cash inflows, where weighted cash inflows are capped at 75.0% of weighted cash outflows. For additional information, see the note titled "*Liquidity and funding risk*" in the Annual Financial Statements.

To qualify as highly liquid assets under the LCR Rules, assets must be non-pledged, liquid and easily priced on the market, repoable at the Icelandic Central Bank and not issued by the Group or related entities. The Icelandic Central Bank has issued rules for minimum LCR. For the year ended 31 December 2015, the LCR requirement was 100% in foreign currency and 80% in total (ISK and foreign currency). For the year ended 31 December 2016, the LCR requirement was 100% in foreign currency and 90% in total (ISK and foreign currency). The requirement for foreign currency is 100% effective from 1 January 2017. The Bank reports the LCR to the Icelandic Central Bank on a monthly basis.

The table below sets forth the LCR as of the dates indicated.

	As of 31 March	As of 31 December		
	2018	2017	2016	2015
ISK	99%	127%	109%	78%
Foreign exchange	315%	323%	263%	212%
Total	**210%**	**221%**	**171%(1)**	**134%**

(1) The Bank's liquidity facility from the Icelandic government expired at the end of 2016, which reduced the Bank's liquidity buffer by ISK 30 billion and, consequently, decreased the LCR.

For additional information on the calculation of the LCR and the Group's composition of liquid assets, see the notes titled "*Liquidity and funding risk*" and "*Liquidity risk*" in the Annual Financial Statements.

The Group's liquidity reserve, measured as the total of liquid assets, amounted to ISK 205,353 million as of 31 March 2018, representing 45.3% of customer deposits as of 31 March 2018 (ISK 228,909 million as of 31 December 2017, ISK 182,712 million as of 31 December 2016 and ISK 192,125 million as of 31 December 2015). The Group's loan-to-deposit ratio as of 31 March 2018 was 172.7% (134.4% excluding covered bonds), as compared to 165.5% as of 31 December 2017 (129.0% excluding covered bonds), 172.9% as of 31 December 2016 (133.8% excluding covered bonds) and 145.0% as of 31 December 2015 (116.0% excluding covered bonds). The Bank expects an increased loan-to-deposit ratio going forward, as the customer loan portfolio is expected to grow faster than deposits.

The table below sets forth the calculation of the loan-to-deposit ratio excluding covered bonds, which is Non-IFRS Information.

	As of 31 March	As of 31 December		
	2018	2017	2016	2015
	(ISK in millions, except percentages)			
Loans to customers	782,255	765,101	712,422	680,350
Covered bonds	173,442	168,980	161,277	136,050
Loans to customers excluding covered bonds	**608,813**	**596,121**	**551,145**	**544,300**
Deposits	453,059	462,161	412,064	469,347
Loan-to-deposit ratio	**172.7%**	**165.5%**	**172.9%**	**145.0%**
Loan-to-deposit ratio excluding covered bonds	**134.4%**	**129.0%**	**133.8%**	**116.0%**

The Group considers liquidity risk as a key risk factor and places emphasis on managing it. For additional information on the Group's liquidity, including liquidity risk, see "*Risk Management—Liquidity Risk*".

Capital Position

The focus of capital management at the Group is to optimise the capital structure in the medium term and, consequently, to maintain the Group's capitalisation comfortably above the regulatory minimum levels, including capital buffers and requirements under the FME's supervisory review and evaluation process (the "**SREP**"). In particular, the Group seeks to maintain a capital adequacy ratio that is 1.5% above the total FME requirements, including Pillar 1, Pillar 2 and combined capital buffer requirements, and in any event to maintain a capital adequacy ratio of not less than 20.0%. It is the intention of the Bank to distribute surplus capital to shareholders, to the extent that capital adequacy ratios are in excess of its targets. However, the speed and quantum of such returns would depend on a number of factors, including (but not limited to) management of the Bank's foreign exchange imbalances, its capital optimisation strategy and regulatory consents, and such returns would likely take place over a number of years. Initially, the Bank anticipates that this strategy would involve an issuance of senior unsecured bonds and ultimately Tier 2 and AT1 instruments, depending on market conditions, in order to fund further capital distributions.

Capital Ratios

The Group's capital ratios are calculated in accordance with the Financial Undertakings Act and Regulation No. 233/2017 on Prudential Requirements for Financial Undertakings, through which CRD IV and CRR have been adopted. Article 501 of the CRR, on capital requirements deduction on exposures to small and medium-sized enterprises, is excluded in the Icelandic adoption. The Group's capital adequacy is based on Arion Bank's consolidated exposures in accordance with the CRR, which excludes insurance operations. The capital position and solvency requirement of Vördur are viewed separately. For additional information, see "*Regulatory Overview—Principal Legislation and Regulations—Capital Requirements Directive*" and "*Risk Factors—Risks Relating to Business and Industry—Changes to the Capital Requirements Directives could adversely affect the Bank's results*". Capital ratios as of 31 December 2015 are based on the preceding Basel II definitions. The Group uses the standardised approach to calculate the capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

The Group is subject to capital requirements specified by the FME following the SREP. The Group's own funds exceeded the FME's requirements under the SREP in each of the years ended 31 December 2017, 2016 and 2015. Based on the FME's final SREP result delivered in October 2017, the Group's total regulatory capital requirement has been 19.8% with effect from 1 November 2017, including fully implemented capital buffer requirements, and based on the Bank's consolidated exposures. In addition to the total regulatory capital requirement, the Group intends to implement a management buffer in the amount of 1.5%.

As of 31 March 2018, the Group's capital base amounted to ISK 183,711 million (exceeding the FME's requirements under the SREP), as compared to ISK 183,958 million as of 31 December 2017. The Group's capital adequacy ratio, calculated in accordance with Icelandic requirements, was 23.6% as of 31 March 2018 (exceeding the minimum legal requirement of 8.0%), as compared to 24.0% as of 31 December 2017.

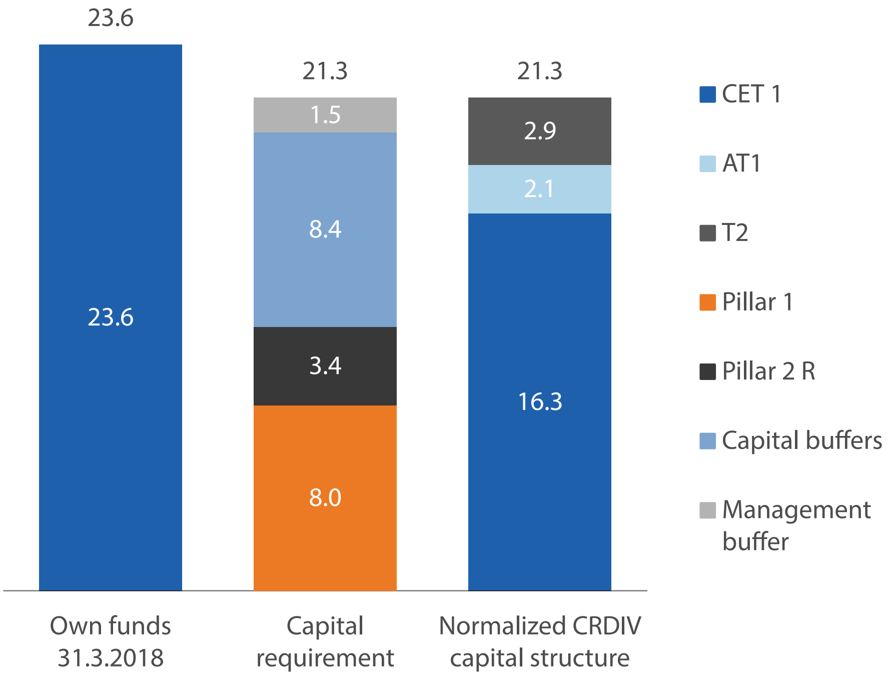
The table below sets forth the total capital requirements for the Group.

	CET1	**AT1**	**Tier 2**	**Total**
Pillar 1	4.5%	1.5%	2.0%	8.0%
Pillar 2R(1)	1.9%	0.7%	0.9%	3.4%
Combined capital buffer requirement(2)	8.4%	—	—	8.4%
Total regulatory capital requirement	**14.8%**	**2.2%**	**2.9%**	**19.8%**
Management buffer	1.5%	—	—	1.5%
Total	**16.3%**	**2.2%**	**2.9%**	**21.3%**

(1) SREP result based on the Group's financial position as of 31 December 2016. The Pillar 2 requirement is 3.7% of risk-weighted assets based on the Group's accounting consolidation. Based on the Group's consolidation situation under CRR, which excludes Vördur, the requirement is 3.4%.

(2) Combined capital buffer requirement of the Group as of 1 November 2017. The institution-specific systemic risk buffer and the countercyclical risk buffer are determined using the weighted average respective buffer levels in countries where the Bank has exposure and weighting is determined by the percentage of risk-weighted assets relating to credit risk. With the FME's possible recognition of systemic risk buffers and countercyclical buffers in other countries, those requirements will apply to the corresponding foreign exposures, resulting in a higher combined buffer requirement.

The graph below sets forth the Group's total capital ratio as of 31 March 2018, the total capital requirements applicable to the Group after full implementation of the combined capital buffer requirements and the composition by type of capital under CRD IV of the Group's total capital requirements.



As stated in "*Business Overview—Financial Targets*", the Bank has a medium-term target to reduce its CET1 ratio to approximately 17%, which it expects to have the most significant impact on achieving its long-term target to achieve a competitive return on equity (post-tax) exceeding 10%. As an illustrative example of how normalisation of the Group's capital structure could have such an impact, assuming a reduction of the CET1 ratio to 17% as of 31 December 2017, with further capital comprising 1.4% AT1 capital and 2.9% Tier 2 capital, and further assuming, during the entire period, a 4.7% (pre-tax) yield on excess capital, an annual financing cost (in EUR) of 5.4% for AT1 capital and 2.5% for Tier 2 capital, and a cost due to negative interest rates (in EUR) of 0.4% on cash held, the Bank's return on equity for the year ended 31 December 2017 would have been approximately 8%. This example is provided for illustrative purposes only based on assumptions the Bank's management deems reasonable at the present time and is not an indication of actual results that may be achieved if the Bank reduces its CET1 ratio.

For additional information on the Group's capital requirements, see "*Risk Management—Capital Management*".

The table below sets forth the Group's total capital and calculations of risk-weighted assets as of the dates indicated. The Group expects growth in risk-weighted assets to be broadly in line with lending growth, and it will continue to look for ways to reduce risk-weighted asset density.

	As of 31 March	As of 31 December		
	2018	2017	2016	2015
	(ISK in millions, except percentages)			
Own funds[1]				
Total equity	**204,245**	**225,734**	**211,384**	**201,894**
Deductions related to the consolidated exposures	(7,870)	(8,635)	(8,126)	—
Non-controlling interest not eligible for inclusion in CET1 capital	(128)	(128)	(172)	(9,108)
Common equity Tier 1 capital before regulatory adjustments	**196,247**	**216,971**	**203,086**	**192,786**
Intangible assets	(10,834)	(11,125)	(8,201)	(9,285)
Tax assets	(425)	(357)	(198)	(205)
Cash flow hedges	(314)	265	(22)	—
Foreseeable dividend[2]	(975)	(25,000)	—	—
Additional value adjustments	(116)	(119)	(127)	—
Equity holdings in financial sector entities[3]	—	—	—	(3,151)
Common equity Tier 1 capital	**183,583**	**180,635**	**194,5,8**	**180,145**
Non-controlling interest not eligible for inclusion in CET1 capital	128	128	172	9,108
Tier 1 capital	**183,711**	**180,763**	**194,710**	**189,253**
Subordinated liabilities	—	—	—	10,365
Regulatory adjustments to Tier 2 capital[4]	—	—	—	(771)
Equity holdings in financial sector entities[3]	—	—	—	(3,118)
General credit risk adjustments[4]	—	3,195	4,557	—
Tier 2 capital	**—**	**3,195**	**4,557**	**6,476**
Total own funds	**183,711**	**183,958**	**199,267**	**195,729**
Risk-weighted assets[1][5]				
Credit risk, loans (Icelandic government and administrative bodies)	1,726	1,550	1,765	1,718
Credit risk, loans (institutions)	20,174	18,545	17,598	37,466
Credit risk, loans (corporates)	361,043	358,315	368,495	142,471
Credit risk, loans (retail)	93,175	95,658	76,386	57,057
Credit risk, loans (real estate—individuals and corporates)	114,717	109,560	97,249	313,919
Credit risk, loans (past due)	19,787	21,429	15,976	14,612
Credit risk, securities and other (other assets)	29,645	28,429	23,145	51,695
Credit risk, securities and other (equity)	13,088	17,436	22,622	51,695
Credit risk, securities and other (bonds)	10,244	11,434	9,269	51,695
Credit risk (counterparty credit risk)	6,009	5,844	5,550	62,096
Total credit risk	**669,608**	**667,882**	**638,056**	**681,033**
Market risk (foreign exchange)	8,695	4,985	5,449	38,401
Market risk (other)	11,522	5,473	12,966	7,035
Credit valuation adjustment	3,148	2,506	2,678	—
Operational risk	86,013	86,013	86,490	81,441
Total risk-weighted assets	**778,986**	**766,768**	**745,639**	**807,910**
Capital ratios				
CET1 ratio[6]	23.6%	23.6%	26.1%	22.3%
Tier 1 ratio[7]	23.6%	23.6%	26.1%	23.4%
Capital adequacy ratio[8]	23.6%	24.0%	26.8%	24.2%

(1) As of 31 December 2017 and 31 March 2018, the Group's capital adequacy is calculated on the basis of its prudential consolidation which excludes insurance subsidiaries. The figures as of 31 December 2016 have been adjusted accordingly.

(2) As of 31 March 2018, the foreseeable dividend was 50% of the accumulated net earnings in 2018, which reflects the Bank's dividend policy. As of 31 December 2017, the foreseeable dividend was the amount of the equity reduction executed in the first quarter of 2018 through the purchase by the Bank of its own shares and the First Monetisation Dividend.

(3) The Financial Undertakings Act No. 161/2002 states that the Bank's CET1 holdings of instruments in financial sector entities are to be deducted from CET1, while the CRR specifies a 10.0% threshold for such deductions. Such deductions were previously

split between Tier 1 and Tier 2 capital, but currently apply to the corresponding type of capital instrument.

(3) Straight-line amortisation for maturities within five years.

(4) Under IAS 39, the Bank's general credit risk adjustments are considered part of Tier 2 capital as stipulated in the CRR. As per the EBA's opinion, all provisions under IFRS 9 are considered specific credit risk adjustments ("**SCRA**"), rather than general adjustments. The FME has adopted the EBA's opinion on this matter , and as a result, since adopting IFRS 9 on 1 January 2018, the Group's own funds no longer include general credit risk adjustments, and these are now treated as SCRA, effectively reducing the Group's risk-weighted assets.

(5) Risk-weighted assets are calculated in accordance with the CRD IV / CRR framework, apart from the application of Article 501 of CRR on capital relief for SME exposures which was excluded in the Icelandic adoption of the regulation. The Group's assets are weighted according to risk to determine the minimum capital requirements. The Group uses the standardised approach to calculate the requirement for credit risk, market risk and operational risk. As of 31 December 2017, the classification of risk-weighted assets relating to credit risk has been altered, without affecting the total amount, and the figures as at 31 December 2016 and 2015 have been adjusted accordingly.

(6) The CET1 ratio is defined as the common equity Tier 1 capital as a percentage of total risk-weighted assets.

(7) The Tier 1 ratio is defined as the Tier 1 capital as a percentage of total risk-weighted assets.

(8) The capital adequacy ratio is defined as the Bank's total capital base, comprising Tier 1 and Tier 2 capital, as a percentage of total risk-weighted assets.

Leverage Ratio

As part of the Basel III regulatory framework, the leverage ratio is seen as a complementary measure to the risk-based capital adequacy ratio. The leverage ratio is the ratio between the Group's total exposure and its Tier 1 capital. On-balance sheet exposure is the Group's total on-balance sheet exposure, excluding derivatives and securities financing transactions ("**SFTs**"). Exposures to both derivatives and SFTs are calculated according to the Basel III framework. Derivatives exposures consist of the costs to replace derivatives contracts and an add-on for potential future exposure over the remaining life of such derivatives contracts. SFT exposures are the sum of gross SFT assets recognised for accounting purposes and a measure of counterparty credit risk. Off-balance sheet items are converted under the standardised approach into credit exposure equivalents through the use of credit conversion factors.

The leverage ratio is calculated on the basis of Arion Bank's consolidated exposures as stipulated by the CRR, which excludes insurance subsidiaries. The table below sets forth the calculation of the Group's leverage ratio as of the dates indicated.

	As of 31 March	As of 31 December		
	2018	2017	2016	2015
	(ISK in millions, except percentages)			
On-balance sheet exposures	1,081,484	1,074,207	995,063	982,348
Derivative exposures	10,931	10,957	8,226	3,789
SFTs exposures	8,542	8,925	9,330	16,287
Off-balance sheet exposures	88,456	83,058	83,156	127,675
Total exposure	**1,189,413**	**1,177,147**	**1,095,775**	**1,130,099**
Tier 1 capital	**183,711**	**180,763**	**194,710**	**189,253**
Leverage ratio	15.4%	15.4%	17.8%	16.7%

Capital Expenditures

Capital expenditures for the Group during the periods under review comprise mainly expenditures on software, IT and office equipment and real estate, which impacted mainly the Headquarters and Elimination and Other Divisions and Subsidiaries segments. The table below sets forth the components of the Group's capital expenditures for the periods indicated.

	Three months ended 31 March	Year ended 31 December		
	2018	2017	2016	2015
	(ISK in millions)			
Software	436	1,657	1,479	819
IT and office equipment	223	776	844	709
Real estate	—	—	166	2
Total	**659**	**2,433**	**2,490**	**1,530**

The Group did not have any material commitments related to capital expenditures as of 31 March 2018.

Working Capital Statement

It is the assessment of the Board of Directors, for and on behalf of the Bank, that at the date of this Prospectus, the Bank has sufficient working capital to fulfil its requirements for the next 12 months.

Hedging and Derivatives

The Group uses over-the-counter derivatives, which are derivatives contracts with third parties, to manage interest rate, basis and inflation risk. These instruments are valued using fair values which are reflected in net interest income and net financial income in the consolidated statement of comprehensive income.

The Group applies fair value hedge accounting to certain bond issuances and uses foreign currency denominated interest rate swaps as hedging instruments. The interest rate swaps are used to hedge the exposure of the Group's changes in the fair value of the fixed-rate foreign currency denominated bonds arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017.

For additional information on the Group's derivatives, see the notes titled "*Financial instruments*", "*Financial assets and financial liabilities*", "*Fair value hierarchy*" and "*Offsetting financial assets and financial liabilities*" in the Annual Financial Statements. See also "*Risk Management—Market Risk*".

Off-Balance Sheet Arrangements and Financial Commitments

The table below sets forth the guarantees, unused overdrafts, loans which the Group has granted to customers, and operating lease payments in respect of the real estate it uses for its operations and in respect of its investment properties, in each case, as of the dates indicated.

	As of 31 March	As of 31 December		
	2018	2017	2016	2015
		(ISK in millions)		
Guarantees[1]	12,892	13,224	15,270	19,162
Unused overdrafts[2]	44,923	45,897	46,379	42,100
Loan commitments[3]	93,388	87,942	82,268	126,068
Operating lease payments (as lessee)[4]	n/a	2,369	2,246	1,309
Operating lease payments (as lessor)[4]	n/a	405	270	272

(1) Guarantees exclude a guarantee to the Depositors' and Investors' Guarantee Fund amounting to ISK 3,210 million. In June 2017, the Bank received confirmation from the Depositors' and Investors' Guarantee Fund that this guarantee would not be collected and the guarantee has therefore been cancelled.

(2) Unused overdrafts include credit card commitments.

(3) Loan commitments relate to corporate and SME customers across a range of industry sectors and are callable by borrowers on short notice. As of 31 December 2017, loan commitments related to real estate and construction (29%), seafood (9%), wholesale and retail (21%), industry, energy and manufacturing (20%), services (4%) and other sectors (17%).

(4) For information on the operating lease payments, see the note titled "Operating lease commitments" in the Annual Financial Statements. Operating lease payments are not available on an interim basis.

Guarantees, unused overdrafts and loan commitment balances have increased during the periods under review. The year ended 31 December 2015 was exceptional due to a number of very high loan commitments outstanding at the end of the period as a result of growth in the Group's loan portfolio. In general, demand for new lending to corporates has increased in connection with the positive economic development during the periods under review.

Quantitative and Qualitative Disclosure about Market Risk

For quantitative and qualitative disclosure about market risk, see "*Risk Management—Market Risk*".

Significant Accounting Estimates and Judgements

The preparation of the Group's consolidated financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

Key Sources of Estimation Uncertainty

The key sources of estimation uncertainty are within impairment losses on loans and reversal of impairment losses on loans for the years ended 31 December 2017, 2016 and 2015. The Group reviews its loan portfolios to assess impairment at least quarterly. See the note titled "*Financial assets and financial liabilities*" in the Annual Financial Statements. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating such cash flows, management makes judgements about a borrower's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the credit risk function. Collective provisions are applied to loans to customers, other than those that have been specifically impaired, to meet the anticipated future losses on such loans to customers. In addition, loans to customers that are more than 90 days in default, but have been determined not to require specific impairment, are exempt from collective provisions. For additional information on credit risk and collective provisions, see "*Risk Management—Credit Risk*".

Future Accounting Developments

IFRS 16 Leases will become effective for annual periods beginning on 1 January 2019. The standard does not significantly change the Group's accounting for leases for lessors. However, it does require lessees to recognise most leases on the balance sheet as lease liabilities, with the corresponding right-to-use assets. Lessees must apply a single model for all recognised leases, but will have the option not to recognise short-term leases and leases of low-value assets. The Group is currently assessing the potential effect of the new standard.

For additional information on the significant accounting policies of the Group, see the note titled "*Significant Accounting Policies*" in the Annual Financial Statements.

CAPITALISATION AND INDEBTEDNESS

The table below sets forth the capitalisation and indebtedness of the Bank as of 31 March 2018. The information has been extracted from the unaudited condensed consolidated interim financial information or from the accounting records as of and for the three months ended 31 March 2018 and should be read in conjunction with "*Operating and Financial Review*" and "*Selected Consolidated Financial, Operating and Other Information*" as well as the Annual Financial Statements and the condensed consolidated interim financial information as of and for the three months ended 31 March 2018, together with the notes thereto, included elsewhere in this Prospectus.

	As of 31 March 2018
	(ISK in millions)
Total current debt	**57,079**
Guaranteed	—
Secured[(1)]	9,027
Unguaranteed/unsecured[(2)]	48,052
Total non-current debt (excluding current portion of long-term debt)	**351,656**
Guaranteed	—
Secured[(3)]	164,415
Unguaranteed/unsecured[(4)]	187,241
Shareholders' equity	**204,117**
(a) Share capital	1,840
(b) Share premium	56,882
(b) Legal reserve	14,753
(c) Other reserves	127
(d) Retained earnings	130,515
Total	**612,852**

(1) Current secured debt comprises the short term portion of covered bonds ("short term" refers to maturities of 12 months or less).

(2) Current unguaranteed/unsecured debt comprises the short term portion of unsecured borrowings (includes unsecured bonds, bills issued and due to credit institutions).

(3) Non-current secured debt comprises the long term portion of covered bonds ("long term" refers to maturities longer than 12 months).

(4) Non-current unguaranteed/unsecured debt comprises the long term portion of unsecured bonds (includes unsecured bonds).

	As of 31 March 2018
	(ISK in millions)
(A) Cash and balances with Central Bank[(1)]	88,540
(B) Cash equivalents (Bank accounts)[(2)]	57,776
(C) Trading securities excluding derivatives[(3)]	30,433
(D) Liquidity (A) + (B) + (C)	**176,749**
(E) Current financial receivable	**—**
(F) Current bank debt[(4)]	7,880
(G) Current portion of non-current debt[(5)]	32,951
(H) Other current financial debt[(6)]	16,248
(I) Current debt (F) + (G) + (H)	**57,079**
(J) Net current financial indebtedness (I) – (E) – (D)	**(119,670)**
(K) Non-current bank loans[(7)]	—
(L) Bonds issued[(8)]	349,943
(M) Other non-current loans[(9)]	1,713
(N) Non-current financial indebtedness (K) + (L) + (M)	**351,656**
(O) Net financial indebtedness (J) + (N)	**231,986**

(1) Cash and balances with Central Bank comprises cash at cash centre and branches, bank accounts at the Icelandic Central Bank and liquid bonds issued by the Icelandic Central Bank excluding the mandatory reserve.

(2) Cash equivalents (Bank accounts) comprises bank accounts held at other credit institutions.

(3) Trading securities excluding derivatives comprises bonds and equity holdings held for trading purposes.

(4) Current bank debt comprises the short term portion of indebtedness due to credit institutions and the Icelandic Central Bank, to be paid within 12 months.

(5) Current portion of non-current debt comprises short term portion of issued bonds, secured and unsecured.

(6) Other current financial debt comprisesbills issued by the Bank.

(7) Non-current bank loans comprises the long term portion of indebtedness due to credit institutions and the Icelandic Central Bank.

(8) Bonds issued comprises the long term portion of issued Bonds.

(9) Other non-current loans comprises other long term loans issued by the Bank.

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. Such pledged assets comprised, as of 31 March 2018, the pool of mortgage loans to individuals.

Other than as disclosed in this Prospectus, there has been no material change in the capitalisation or indebtedness of the Bank since 31 March 2018.

SELECTED STATISTICAL INFORMATION

The statistical information presented below is derived from the Annual Financial Statements and the Group's financial reporting and management information systems. The statistical information below is unaudited and has been labelled accordingly when applicable.

Average Balance Sheet and Interest Information

The table below sets forth the average balances of the Bank's interest-earning assets and interest-bearing liabilities, other assets and liabilities, the interest generated from such assets and liabilities and average return rate for the periods indicated. Average balances are calculated based on monthly averages.

	Year ended 31 December								
	2017			2016			2015		
	Average balance	Interest	Yield (in %)	Average balance	Interest	Yield (in %)	Average balance	Interest	Yield (in %)
	(unaudited) (ISK in millions, unless otherwise stated)								
Assets									
Cash and balances with Central Bank	113,727	6,449	5.7%	67,868	4,584	6.8%	34,583	736	2.1%
Loans to credit institutions and customers	822,124	47,832	5.8%	780,190	51,910	6.7%	762,071	49,414	6.5%
Bonds and derivatives	73,723	1,964	2.7%	82,378	4,347	5.3%	74,344	3,532	4.8%
Other assets	8,783	844	9.6%	6,599	814	12.3%	4,048	864	21.3%
Total interest-earning assets	**1,018356**	**57,089**	**5.6%**	**937,035**	**61,655**	**6.6%**	**875,044**	**54,546**	**6.2%**
Liabilities									
Total deposits	(444,791)	(12,725)	2.9%	(455,393)	(16,278)	3.6%	(479,292)	(15,453)	3.2%
Other liabilities	(40,100)	(80)	0.2%	(53,778)	(90)	0.2%	(37,890)	(56)	0.1%
Borrowings	(362,237)	(14,449)	4.0%	(297,767)	(14,858)	5.0%	(228,319)	(11,344)	5.0%
Subordinated liabilities	—	—	—	(5,183)	(529)	10.2%	(21,002)	(701)	3.3%
Total liabilities	**(847,128)**	**(27,254)**	**3.2%**	**(810,120)**	**(31,755)**	**3.9%**	**(766,502)**	**(27,554)**	**3.6%**

Average Tangible Equity

The table below sets forth the Bank's average equity and average tangible equity as of the dates indicated.

	As of 31 December		
	2017	2016	2015
	(unaudited) (ISK in millions)		
Total equity—start of period	211,384	201,894	162,212
Total equity—end of period	225,734	211,384	201,894
Simple average equity(1)	218,559	206,639	182,053
Intangible assets—start of period	11,057	9,285	9,596
Intangible assets—end of period	13,848	11,057	9,285
Simple average intangible assets(2)	12,453	10,171	9,441
Simple average tangible equity(3)	206,106	196,468	172,613
Average risk-weighted assets(4)	756,204	780,614	739,713

(1) Simple average equity is calculated as the sum of the start and end period values, divided by two.

(2) Simple average intangible assets is calculated as the sum of the start and end period values, divided by two.

(3) Simple average tangible equity is calculated as the simple average equity for the period, minus the simple average intangible assets for the period.

(4) Average risk-weighted assets is calculated as the average of the opening, quarter-end and closing balances for the period.

The table below sets forth certain information regarding the Bank's returns on equity and assets for the periods indicated.

	Year ended 31 December		
	2017	2016	2015
	(unaudited)		
Return on assets(1)	1.3%	2.1%	5.0%
Return on equity(2)	6.6%	10.5%	28.1%
Adjusted return on equity(3)	4.8%	4.7%	8.7%
Return on risk-weighted assets(4)	1.9%	2.8%	6.7%

(1) Return on assets is calculated as net earnings for the period divided by average total assets calculated as the average of the opening, quarter-end and closing balances for the applicable period.

(2) Return on equity is calculated as net earnings for the period divided by average total equity calculated as the average of the opening, quarter-end and closing balances for the applicable period.

(3) Adjusted return on equity is calculated as adjusted net earnings for the period divided by average total equity, calculated as described in note (2) above. For a description of adjusted net earnings, see "*Selected Consolidated Financial, Operating and Other Information—Certain Other Financial Information—Adjusted Income Statement Information*".

(4) Return on risk-weighted assets is calculated as net earnings for the period divided by average risk-weighted assets calculated as the average of the opening, quarter-end and closing balances for the applicable period.

Loan Portfolio

The tables below set forth information with respect to the Bank's loans to customers classified by type of loan as of the dates indicated.

	As of 31 December 2017		
	Individuals	Corporates	Total
	(ISK in millions)		
Overdrafts	14,469	18,778	33,247
Credit cards	11,133	1,123	12,256
Mortgage loans	311,507	19,632	331,139
Other loans	33,629	368,312	401,941
Provision on loans	(5,451)	(8,031)	(13,482)
Loans to customers	**365,287**	**399,814**(1)	**765,101**

(1) Of this total, ISK 138,840 million relates to SMEs, defined as corporates which are customers of the Retail Banking division.

	As of 31 December 2016		
	Individuals	Corporates	Total
	(ISK in millions)		
Overdrafts	14,805	19,314	34,119
Credit cards	11,363	1,180	12,543
Mortgage loans	285,784	16,298	302,082
Other loans	34,777	351,739	386,516
Provision on loans	(9,313)	(13,525)	(22,838)
Loans to customers	**337,416**	**375,006**(1)	**712,422**

(1) Of this total, ISK 127,275 million relates to SMEs, defined as corporates which are customers of the Retail Banking division.

	As of 31 December 2015		
	Individuals	Corporates	Total
	(ISK in millions)		
Overdrafts	16,840	24,248	41,088
Credit cards	10,842	1,054	11,896
Mortgage loans	271,895	12,889	284,784
Other loans	38,058	334,849	372,907
Provision on loans	(13,016)	(17,309)	(30,325)
Loans to customers	**324,619**	**355,731**(1)	**680,350**

(1) Of this total, ISK 120,671 million relates to SMEs, defined as corporates which are customers of the Retail Banking division.

The table below sets forth the information with respect to the book value of the Bank's loans to customers classified by customer industry sector, as a percentage of total loans to customers, as of the dates indicated.

	As of 31 December		
	2017	2016	2015
Individuals	47.7%	47.4%	47.7%
Real estate activities and construction	16.7%	16.1%	15.1%
Seafood	10.3%	10.7%	11.1%
Information and communication technology	3.0%	4.1%	4.7%
Wholesale and retail trade	7.5%	7.4%	7.6%
Financial and insurance activities	4.5%	4.9%	4.9%
Industry, energy and manufacturing	3.8%	4.0%	3.1%
Transportation	2.2%	0.9%	0.9%
Services	2.4%	2.4%	2.9%
Public sector	1.0%	1.2%	1.2%
Agriculture and forestry	0.9%	0.9%	0.8%
Total	**100.0%**	**100.0%**	**100.0%**

As of 31 December 2017, 2016 and 2015, the aggregate amount of the Bank's 10 largest loans to customers amounted to 12.1%, 11.8% and 11.7%, respectively, of its total gross loans to customers.

In the Retail Banking division, as of 31 December 2017, ISK 500,367 million, or 65.4% of the customer loan portfolio which is attributable to the Retail Banking division, related to loans to individuals (principally mortgage loans) and ISK 135,414 million, or 17.7%, related to loans to SMEs. The table below sets forth the composition by industry sector of the loans to SMEs in the Retail Banking division as of 31 December 2017.

	% of customer loan portfolio (SMEs)
Industry sector	As of 31 December 2017
Real estate	29.1%
Wholesale and retail trades	17.4%
Seafood	16.3%
Services	9.5%
Industry, energy and manufacturing	9.3%
Financial services	5.4%
Other	12.9%
Total loans to SME customers	**100.0%**

The table below sets forth the composition by industry sector of the loans in the Corporate Banking division as of 31 December 2017.

	% of customer loan portfolio (Corporate Banking)
Industry sector	As of 31 December 2017
Real estate	34.4%
Seafood	22.1%
Wholesale and retail trades	13.4%
Industry, energy and manufacturing	6.5%
Technology	7.6%
Financial services	8.2%
Other	7.8%
Total loans in the Corporate Banking division	**100.0%**

In addition to the loans to customers, the Bank has a portfolio of loans to credit institutions. The table below sets forth information with respect to the Bank's loans to credit institutions classified by type of loan as of the dates indicated.

	As of 31 December		
	2017	2016	2015
	(ISK in millions)		
Bank accounts	51,303	45,631	74,533
Money market loans	32,309	32,267	7,976
Other loans	2,997	2,218	4,982
Loans to credit institutions	**86,609**	**80,116**	**87,491**

The tables below set forth the credit quality of the Bank's financial assets, including its net loans to customers, as of the dates indicated.

	As of 31 December 2017			
	Neither past due nor impaired	Past due but not impaired(1)	Individually impaired(2)	Total
	(ISK in millions)			
Cash and balances with Central Bank	139,819	—	—	**139,819**
Loans to credit institutions	86,609	—	—	**86,609**
Loans to customers				
Loans to corporates	385,197	13,655	962	**399,814**
Loans to individuals	344,829	18,929	1,529	**365,287**
Financial instruments	78,784	—	—	**78,784**
Other assets with credit risk	8,948	—	—	8,948
Total	**1,044,186**	**32,584**	**2,491**	**1,079,261**

(1) "Past due but not impaired" includes loans to customers which the Bank has reviewed but for which it has determined that it was not necessary to record a provision.

(2) Represents book value of individually impaired loans to customers after provision for impairment was recorded.

	As of 31 December 2016			
	Neither past due nor impaired	Past due but not impaired(1)	Individually impaired(2)	Total
	(ISK in millions)			
Cash and balances with Central Bank	87,634	—	—	**87,634**
Loans to credit institutions	80,116	—	—	**80,116**
Loans to customers				
Loans to corporates	358,709	14,251	2,046	**375,006**
Loans to individuals	312,259	21,854	3,303	**337,416**
Financial instruments	82,042	—	—	**82,042**
Other assets with credit risk	8,617	—	—	8,617
Total	**929,377**	**36,105**	**5,349**	**970,831**

(1) "Past due but not impaired" includes loans to customers which the Bank has reviewed but for which it has determined that it was not necessary to record a provision.

(2) Represents book value of individually impaired loans to customers after provision for impairment was recorded.

	As of 31 December 2015			
	Neither past due nor impaired	Past due but not impaired(1)	Individually impaired(2)	Total
	(ISK in millions)			
Cash and balances with Central Bank	48,102	—	—	**48,102**
Loans to credit institutions	87,491	—	—	**87,491**
Loans to customers				
Loans to corporates	337,153	17,302	1,276	**355,731**
Loans to individuals	291,277	26,532	6,810	**324,619**
Financial instruments	82,714	—	—	**82,714**
Other assets with credit risk	4,581	—	—	**4,581**
Total	**851,318**	**43,834**	**8,086**	**903,238**

(1) "Past due but not impaired" includes loans to customers which the Bank has reviewed but for which it has determined that it was not necessary to record a provision.

(2) Represents book value of individually impaired loans to customers after provision for impairment was recorded.

The tables below set forth the ageing of the Bank's past due but not impaired loans to customers by type of customer as of the dates indicated.

	As of 31 December 2017					
	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
	(ISK in millions)					
Loans to corporates	4,361	4,221	1,774	1,339	1,960	**13,655**
Loans to individuals	3,065	8,149	4,387	350	2,978	**18,929**
Past due but not impaired loans	**7,426**	**12,370**	**6,161**	**1,689**	**4,938**	**32,584**

	As of 31 December 2016					
	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
	(ISK in millions)					
Loans to corporates	5,388	4,282	1,589	1,211	1,781	**14,251**
Loans to individuals	3,196	8,708	4,989	391	4,570	**21,854**
Past due but not impaired loans	**8,584**	**12,990**	**6,578**	**1,602**	**6,351**	**36,105**

	As of 31 December 2015					
	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
	(ISK in millions)					
Loans to corporates	9,638	3,779	1,681	662	1,542	**17,302**
Loans to individuals	3,706	9,437	5,237	554	7,598	**26,532**
Past due but not impaired loans	**13,344**	**13,216**	**6,918**	**1,216**	**9,140**	**43,834**

The table below sets forth the Bank's impaired loans to customers classified by industry sector of the customer as of the dates indicated.

Impaired loans to customers classified by industry sector						
	As of 31 December					
	2017		2016		2015	
	Provision amount	Gross carrying amount	Provision amount	Gross carrying amount	Provision amount	Gross carrying amount
	(ISK in millions)					
Individuals	4,010	5,539	7,069	10,372	10,593	17,403
Real estate activities and construction	467	762	770	1,056	1,515	1,867
Seafood	658	861	966	1,648	257	373
Information and communication technology	111	112	179	182	308	332
Wholesale and retail trade	490	702	540	868	681	893
Financial and insurance activities	297	314	261	298	5,953	6,011
Industry, energy and manufacturing	473	581	786	878	828	1,025
Transportation	1	1	4,301	4,307	4,433	4,440
Services	3,570	3,617	3,145	3,624	504	682
Public sector	45	45	89	113	143	215
Agriculture and forestry	165	244	175	284	126	186
Total	**10,287**	**12,778**	**18,281**	**23,630**	**25,341**	**33,427**

As of 31 December 2017, 2016 and 2015, 8.8%, 12.9% and 4.0% of problem loans was attributable to five customers and 15.5%, 17.8% and 7.0% to 10 customers, respectively. An additional 21.4%, 13.5% and 10.1% of problem loans was attributable to further 26 customers as of 31 December 2017, 2016 and 2015, respectively.

Investments

The Bank has a small portfolio of debt and equity investments held on balance sheet for its own account. These instruments are classified either as trading assets (*i.e.*, assets which are held by the Bank with a view to generating profit from short-term changes in price) or as assets held at fair value through profit and loss. The Bank's shares and equity instruments include those shareholdings that the Bank has acquired in recent years through debt restructurings and other enforcement procedures. Since 2012, the Bank has made steady progress in the sale of companies acquired as a result of these collateral enforcement procedures.

The tables below set forth the classification of the Bank's investment portfolio as of the dates indicated.

	As of 31 December 2017			
	Trading	Designated at fair value	Available for sale	Total
	(ISK in millions)			
Listed bonds and debt instruments	2,452	46,638	—	49,090
Unlisted bonds and debt instruments	23	2,642	—	2,665
Total bonds and debt instruments	**2,475**	**49,280**	**—**	**51,755**
Listed shares and equity instruments	1,677	5,380	—	7,057
Unlisted shares and equity instruments	1,303	10,397	—	11,700
Bond funds with variable income	1,782	15,651	—	17,433
Total shares and equity instruments	**4,762**	**31,428**	**—**	**36,190**

	As of 31 December 2016			
	Trading	Designated at fair value	Available for sale	Total
	(ISK in millions)			
Listed bonds and debt instruments	5,284	61,055	—	66,339
Unlisted bonds and debt instruments	102	3,124	—	3,226
Total bonds and debt instruments	**5,386**	**64,179**	**—**	**69,565**
Listed shares and equity instruments	2,949	9,125	—	12,074
Unlisted shares and equity instruments	1,348	10,579	—	11,927
Bond funds with variable income	1,027	2,007	—	3,034
Total shares and equity instruments	**5,324**	**21,711**	**—**	**27,035**

	As of 31 December 2015			
	Trading	**Designated at fair value**	**Available for sale**	**Total**
	(ISK in millions)			
Listed bonds and debt instruments	2,526	74,757	—	77,283
Unlisted bonds and debt instruments	99	1,412	—	1,511
Total bonds and debt instruments	**2,625**	**76,169**	**—**	**78,794**
Listed shares and equity instruments	2,138	13,869	—	16,007
Unlisted shares and equity instruments	1,668	10,665	5,852	18,185
Bond funds with variable income	1,090	222	—	1,312
Total shares and equity instruments	**4,896**	**24,756**	**5,852**	**35,504**

RISK MANAGEMENT

Overview

The Bank seeks to manage its risks through a process of ongoing risk identification, measurement and monitoring, using limits and other controls. This process of risk management and the ability to evaluate, manage and price the risks encountered is critical to the Bank's continuing profitability and its ability to ensure that the Bank's exposure to risk remains within acceptable levels.

The Board of Directors is ultimately responsible for the Bank's risk management framework and ensuring that satisfactory risk policies and governance for controlling the Bank's risk exposure are in place. The Board of Directors defines the overall risk appetite of the Bank which is translated into exposure limits and targets that are monitored by the Risk Management division, which reports its findings regularly to the CEO and the Board of Directors. Risk is measured, monitored and reported according to internal policies, principles and processes that are reviewed and approved by the Board of Directors at least annually. The Board of Directors is also responsible for the internal capital adequacy assessment process ("**ICAAP**") and internal liquidity adequacy assessment process ("**ILAAP**"). The Board of Directors has determined that management of risks encountered within subsidiaries should principally be carried out within each subsidiary.

The CEO is responsible for enforcement of the risk management policies established by the Board of Directors, sustaining an effective risk management framework, processes and controls as well as maintaining a high level of risk awareness among the Bank's employees.

The table below sets forth the Bank's risk appetite metrics measured as of 31 December 2017. In each case, the Bank is operating within prescribed legal limits and within its prescribed risk appetite.

	As of 31 December 2017	Legal Limit
Credit risk		
Largest customer exposure—Group level(1)	9.2%	≤25.0%
Sum of exposure to the three largest industry sectors (real estate and construction, seafood and wholesale and retail trades)(2)	66.1%	N/A
Exposure to the largest industry sector (real estate and construction)(2)	32.1%	N/A
Expected loss(3)	0.39%	N/A
Market risk		
Total equity exposure(4)	13.0%	N/A
Unlisted equity exposure(5)	7.9%	N/A
Indirect equity exposure(6)	0.65%	N/A
Funding and liquidity risk		
Total LCR(7)	221%	≥100.0%(6)
Loan-to-deposit ratio(8)	166%	N/A
Encumbered asset ratio(9)	18.8%	N/A
Capital management		
Capital adequacy ratio(10)	24.0%	≥19.8%
Leverage ratio(11)	15.4%	≥3.0%
Assets and liability management		
Currency imbalance—Group level(12)	0.1%	≤15.0%
Interest rate risk(13)	2.7%	N/A

(1) Largest customer exposure—Group level is defined as net exposure to a single customer or group of connected customers as a percentage of the Group's total own funds, comprising Tier 1 and Tier 2 capital.

(2) Exposure to the largest industry sector or the three largest industry sectors is defined as the book value of loans to the largest industry sector or the three largest industry sectors, as the case may be, as a percentage of the corporate loan portfolio.

(3) Expected loss is defined as the one-year expected loss for the customer loan portfolio as a percentage of the total customer loan portfolio and is calculated using the following formula: expected loss = probability of default x loss given default x exposure at default, where exposure at default is an estimate of the gross exposure under a loan upon default by a customer.

(4) Total equity exposure is defined as the total equity position of the Bank, excluding investments in core assets, as a percentage of the Group's total own funds, comprising Tier 1 and Tier 2 capital.

(5) Unlisted equity exposure is defined as the unlisted equity position of the Bank, excluding investments in core assets, as a percentage of the Group's total own funds, comprising Tier 1 and Tier 2 capital.

(6) Indirect equity exposure is defined as the maximum capital loss to the Bank due to derivatives and margin lending in the event of an equity market stress event, based on assumptions which the Bank has adopted for such purposes.

(7) LCR is defined and calculated in accordance with the CRD IV framework. See "*Operating and Financial Review—Liquidity*".

(8) Loan-to-deposit ratio is defined as the ratio of total loans to customers to total customer deposits on a Group level.

(9) Encumbered asset ratio is defined as assets pledged as security for borrowings as a percentage of total assets on a Group level.

(10) Capital adequacy ratio is defined and calculated in accordance with the CRD IV framework as the Group's total own funds, comprising Tier 1 and Tier 2 capital, as a percentage of total risk-weighted assets. See "*Operating and Financial Review—Capital Position*".

(11) Leverage ratio is defined and calculated in accordance with the CRD IV framework. See "*Operating and Financial Review—Capital Position—Leverage Ratio*".

(12) Currency imbalance is defined as the Group's net position by which foreign currency assets exceed foreign currency liabilities as a percentage of the Group's total own funds, comprising Tier 1 and Tier 2 capital.

(13) Interest rate risk is defined as the amount at risk, which is calculated as a change in fair value due to yield curve movements that corresponds to the 99th percentile of the loss distribution.

The Bank operates the following committees to manage risk:

- *Board Risk Committee*, which is responsible for supervising the Bank's risk management framework, risk appetite and ICAAP/ILAAP. The Board Risk Committee regularly reviews reports on the Bank's risk exposures. The Board Risk Committee meets as often as required but at least five times annually. As of the date of this Prospectus, the Board Risk Committee consists of Måns Höglund (chairman), John P. Madden III and Steinunn Kristín Thórdardóttir.

- *Asset and Liability Committee* (the "**ALCO**"), which is responsible for managing any asset and liability mismatches, liquidity risk, market risk, interest rate risk and capital management. The ALCO meets as often as required but at least eight times annually. As of the date of this Prospectus, the ALCO consists of Höskuldur H. Ólafsson (CEO), Stefán Pétursson (Chief Financial Officer) and Sigurbjörg Ólafsdóttir, with

Gísli S. Óttarsson (Chief Risk Officer) as a non-voting observer, none of whom is a member of the Board of Directors.

- *Underwriting and Investment Committee* (the "**UIC**"), which decides on underwriting and principal investments. The UIC meets as often as required but at least quarterly. As of the date of this Prospectus, the UIC consists of Höskuldur H. Ólafsson (CEO), Stefán Pétursson (Chief Financial Officer) and Elísabet Árnadóttir (Head of Business Relations, Retail Banking) with Gísli S. Óttarsson (Chief Risk Officer) as a non-voting observer, none of whom is a member of the Board of Directors.
- *Data Committee* (the "**DC**"), which is responsible for ensuring that data is managed properly. The DC meets ten times annually. As of the date of this Prospectus, the DC consists of Gísli S. Óttarsson (Chief Risk Officer), Stefán Pétursson (Chief Financial Officer), Halldór Hardarson (Head of Marketing) and Hrannar Már Hallkelsson (Head of Software Development).
- *Security Committee* (the "**SC**"), which is responsible for security matters, both information security and physical security. The SC meets as often as required but at least quarterly. As of the date of this Prospectus, the SC consists of Höskuldur H. Ólafsson (CEO), Ida Brá Benediktsdóttir (Managing Director of Retail Banking), and Rakel Óttarsdóttir (Managing Director of IT). The Bank maintains a role of security officer, who reports to the SC.
- The Bank has four levels of *credit committees*:
  - the Board Credit Committee (the "**BCC**"), which decides on all major credit risk exposures (new exposures greater than 5% of the Bank's own funds and other major credit decisions that may materially increase the Bank's credit risk);
  - the Arion Credit Committee (the "**ACC**"), which operates within limits specified as a fraction of the Bank's capital (new exposures less than 5% of the Bank's own funds and other credit decisions if the exposure to a group of financially related parties is less than 10% of the Bank's own funds);
  - the Corporate Credit Committee (the "**CCC**"), which operates within tighter credit approval limits (new exposures less than or equal to ISK 750 million, refinancing up to ISK 1,000 million and other credit decisions if the total exposure to a group of financially related parties is less than 5% of the Bank's own funds); and
  - the Retail Branch Credit Committee (the "**RBC**"), which also operates within tighter credit approval limits (new exposures less than or equal to ISK 100 million and other credit decisions if the total exposure to a group of financially related parties is less than ISK 500 million).

The BCC meets as often as required and each of the other three credit committees has scheduled meetings at least twice a week.

In addition, the Bank operates five Collateral Valuation Committees, which set guidelines on collateral assessment and valuation, and two Debt Cancellation Committees, which deal with applications to reach composition with debtors.

The Bank's internal audit division conducts independent reviews of the Bank's operations, risk management framework, processes, policies and measurements. Internal audits examine both the adequacy and completeness of the Bank's control environment and processes as well as the Bank's compliance with its procedures, internal rules and external regulations. Results of internal audits are discussed with the Bank's management and reported to the Board Risk Committee.

The Risk Management division is headed by the Chief Risk Officer. It is independent and centralised and reports directly to the CEO. The division is divided into three subdivisions: (i) Credit Control, which monitors weak and impaired credit exposures on a customer-by-customer basis and the loan portfolio credit risk; (ii) Balance Sheet Risk, which oversees all risks related to asset and liability mismatches, including capital, and is responsible for the Bank's ICAAP/ILAAP; and (iii) Operational Risk, which is a part of the Bank's second line of defence and monitors risks associated with the daily operations of the Bank. The Bank's Data Officer is part of the Risk Management division.

The Bank is exposed to four major areas of risk: credit risk, market risk, liquidity risk and operational risk. In addition, the Bank manages its capital position with the focus on optimising the capital structure in the medium term and maintaining the Group's capitalisation comfortably above the regulatory minimum, including capital buffer and the SREP requirements.

Credit Risk

Credit risk is managed and controlled by setting limits on the amount of risk the Bank is willing to accept for individual counterparties and groups of connected customers and by monitoring exposures in relation to such limits. The main sources of credit risk are from the customer loan portfolio, commitments and guarantees, counterparty credit risk and equity risk in the banking book, which arises primarily from investment in positions that are not made for short-term trading purposes and assets repossessed as a result of credit recovery, *i.e.*, restructuring or collection.

The Bank's credit policy forms the basis for its credit strategy as integrated in the business plan, risk appetite towards credit exposure, credit rules and its credit procedures and controls. It contains high level criteria for the granting of credit and also outlines roles and responsibilities for further implementation and compliance. The emphasis of the credit policy is on keeping a high quality credit portfolio by maintaining a strict credit process and seeking business with financially strong parties with strong collateral and good repayment capacity. The risk level of each credit is considered in the pricing decision.

The Bank's main asset is its customer loan portfolio. Therefore, managing and analysing the customer loan portfolio is of utmost importance. Credit risk management entails diversification of risk, well-informed lending decisions, good oversight of the portfolio performance and a clear identification of any sign of weaknesses to conduct a timely recovery.

To ensure well-informed lending decisions, the Credit Office assesses credit risk before a credit decision is made and participates in credit committee meetings at the ACC and CCC levels. Various controls ensure that a loan is only disbursed following a thorough review of all documents and the registration of all relevant information regarding the loan and collaterals into the Bank's IT systems.

During the repayment phase, Risk Management monitors the credit portfolio. The Credit Control department aggregates the portfolio monthly, based on consistent criteria, to analyse the outstanding risk, the collateral level, as well as the portfolio quality. Credit Control analyses loans that have been classified at risk and maintains an independent and centralised overview of distressed credits. Credit Control, based on its analysis, suggests provisions and reviews write-offs. Monthly credit risk reports are sent to the ACC, the BRIC and the Board of Directors.

The Bank seeks to limit its total credit risk through diversification of the loan portfolio across industry sectors and by limiting large exposures to groups of connected customers. For additional information on the Bank's maximum exposure to credit risk by type of financial instrument and industry sector classification of customer, see the note titled "*Credit risk*" in the Annual Financial Statements. As of 31 December 2017, 2016 and 2015, the Bank's total on- and off-balance sheet credit risk exposure equalled to the total amount of ISK 1,266,324 million, ISK 1,124,007 million and ISK 1,094,624 million, respectively. The major industry sector exposures for loans to customers as of 31 December 2017 were (i) individuals (47.7% of loans to customers), (ii) real estate activities and construction (16.7% of loans to customers) and (iii) fishing industry (10.3% of loans to customers).

Underwriting and Credit Approval Process

As discussed above, the Bank has a tiered structure of credit approval committees.

The BCC, which acts on behalf of the Board of Directors, is the Bank's top credit, investment and underwriting authority. The ACC, which has granting limits below those of the BCC's, has the right to delegate authority within its own credit limits and sets credit approvals rules and guidelines for the divisions of the Bank.

For each credit application, the Bank gathers information and evaluates certain elements that serve as a basis for the decision, for example the borrower's profile and financial analysis, evaluation of any proposed collateral, the borrower's credit rating and related parties' total exposure. The first stage is interaction between the borrower and an account manager in the relevant division, followed by the preparation of a credit application, which must contain the following minimum information about the borrower:

- credit rating (internal rating system);
- financial accounts;
- collateral;
- the borrower's request and the account manager's proposal;
- the borrower's ability to pay;

- general information about the borrower; and
- the rationale for the proposal.

When the loan application is submitted for approval to the relevant credit committee, it is first analysed by the Credit Office. The Credit Office prepares an opinion for all credit applications that are submitted to the BCC, the ACC and the CCC. The Credit Office also monitors the activities of the RBC. It ensures that credit decisions are within a committee's credit approval authority. The Chief Risk Officer or his designated representative has the right to attend all credit committee meetings and is authorised to escalate controversial credit decisions from one committee to a committee with a higher authority.

The Credit Office is also responsible for the approval of the corporate credit rating performed by account managers by challenging the qualitative input and verifying the quality of quantitative information used to produce the ratings.

The relevant credit committee then either approves or declines the loan application, and the decision is recorded in the minutes of the meeting, which are signed and registered. If the loan application has been approved, the account manager and the borrower then negotiate the terms and conditions of the loan, and the loan is documented by the Legal division in accordance with the approval of the relevant credit committee. When the back office receives the signed documents, it disburses the loan.

Collateral

The Bank generally requires collateral, but a central element in its assessment of a proposed borrower's creditworthiness is the borrower's ability to service debt. The main types of collateral obtained by the Bank include:

- retail loans to individuals are collateralised by mortgages on residential properties;
- corporate loans are collateralised by real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities; and
- derivative exposures are collateralised by cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

The Bank collects and stores collateral information, including information on collateral maintenance and valuation. In addition to collateral, other important credit risk mitigating techniques are pledges, guarantees and master netting agreements.

To ensure consistent collateral value assessment, the Bank has five collateral valuation committees. The committees set guidelines on collateral valuation techniques, collateral value and valuation parameters. The committees are divided by area of expertise as follows:

- agriculture;
- fishing vessels and fishing quotas;
- real estate;
- securities; and
- inventory and trade receivables.

The collateral value is monitored and additional collateral requested in accordance with the underlying agreement. The collateral value is reviewed in line with the adequacy of the allowance for impairment losses.

Portfolio Credit Quality

The Bank emphasises monitoring and reporting the quality of its loan portfolio. The credit portfolio quality is regularly aggregated and assessed in terms of industry concentration, single name concentration, product type and credit rating.

The Bank uses an internal rating system to rate its customers, companies and individuals. The rating model for larger companies bases its rating both on qualitative factors, such as industry sector stability and outlook, and quantitative factors, such as their equity and liquidity ratios. The rating models for SMEs and individuals are purely quantitative models.

During the repayment phase, Risk Management monitors the credit portfolio. The Credit Control department aggregates the portfolio monthly, based on consistent criteria, to analyse the outstanding risk, the collateral level, as well as the portfolio quality. Credit Control analyses loans that have been classified at risk and maintains an independent and centralised overview of distressed credits. Credit Control, based on its analysis, suggests provisions and reviews write-offs. Monthly credit risk reports are sent to the ACC, the BRIC and the Board of Directors. Impairment and Provisions

The Credit Control department is in charge of the Bank's provisioning process. Provisions for impairment are made both on a portfolio level and by individual assessment. All exposures to borrowers with loans that are considered impaired are moved to risk class 5 (DD rating), with the exception that impairment on prime mortgages to individuals do not trigger movement to risk class 5 for other exposures to the borrower, and vice versa.

On 1 January 2018, the Bank implemented IFRS 9 Financial instruments, and as part of the implementation, the process for provisioning for loss allowance has been split in to three stages. Stage 1 calculates one-year expected credit losses. Stage 2 calculates expected lifetime credit losses. Stage 3 calculates expected lifetime credit losses for impaired financial assets. Calculation of the loss allowance is performed for all loans, facilities and loan commitments carried at amortised cost or at fair value through other comprehensive income (for these purposes, referred to as "loans"). For further information on the calculation methodology, see note 42 in the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018 in "*Consolidated Financial Statements*".

Financial assets and financial liabilities—Classification and Measurement

Loss allowance for Performing Loans

Stage 1 loss allowance is calculated for all performing loans. Stage 1 assets are subject to one-year expected credit losses. The calculation is based on estimates of the borrower's one year probability of default, loss given default and exposure at default. Assets classified as Stage 2 have encountered significant increase in credit risk as defined by the Bank and carry expected lifetime credit losses. The calculation is based on estimation of the borrower's lifetime probability of default, loss given default and exposure at default. Probability of default, loss given default and exposure at default models for loans are based on the Bank's internal models.

Individual Assessment

Loans classified as Stage 3 are impaired when objective evidence demonstrates that a loss event has occurred and that the loss event has an impact on the future cash flows of the asset or the asset is 90 days or more past due. The level of detail for credit monitoring depends on the size of the exposure, where factors such as delinquency by the borrower, forbearance measurements, and the internal credit rating are considered. For larger borrowers, interviews with account managers are also conducted. Loans are not classified as Stage 3 even if the value of collateral prudently covers the outstanding amount.

Portfolio Assessment

The provisioning process for prime mortgages and other exposures to individuals, where the amount of the exposure is within a predetermined and acceptable range, is made on a portfolio basis. The impairment is based on a 90 days delinquency status and a collateral allocation method where the collateral is usually the tax value of the pledged real estate property. For additional information on the Bank's measurement of impairment, see the note titled "Financial assets and financial liabilities" in the Annual Financial Statements.

Counterparty Credit Risk

The Bank offers financial derivative instruments to professional investors. The table below sets forth the derivative trading products that are currently offered by the Bank to its customers classified according to the primary risk factor and type of derivative instrument.

Primary risk factor	Swaps	Forwards	Options
Interest rate	X		
Foreign exchange	X	X	X
Securities (equities and bonds)		X	X
Commodities		X	X

Valuation changes are made in response to changes in interest rates, exchange rates, security prices and commodity prices.

The Bank sets limits on a customer's total exposure to control the Bank's risk associated with derivatives trading. These limits are generally specific for each customer and may refer specifically to different categories of contracts. Generally, collateral is required to cover potential losses on a contract. Should the net-negative position of the contract fall below a certain level, a call is made for additional collateral. If additional collateral is not supplied within a tightly specified deadline, the contract is closed. The margin call process is monitored by the Risk Management division.

Large Exposures

In accordance with applicable Icelandic regulations, a large exposure is defined as an exposure to a group of financially related borrowers, which exceeds 10.0% of the Group's eligible capital. The legal maximum for individual large exposures is 25.0% of the Group's eligible capital, net of eligible collateral. As of 31 March 2018, the Bank had one large exposure to a foreign credit institution. The exposure was 12.9% of the Group's eligible capital before taking account of eligible credit risk mitigation, or 6.6% after credit risk mitigation effects.

The table below sets forth all gross exposures exceeding 10.0% of the Group's eligible capital as of 31 December 2017 and 2016 and of the Group's capital base as of 31 December 2015, together with the net amount of each of those exposures after taking into account eligible collateral.

	As of 31 December					
	2017		2016		2015	
	Gross	**Net**	**Gross**	**Net**	**Gross**	**Net**
Borrower 1	<10%	<10%	<10%	<10%	11%	11%
Sum of large exposure gross and net >10%	**0%**	**0%**	**0%**	**0%**	**11%**	**11%**

The table below sets forth the five largest credit exposures of the Bank as of 31 December 2017 as a percentage of the Group's eligible capital.

	As of 31 December 2017		
Borrower industry sector	**Weighted average credit rating**	**Exposure at default (ISK billion)**	**% of eligible capital**
Information and communication technology	BBB–	16.8	9.2%
Real estate and construction	BB	14.3	7.8%
Real estate and construction	BBB–	13.9	7.6%
Real estate and construction	BBB–	12.5	6.8%
Fishing industry	BBB–	12.5	6.8%

Other Credit Exposures where the Bank Has an Equity Stake

The table below sets forth credit exposures to entities exceeding ISK 1 billion where the Bank also holds a strategic equity interest (trading or hedging exposures excluded) as of 31 March 2018.

	As of 31 March 2018		
	Entity credit exposure	**Strategic equity holdings in entity (book value)**	**Group credit exposure[(1)]**
		(ISK in millions)	
Entity 1 (a subsidiary)	6,108	1	6,108
Entity 2	5,199	242	12,159
Entity 3 (a subsidiary)	8	4,936	4,945
Entity 4	2,612	28	2,642

(1) Group credit exposure represents the total credit exposure (entity basis) as well as related parties.

Market Risk

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments. The risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives and other commitments which are marked to market.

The Group monitors market risk and separates its exposures for its trading book (which represents positions held with trading intent and associated hedging positions) and banking book. Market risk in the trading book arises from market-making activities and non-strategic derivatives positions arising from the Bank's customers' investments and risk management needs. Market risk in the banking book arises from various mismatches in assets and liabilities, principally in relation to currencies, maturities and interest rates. Market risk in the trading and banking books is managed separately by the Treasury division and Market Making.

The Bank's overall market risk allowance is set by the Board of Directors in the Bank's risk appetite, and the CEO, or through the appropriate framework set up by the CEO, determines the limit framework for each trading desk and sets individual limits. The ALCO is responsible for managing the Bank's overall market risk. The Risk Management division is responsible for measuring and monitoring market risk exposure and reporting the exposure, usage and limit breaches.

The Group's strategy towards market risk is to seek to limit the risk exposure that arises in its banking book as a result of imbalances in the Group's balance sheet, but accept limited risk in its trading book, in accordance with its strategic goals for net profit.

The Balance Sheet Risk subdivision is responsible for monitoring compliance with the limits that have been set in each of the trading and banking books. In respect of the trading book, it reviews exposures for potential shortfalls and analyses scenarios with traders. Any issues of concern are escalated to the relevant managing directors and the Chief Risk Officer, and performance, exposures and relevant risks are summarised and reported daily to relevant employees and managing directors and on a regular basis to the Board of Directors. In respect of the banking book, market risk exposure is monitored and reported on a monthly basis and measured against the risk limits set in terms of the Bank's risk appetite.

The elements of the Group's market risk are presented below.

Interest Rate Risk

Interest rate risk arises from the possibility that changes in market rates adversely affect net interest earnings and fair value of interest-bearing instruments on the Bank's balance sheet. The Bank's operations are subject to interest rate risk due to mismatches in the fixing of interest rates between assets and liabilities, resulting in a repricing risk for the Bank. The Bank also faces interest basis risk between interest-bearing assets and interest-bearing liabilities due to different types of floating-rate indices in different currencies.

The Bank's interest rate risk for foreign currencies is limited as foreign denominated assets predominantly have short interest fixing periods (i.e., the period during which interest is payable at a fixed rate), and the Bank hedges its foreign denominated fixed rate borrowings. For domestic rates, longer interest fixing periods are more common, and this especially applies to indexed mortgages issued between 2004 and 2006. The profile of the interest fixing periods of indexed mortgages is however largely matched by that of the Bank's structured covered bond issues, which serves as a hedge against repricing risk. The Bank has been able to manage relatively small interest gaps for interest fixing periods.

In the past few years domestic rates, nominal and real, have fallen. Due to favourable refinancing spreads, prepayments and/or refinancing of loans have been considerable. Prepayment risk is mitigated by prepayment fees and the Bank's own prepayment options on its borrowings. The Bank's prepayment of structured covered bonds is a reaction to mortgage prepayments and mortgage refinancing. Additional prepayments of the one remaining outstanding series of structured covered bonds are possible, but the issuance is not partly callable and would need to be prepaid in full. As of 31 December 2017, the series had a book value of ISK 78,267 million.

For additional information on the Bank's interest rate risk, see the note titled "Market risk" in the Annual Financial Statements.

Indexation Risk

A significant part of the Bank's balance sheet is linked to the Icelandic CPI. Index-linked loans and borrowings are typically annuities, where the principal and monthly payments change in the same proportion as the CPI. The Bank is exposed to indexation risk as indexed assets exceed indexed liabilities. As of 31 December 2017, the total amount of the Bank's CPI-linked assets was ISK 363,791 million and the total amount of its CPI-linked liabilities was ISK 230,851 million. See the note titled "*Market risk*" in the Annual Financial Statements.

Currency Risk

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

The table below sets forth the currencies to which the Bank had significant exposure for the year ended 31 December 2017. The analysis calculates the effect of a 10.0% movement of each indicated currency rate against Icelandic Krona on the Bank's income statement as a result of the change in fair value of currency sensitive non-trading monetary assets and liabilities. A negative amount reflects a potential net reduction in income statement or equity, while a positive amount reflects a potential net increase in income statement or equity. The table below assumes that all other variables remain constant.

	Year ended 31 December 2017	
	-10.0%	**+10.0%**
	(ISK in millions)	
EUR	239	(239)
USD	(75)	75
GBP	(277)	277
DKK	232	(232)
NOK	(36)	36
Other	(101)	101

(1) A +10.0% in the table denotes a depreciation of Icelandic Krona.

Equity Price Risk

Equity price risk is the risk that the fair value of equities held as financial instruments and investments in associates on the Group's consolidated balance sheet decreases as the result of changes in the level of equity indices and individual stocks. In addition to equity price risk in the trading book, the non-trading equity price risk exposure is primarily due to restructuring of the Bank's assets, *i.e.*, restructuring of troubled companies which the Bank has taken over after the financial crisis in 2008. The associated risk has, however, been significantly reduced in recent years through successful divestment of such assets. For information on assets taken over by the Bank and held for sale and equity exposures, see the notes titled "*Financial assets and financial liabilities*" and "*Other assets*" in the Annual Financial Statements.

Derivatives

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

Prepayment Risk

Prepayment risk is the risk that the Bank will incur a financial loss because its customers and counterparties repay, or request repayment of, loans earlier or later than expected, such as with respect to fixed rate mortgage loans when interest rates decline. Prepayment risk is mitigated by prepayment fees and the Bank's own prepayment options on its borrowings.

Liquidity and Funding Risk

Liquidity risk is defined as the risk that the Group, although solvent, either does not have sufficient financial resources available to meet its liabilities when they become due or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases in available funding or changes in funding sources. The ALCO is responsible for managing liquidity risk within the risk appetite set by the Board of Directors, the Treasury division manages the liquidity positions on a day-to-day basis and the Balance Sheet Risk subdivision monitors the liquidity risk, with processes and reports regarding the liquidity status reviewed regularly by the executive management. The Treasury division provides the other divisions of Arion Bank with funds for their activities against a charge of internal interest.

The Bank's primary source of funding is deposits from individuals, businesses and financial institutions. The Bank's liquidity risk stems from the fact that the average maturity of its loans exceeds the average maturity of its deposits. As of 31 December 2009, over 90% of the Bank's deposits were on demand, as compared to 59.7% as of 31 December 2012, 52.2% as of 31 December 2013, 58.0% as of 31 December 2014, 57.3% as of 31 December 2015, 70.0% as of 31 December 2016 and 71.8% as of 31 December 2017. As of 31 December 2017, 71.8% of the Group's deposits were on demand, 18.7% had a maturity of up to three months, 6.5% had a maturity of between three and 12 months, 2.8% had a maturity of between one and five years and 0.5% had a maturity of more than five years.

As of 31 December 2017, a majority (73.9%) of the Group's deposits were deposits in the Retail Banking division, of which 92.2% were denominated in Icelandic Krona, 13.5% were CPI-linked and 7.8% were denominated in foreign currency. Deposits in the Corporate Banking division, which as of 31 December 2017 accounted for 4.1% of the Group's deposits, were spread across a broad range of industry sectors, as set forth in the table below.

Industry sector	% of deposits in the Corporate Banking division As of 31 December 2017
Real estate	18.2%
Wholesale and retail trades	11.7%
Financial services	14.3%
Seafood	15.2%
Industry, energy and manufacturing	7.3%
Technology	3.9%
Other	29.5%
Total deposits in the Corporate Banking division	**100%**

As per the LCR methodology, the Bank's deposit base is split into different categories depending on customer type. A second categorisation is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposits are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions.

The tables below set forth the composition of the Group's deposit base according to the LCR categorisation described above, with the associated expected stressed outflow weights as of the dates indicated.

	As of 31 December 2017					
	Deposits maturing within 30 days					
	Less stable	Weight (%)(1)	Stable	Weight (%)(1)	Term deposits(2)	Total deposits
	(ISK in millions, except percentages)					
Retail	163,542	11%	52,401	5%	68,741	284,684
Corporations	51,968	40%	811	20%	5,757	58,536
Sovereigns, central banks and public services enterprises	14,583	40%	—	—	1,383	15,966
Pension funds	53,116	100%	—	—	15,391	68,507
Domestic financial entities	23,175	100%	—	—	15,949	39,124
Foreign financial entities	2,714	100%	—	—	—	2,714
Total	**309,098**		**53,212**		**107,221**	**469,531**

(1) "Weight" represents the proportion of deposits the Group considers to be expected to become unavailable to the Group under stressed conditions.

(2) Term deposits in this context refer to deposits with maturities greater than 30 days. No outflow assumed from term deposits.

	As of 31 December 2016					
	Deposits maturing within 30 days				Term deposits[(2)]	Total deposits
	Less stable	Weight (%)[(1)]	Stable	Weight (%)[(1)]		
	(ISK in millions, except percentages)					
Retail	137,055	10%	52,401	5%	68,741	284,684
Corporations	55,094	40%	921	20%	5,850	61,865
Sovereigns, central banks and public services enterprises	11,653	40%	—	—	1,379	13,032
Pension funds	31,157	100%	—	—	15,959	47,116
Domestic financial entities	24,310	100%	—	—	16,730	41,040
Foreign financial entities	2,150	100%	—	—	—	2,150
Other foreign parties	4,466	100%	3,276	25%	2,288	10,030
Total	**265,885**		**48,528**		**105,312**	**419,725**

(1) "Weight" represents the proportion of deposits the Group considers to be expected to become unavailable to the Group under stressed conditions.

(2) Term deposits in this context refer to deposits with maturities greater than 30 days. No outflow assumed from term deposits.

	As of 31 December 2015					
	Deposits maturing within 30 days				Term deposits[(2)]	Total deposits
	Less stable	Weight (%)[(1)]	Stable	Weight (%)[(1)]		
	(ISK in millions, except percentages)					
Retail	123,979	10%	43,526	5%	57,926	225,431
Operational relationship	—	25%	—	5%		
Corporations	36,300	40%	823	20%	4,945	42,068
Sovereigns, central banks and public services enterprises	11,900	40%	—	—	1,304	13,204
Financial entities being wound up	16,948	100%	—	—	47,062	64,010
Pension funds	41,609	100%	—	—	35,104	76,713
Domestic financial entities	32,727	100%	—	—	11,016	43,743
Foreign financial entities	5,193	100%	—	—		5,193
Other foreign parties	3,707	100%	3,260	25%	1,923	8,890
Total	**272,363**		**47,609**		**159,280**	**479,252**

(1) "Weight" represents the proportion of deposits the Group considers to be expected to become unavailable to the Group under stressed conditions.

(2) Term deposits in this context refer to deposits with maturities greater than 30 days. No outflow assumed from term deposits.

The Bank calculates the net stable funding ratio ("**NSFR**"), which measures the amount of available stable funding ("**ASF**") at the Group against the required stable funding ("**RSF**"), as per the definition of the Icelandic Central Bank's Rules No. 1032/2014. Under NSFR, funding with maturity greater than one year is considered stable. Different weights are applied to funding with shorter maturities depending on the type of funding. In general, RSF is determined by applying different weights to the Group's on- and off-balance sheet items on the asset side depending on the level of maturity and liquidity. On the other hand, ASF is calculated by applying different weights to the Group's on- and off-balance sheet items on the liability side depending on the level of maturity and / or expected stickiness. The ratio for foreign currency is required to exceed 100%. The purpose of the requirements with respect to the foreign exchange ratio is to prevent domestic financial institutions from accumulating short-term need for market funding in foreign currency, as the Icelandic Central Bank is not a lender of last resort in foreign currency.

The table below sets forth the Group's total NSFR as of the dates indicated based on sub-consolidated figures for the Bank and ABMIIF.

	As of 31 December		
	2017	2016	2015
ISK	115%	113%	100%
Foreign exchange[(1)]	181%	191%	123%
Total NSFR	**125%**	**124%**	**105%**

(1) The foreign exchange ratio is the calculation of NSFR for the Bank's consolidated statement of financial position restricted to foreign currency. When calculating the foreign exchange ratio, a negative foreign exchange imbalance is subtracted from the numerator and a positive foreign exchange imbalance is subtracted from the denominator.

The foreign exchange imbalance discrepancy between the Group's official foreign exchange imbalance and the imbalance reported in the NSFR is due to the fact that the Bank's subsidiaries have a substantial positive foreign exchange imbalance but are settled in Icelandic Krona. See "*Risk Factors—Risks Relating to Business and Industry—The Bank is exposed to significant liquidity risk*".

The Group carries out an ongoing process for the ILAAP, with the aim of ensuring that the Group has in place sufficient risk management processes and systems to identify, manage and measure the Group's liquidity. As part of the ILAAP, main liquidity and funding risks are identified and stressed scenarios considered to provide senior management and regulators with a better understanding of the Group's liquidity and funding positions. The FME supervises the Group and reviews the Group's ILAAP.

Operational Risk

Operational risk is the risk of direct or indirect loss or damage to the Bank's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Bank's image and operational earnings. The Bank assesses its primary sources of operational risk as IT risk, legal risk and reputational risk.

Operational risk is inherent in every activity undertaken within the Bank, in outsourced activities and in all interactions with external parties. The Bank aims to reduce the frequency and impact of operational risk events in a cost effective manner and seeks to do so with a selection of internal controls and quality management, along with sufficiently qualified staff.

Each division within the Bank is primarily responsible for taking and managing its own operational risk. Operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Bank's operational risk. The Bank uses the Basel II standardised approach to the calculation of capital requirements for operational risk.

The Operational Risk subdivision serves as a partner to senior management and supports and challenges the senior management to align the business control environment with the Bank's strategy by measuring and mitigating risk exposure, with the view of contributing to optimal returns for the stakeholders.

The Bank's losses due to operational risk are registered in the Bank's loss database. Loss events are analysed to understand the cause of the event and any control failure, and changes to controls are made where applicable to reduce the risk of the event recurring. Losses are categorised according to the Basel II event categories for operational risk.

Capital Management

The Bank's capital ratios are calculated in accordance with the Financial Undertakings Act and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR), but has temporarily excluded Article 501 on capital requirements relief for small and medium enterprises. The Bank uses the standardised approach to calculate capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

As at 31 December 2017, the Bank's consolidated exposures as stipulated in CRR is the Bank's accounting consolidation without Vördur. As the full accounting consolidation has been applied in prior statements, figures for earlier dates are restated to reflect the defined consolidated exposures. The capital position and solvency requirements of Vördur should be viewed independently from capital adequacy for the Bank's consolidated exposures. An adjustment is made to the Bank's Pillar 2 requirements as the latest SREP result is based on the accounting consolidation which includes an add-on due to the solvency requirements of Vördur.

The Bank carries out an ongoing process, the ICAAP, with the aim of ensuring that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank's total risk exposure. The ICAAP is aimed at identifying and measuring the Bank's risk across all risk types and ensuring that the Group has sufficient capital in accordance with its risk profile. The FME supervises the Bank, reviews the Bank's ICAAP and sets capital requirements for the Bank's consolidated exposures as a whole following the SREP. Stress tests constitute an important part of the ICAAP, because they demonstrate how the Bank's capital could be affected by sharp macroeconomic changes, downturns in the Bank's core businesses or other major events.

Capital requirements according to Pillar 1 are based on the sum of risk-weighted assets for credit risk, credit valuation adjustment, market risk and operational risk, computed using formulas from CRD IV and the CRR. See "*Risk Factors—Risks Relating to Business and Industry—Changes to the Capital Requirements Directives* *could adversely affect the Bank's results*" and "*Regulatory Overview—Principal Legislation and Regulations—Capital Requirements Directive*". The Bank uses the standardised approach to calculate the capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

Banking operations are categorised as either trading book or banking book, and the calculation of risk-weighted assets is conducted differently for the assets in each book. Banking book exposures, including on-balance and off-balance sheet items, derivatives and repurchase agreements, give rise to credit risk, and risk-weighted assets are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account eligible collateral or guarantees. Trading book risk-weighted assets are determined by taking into account market related risks, such as foreign exchange, interest rate risk and equity position risks. Operational risk also gives rise to risk-weighted assets, measured on the basis of the Bank's average operating income over three years.

To measure the Pillar 2 capital requirement, the Bank uses internal economic capital models. Capital add-ons under Pillar 2 are based on risks that are underestimated or not covered in Pillar 1, including credit risk, market position risk, concentration risk, interest rate risk in the banking book, indexation risk, reputational risk, legal and compliance risk, business risk and political risk. Capital is allocated to the Group's business units based on the capital requirements that arise due to their exposures and operations. The performance of the business units is then evaluated based on the return on allocated capital. The Bank is seeking to implement return on allocated capital as a management tool, such that, should capital scarcity arise, return on allocated capital will guide in aligning the business with available capital and the reallocation of capital.

The table below sets forth the implementation of the capital buffer requirements in accordance with the Financial Undertakings Act, as prescribed by the Financial Stability Council and approved by the FME.

Capital buffer requirement as a percentage of risk-weighted assets	As of 1 June 2016	As of 1 January 2017	As of 1 March 2017	As of 1 November 2017
Capital conservation buffer	1.75%	2.50%	2.50%	2.50%
Capital buffer for systemically important institutions	2.00%	2.00%	2.00%	2.00%
Systemic risk buffer(1)	3.00%	3.00%	3.00%	3.00%
Countercyclical risk buffer(1)	—	—	1.00%	1.25%
Combined capital buffer requirement	**6.75%**	**7.50%**	**8.50%**	**8.75%(2)**

(1) The institution specific systemic risk buffer and the countercyclical risk buffer are determined using the weighted average of respective buffer levels in countries where the Bank has exposure, and weighting is determined by the percentage of risk-weighted assets relating to credit risk. With the FME's possible recognition of systemic risk buffers and countercyclical buffers in other countries, those requirements will apply to the corresponding foreign exposures, resulting in a higher combined buffer requirement. The maximum countercyclical risk buffer which can be applied in Iceland is 2.5%; however, the FME is authorised to apply a higher countercyclical risk buffer on the basis of a recommendation from the Financial Stability Council. In April 2018, the Financial Stability Council proposed a 0.50% increase to the countercyclical capital buffer to take effect from 1 May 2019, as confirmed by the FME.

(2) Because the institution specific systemic risk buffer and the countercyclical risk buffer are determined as described above, the Bank had the effective combined capital buffer requirement of 8.40% based on the Bank's risk profile as of 31 December 2017.

The Bank's Pillar 2R capital add-on, which is the result of ICAAP / SREP, may be comprised of 56.25% CET1 capital, 18.75% AT1 capital and 25.00% Tier 2 capital. With the current capital structure of the Bank, the Pillar 2R requirement is solely met with CET1 capital.

The table below sets forth the total regulatory capital requirement, as applied to the Bank on the basis of its consolidated exposures, as a percentage of risk-weighted assets as of 31 December 2017.

Total regulatory capital requirement as a percentage of risk-weighted assets	
Pillar 1 capital requirement	8.0%
Pillar 2R capital requirement(1)	3.4%
Combined buffer requirement(2)	8.4%
Total regulatory capital requirement	**19.8%**
Available capital	24.0%

(1) SREP result based on the Group's financial position as of 31 December 2017. The Pillar 2 requirement is 3.7% of risk-weighted assets based on accounting consolidation. Based on the Group's consolidation situation under CRR, which excludes Vördur, the requirement is 3.4%.

(2) With the possible recognition by the FME of systemic risk buffers and countercyclical buffers applied in other countries, those requirements will apply to the corresponding foreign exposures, resulting in a higher combined buffer requirement.

The table below sets forth the CET1 regulatory capital requirement, as applied to the Bank, as a percentage of risk-weighted assets as of 31 December 2017.

CET1 regulatory capital requirement as a percentage of risk-weighted assets	
Pillar 1 CET1 requirement	4.5%
Pillar 2R CET1 requirement(1)	1.9%
Combined buffer requirement	8.4%
Total CET1 regulatory capital requirement	**14.8%**
Available CET1 capital	23.6%

(1) SREP result based on the Group's financial position as of 31 December 2017. The Pillar 2 requirement is 3.7% of risk-weighted assets based on accounting consolidation. Based on the Group's consolidation situation under CRR, which excludes Vördur, the requirement is 3.4%.

Stress Testing

Overview

The Bank's stress testing framework is aligned with the relevant FME guidelines, which in turn are based on the Guidelines on Stress Testing of the European Banking Authority. Stress testing at the Bank focuses on sensitivity and scenario analyses. The sensitivity analysis measures the potential impact of a specific single risk factor or simple multi-risk factors affecting capital or liquidity. In turn, scenario analysis measures the Bank's resilience to a given scenario, which comprises a set of risk factors that are aligned in an internally consistent way, presuppose the simultaneous occurrence of forward-looking events covering a range of risks and business areas and aims at revealing the nature of linked risks across the Bank and across time, system-wide interactions and feedback effects.

The stress tests serve as an important management tool for the Bank and are incorporated into the review of the Bank's risk appetite and the Bank's limits framework, and raise risk awareness and improve general understanding of the Bank's operations. The Board of Directors and Board Risk Committee consider the results for strategic, capital and contingency planning.

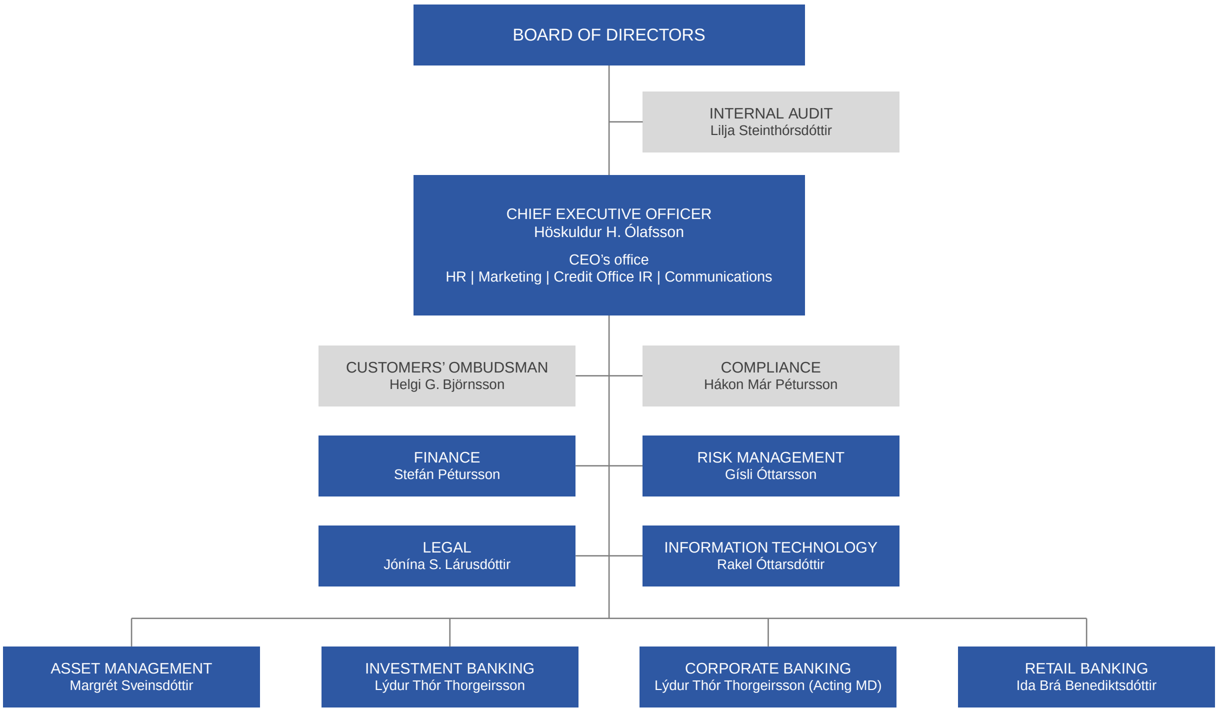
The Bank's business plan is stress tested annually with at least two adverse economic scenarios. One of the two stressed scenarios carried out on the business plan is provided by the Central Bank in collaboration with the FME. The Bank's Economic Research department contributes stressed projections that are used in the Bank's internal stress test on the Bank's business plan. The design of the bank-wide internal stress test is challenged and reviewed by the Executive Committee and the Board Risk Committee. The impact is estimated on the Bank's earnings and own funds as well as for the Bank's capital and liquidity ratios and other risk appetite metrics. In addition to the internal bank-wide stress test and the Central Bank stress test, the Bank performs both focused ad hoc stress tests and regular planned stress tests. The focused stress tests are used to estimate losses for example due to changes in regulations.

The table below sets forth the stress tests which the Bank regularly performs.

Stress Test	Frequency	Description
Icelandic Central Bank and FME stress tests	Annually	Stressed scenarios provided by the Icelandic Central Bank in collaboration with the FME
Internal stress tests on the Bank's business plan	Annually	Risks and stressed scenarios designed on the basis of input from each division, stressed macro-economic projections provided by the Research subdivision
ICAAP / ILAAP	Annually	Interest rate risk, value-at-risk on trading book, credit risk stress tests
Focused stress tests	Daily / Monthly	Liquidity and market risk, risk appetite for indirect equity positions

BOARD OF DIRECTORS, EXECUTIVE COMMITTEE, AUDITOR AND CORPORATE GOVERNANCE

The chart below illustrates Arion Bank's principal operating and support functions, including the Board of Directors and the Executive Committee, each of which is described in greater detail below.



Board of Directors

Overview

Under Arion Bank's articles of association, the Board of Directors must consist of five to eight members elected by the shareholders at the Annual General Meeting for a one year term. In addition, pursuant to the Financial Undertakings Act, the Bank is required to appoint a minimum of two, and a maximum of three, alternate members to the Board of Directors (the "**Alternate Directors**"), who attend a meeting of the Board of Directors if a regular member resigns or is unable to attend. The Board of Directors currently consists of six members as well as three Alternate Directors. Seven members of the Board of Directors and three Alternate Directors were elected at the last Annual General Meeting held on 15 March 2018. One member of the Board of Directors was nominated by Attestor Capital LLP and the remaining six members of the Board of Directors were nominated by Kaupskil. Since that time, one member of the Board of Directors has resigned and will be replaced by an Alternate Director until shareholders decide otherwise.

Pursuant to the Financial Undertakings Act, Arion Bank is obligated to comply with recognised guidelines on good corporate governance. The Board of Directors has approved rules of procedure for the Board of Directors (the "**Rules of Procedure**"), which were established with reference to Article 54 (4) of the Financial Undertakings Act, Article 70 (5) of the Public Limited Companies Act and the FME Guidelines No. 1/2010. In addition, Arion Bank complies with the fifth edition of the Icelandic Guidelines on Corporate Governance issued by the Iceland Chamber of Commerce, SA—Business Iceland and NASDAQ Iceland (the "**Corporate Governance Guidelines**").

Independence Requirements

Pursuant to the Corporate Governance Guidelines, the majority of members of the Board of Directors shall be independent of Arion Bank and its day-to-day managers. Furthermore, at least two members of the Board of Directors shall be independent of Arion Bank's significant shareholders, which are shareholders controlling at least 10% of the total share capital or weight of votes in a company, alone or in cooperation with associated parties. Under the Corporate Governance Guidelines, the Board of Directors itself evaluates whether members of the Board of Directors are independent of Arion Bank and its significant shareholders. Information on the independence of the proposed members of the Board of Directors is sent to shareholders before the Annual General Meeting and also published on Arion Bank's website.

The Corporate Governance Guidelines provide that a member of the Board of Directors is not considered independent of Arion Bank if:

1. he/she is or has been an employee of Arion Bank, or a company closely related to Arion Bank, during the three years prior to the commencement of membership on the Board of Directors;
2. he/she receives or has received payments from Arion Bank, a company closely related to Arion Bank or its day-to-day managers, apart from a director's fee, *e.g.*, as a consultant or contractor, during the three years prior to commencement of membership on the Board of Directors, whereby any payments are examined and assessed from the perspective of whether they are a considerable amount for both Arion Bank and the individual member of the Board of Directors, *e.g.*, a payment represents a large portion of the gross income;
3. he/she is in, or has been the past year in, significant business with Arion Bank or closely related companies, e.g., as a customer, supplier or partner, or he/she has other significant business interests in Arion Bank, whether personally or through another company;
4. he/she is one of the daily managers of another company in which one of the members of the Board of Directors is a daily manager of Arion Bank;
5. he/she is, or has been, in the past three years prior to taking a seat on the Board of Directors, a partner of the external auditor, or closely related company, or an employee who has taken part in the external audit of Arion Bank; or
6. he/she has close family ties with any of Arion Bank's day-to-day managers or any other persons mentioned above and that person is in direct or indirect business with Arion Bank of such a proportion that such member of the Board of Directors should not be considered independent.

The Corporate Governance Guidelines further provide that a member of the Board of Directors is not considered independent of significant shareholders of Arion Bank if:

1. he/she has direct or indirect control of Arion Bank or is a member of the board of directors or an employee of a company which has control of Arion Bank; and
2. he/she owns a significant share in Arion Bank or is a member of the board of directors or an employee of a company which owns a significant share in Arion Bank.

The Corporate Governance Guidelines further state that the foregoing factors that can cause a member of the Board of Directors to be considered not independent are not exhaustive and it remains in the hands of the Board of Directors to evaluate if any interest of specific members of the Board of Directors, large shareholders and Arion Bank itself can collide, both in fact and in appearance. As of the date of this Prospectus, six members of the Board of Directors and two Alternate Directors are independent of Arion Bank and its day-to-day managers as well as of Arion Bank's significant shareholders.

Members of the Board of Directors and Alternate Directors

The table below sets forth the members of the Board of Directors, their year of birth, the year of their initial election to the Board of Directors, their position and whether or not they are considered to be independent under the Corporate Governance Guidelines of Arion Bank and its day-to-day management as well as of Arion Bank's significant shareholders.

Name	Position	Year of birth	Director since	Independent
Eva Cederbalk	Chairman	1952	2017	Yes
Brynjólfur Bjarnason	Vice Chairman	1946	2014	Yes
Herdís Dröfn Fjeldsted	Director	1971	2018	Yes
John P. Madden III	Director	1973	2016	No
Måns Höglund	Director	1951	2011	Yes
Steinunn Kristín Thórdardóttir	Director	1972	2017	Yes
Ólafur Örn Svansson	Alternate Director	1972	2013	Yes
Sigurbjörg Ásta Jónsdóttir	Alternate Director	1970	2014	Yes
Thórarinn Thorgeirsson	Alternate Director	1974	2017	No

Members of the Board of Directors and Alternate Directors are normally elected annually at the Annual General Meeting for a one year term or at any extraordinary meeting of shareholders.

Members of the Board of Directors

Eva Cederbalk, Chairman

Born in 1952, Eva was first elected to the Board of Directors at a meeting of shareholders held on 23 June 2017 and elected as Chairman on 26 June 2017. Eva is Swedish and currently resides in Sweden. She is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Eva is the chairman of the Board Credit Committee.

Eva currently serves on the board of directors of National Bank of Greece Group, Ikano Group S.A. and Svolder AB. She previously worked within Swedish financial services and until 2011 served as CEO of SBAB Bank AB (publ) and prior to that was CEO of the insurance company DIAL AB and held executive positions within SEB AB (publ). Eva also previously served as chairman of the board of directors of Klarna AB and on the boards of directors of Gimi AB, Ticworks AB and Íslandsbanki.

Brynjólfur Bjarnason, Vice Chairman

Born in 1946, Brynjólfur was first elected to the Board of Directors at a meeting of shareholders held on 20 November 2014. He is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Brynjólfur is also a member of the Board Credit Committee and the chairman of the Board Audit Committee.

Brynjólfur was the head of the economics department of Vinnuveitendasamtök Íslands, an association of employers, between 1973 and 1976 and the chief executive officer of AB bókaútgáfa, a book publishing company, between 1976 and 1983. He was employed as the chief executive officer of HB Grandi, one of Iceland's largest seafood companies, between 1984 and 2002 and as the chief executive officer of Síminn between 2002 and 2007. Brynjólfur was the chief executive officer of Skipti hf., a telecommunications and information technology company, between 2007 and 2010, the chief executive officer of the Icelandic Group, a seafood processing company, in 2011 and the chief executive officer of the Enterprise Investment Fund, an investment fund owned by a group of Icelandic pension funds, between 2012 and 2014. Brynjólfur has served on the boards of directors of numerous companies and organisations, including in the telecommunications and information technology, seafood and financial services industry sectors. Brynjólfur graduated with a cand. oecon. degree in business administration from the University of Iceland in 1971 and received a Master of Business Administration degree from the University of Minnesota in Minnesota, United States in 1973.

Herdís Dröfn Fjeldsted, Director

Born in 1971, Herdís was first elected to the Board of Directors at the Annual General meeting held on 15 March 2018. She is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Herdís is also a member of the Board Audit Committee and the Board Remuneration Committee.

Herdís was until recently the CEO of The Icelandic Enterprise Investment Fund (Framtakssjódur Íslands - FSÍ), a role in which she served for over four years. Previously she was Investment Manager at FSÍ from the year 2010. Herdís is a board member at The Icelandic-Canadian Chamber of Commerce. Before joining FSÍ, Herdís worked as a Senior Investment Analyst at Thule Investments from 2004 to 2010. Through the years she has served many companies as a member of a board of director and in various sectors, including as Chairman of Icelandic Group and VÍS hf., Vice-Chairman of Promens hf. and Director at Invent Farma, Icelandair Group and Copeinca ASA. Herdís graduated with a BSc in Business Administration with emphasis on International Marketing from the Technical University of Iceland in 2004 and a Master's degree in Corporate Finance from Reykjavík University in 2011. She is a Certified Securities Broker.

John P. Madden III, Director

Born in 1973, John was first elected to the Board of Directors at a meeting of shareholders held on 15 September 2016. John holds a dual citizenship from the United States and the United Kingdom and currently resides in the United Kingdom. John is not an independent member of the Board of Directors and is not a shareholder of Arion Bank. John is a member of the Board Remuneration Committee and the Board Risk Committee.

John is a senior managing director at Kaupthing, which is the majority shareholder of Arion Bank through its subsidiary Kaupskil. He has also worked with BC Partners, Arle, ICG since 2014. Between 1998 and 2013, John worked at Arcapita, first in the United States, then in the United Kingdom. Prior to 1998, he was at Lehman Brothers, New York. John serves on the board of directors at Fairhold Securitisation Limited, Karen Millen Holdco 1 Limited, Huurre Group OY and Noreco ASA. John graduated with a Bachelor of Arts degree in political economy from Williams College in Massachusetts, United States in 1996.

Måns Höglund, Director

Born in 1951, Måns was first elected to the Board of Directors at the Annual General Meeting held on 24 March 2011. Måns is Swedish and currently resides in Portugal. He is an independent member of the Board of Directors and is not a shareholder of Arion Bank. Måns is also the chairman of the Board Risk Committee and a member of the Board Credit Committee.

Måns was employed in various positions at Hambros Bank in London between 1977 and 1984, including serving as the regional director for Denmark and Iceland for two years. In 1984, he began working for Götabanken in London and was transferred to Götabanken's Stockholm operations in 1989, where he was the head of international finance until 1991. Between 1991 and 1999, Måns worked for Swedbank AB, including serving as the head of Swedbank AB's large corporate business. Between 1999 and 2002, he worked for both UniBank AS as the head of Swedish operations and Nordea Bank AB as the head of private banking. From 2002 to 2011, Måns worked for Swedish Export Credit Corporation as the executive director and the head of corporate and structured finance. He was also a member of the Swedish Export Credit Corporation's executive committee. Måns graduated with a Bachelor of Science degree in business and economics from the Stockholm School of Economics in 1975.

Steinunn Kristín Thórdardóttir, Director

Born in 1972, Steinunn was first elected to the Board of Directors at a shareholders' meeting on 30 November 2017. She is not a shareholder of Arion Bank and is an independent Director. Steinunn is also a member of the Board Credit Committee and the Board Risk Committee.

Steinunn was partner and CEO of Beringer Finance Norway in 2015-2016 and interim CEO of Beringer Finance in Iceland and global head of food and seafood until 2017. In 2010 she founded Akton AS, a management consulting company in Norway where she worked as a managing director until 2015. Steinunn worked at Íslandsbanki (later Glitnir) in Iceland from 2001 until 2005 when she became the managing director and head of the bank's UK operations and remained there until 2008. Before that Steinunn worked at Enron Corporation from 1999 to 2001. Steinunn was a board member of Silver Green AS and Silver Green TC AS in Norway from 2011 to 2013, Versobank AS in Estonia from 2012 to 2013, board member of the Icelandic State Financial Investment (ISFI) from March 2011 to October 2011 and alternate board member at Kredittbanken, later Glitnir Norway, from 2005 to 2008. Steinunn is a member of Exedra, a discussion forum for women in leadership in various sectors, as well as a board member of Cloud Insurance AS, an insurance tech company that provides solutions to traditional insurance companies, Acton Capital AS and Akton AS and a board member of the British-Icelandic Chamber of Commerce and vice chairman of the Norwegian-Icelandic Chamber of Commerce. Steinunn has a master's degree in international management from Thunderbird, Arizona and a BA in international business and politics from University of South Carolina.

Alternate Directors

In the event that a member of the Board of Directors resigns or is unable to attend a meeting of the Board of Directors, an Alternate Directors attends such meeting. There are currently three Alternate Directors, who were elected at the Annual General Meeting held on 15 March 2018.

Ólafur Örn Svansson

Born in 1972, Ólafur was first elected as an Alternate Director at the Annual General Meeting held on 21 March 2013. He is an independent member of the Board of Directors and is not a shareholder of Arion Bank.

Ólafur started his career at the law firm Lögmenn Klapparstíg, where he was employed between 2000 and 2004. He has been a partner at the law firm Forum Lawyers since 2005 and at the tort law office since 2007. In addition, Ólafur worked as the director of the real estate agency supervisory authority between 2005 and 2011. Ólafur has taught courses on commercial law and civil justice at the University of Bifröst, the University of Reykjavík and the University of Iceland as well as served as an advisor on Master of Laws theses in commercial law at the University of Reykjavík. Ólafur graduated with a cand. jur. degree from the University of Iceland in 2000. He qualified as a district court attorney in Iceland in 2001 and as a supreme court attorney in Iceland in 2008.

Sigurbjörg Ásta Jónsdóttir

Born in 1970, Sigurbjörg was first elected as an Alternate Director at the Annual General Meeting held on 20 March 2014. She is an independent member of the Board of Directors and is not a shareholder of Arion Bank.

Sigurbjörg has been employed as the policy officer at the NATO Headquarters in Brussels since 1999. Between 2014 and 2015, Sigurbjörg also worked as the legal officer at the Ministry of Interior, where she performed financial and structural analysis and undertook scenario-based long-term strategic planning. She has served on the boards of directors of various companies and organisations, including the Junior College Breidholt and the Health Clinic in Efra Breidholt, and has been a member of the Icelandic Bar Association (*Lögmannafélag Íslands*) since 1997. Sigurbjörg graduated with a cand. jur. degree from the University of Iceland in 1996 and received a Master of Laws degree in international law from the University of Cambridge in the United Kingdom in 1998.

Thórarinn Thorgeirsson

Born in 1974, Thórarinn was first elected as an Alternate Director at the shareholders' meeting held on 23 June 2017. He is not an independent member of the Board of Directors and is not a shareholder of Arion Bank.

Thórarinn has been employed as a managing director at Kaupthing's legal department since 2013, where prior to this, he was an associate managing director. Thórarinn has also been head of legal at a private equity advisory firm, associate at Lex law offices, specialist at the FME and a committee secretary at the standing committee department of Althingi, the Icelandic Parliament. Thórarinn graduated with a law degree from the University in Iceland in 2000. Thórarinn is licensed as a district court attorney in Iceland.

Other Members of the Board of Directors

The Board of Directors has appointed Heimir Thorsteinsson as an external member of the Board Audit Committee to bring in a greater level of expertise.

Duties and Responsibilities of the Board of Directors

The Board of Directors has approved the Rules of Procedure with reference to Article 54 (4) of the Financial Undertakings Act, Article 70 (5) of the Public Limited Companies Act and the FME Guidelines No. 1/2010, which set forth its duties and responsibilities.

The Board of Directors is the highest authority in the affairs of Arion Bank between meetings of the shareholders, and one of its main duties is to supervise Arion Bank's activities. Accordingly, the Board of Directors is responsible for Arion Bank's affairs and for ensuring that its organisation and activities are at all times in correct and good order. The Board of Directors makes decisions on all unusual or major arrangements, which fall outside the daily operations, but it can also authorise the CEO to make such decisions. The Board of Directors is also responsible for ensuring that the book-keeping and the handling of Arion Bank's funds is sufficiently supervised. The Board of Directors engages in regular discussions on the manner in which it discharges its duties and where its main areas of focus should be.

The Board of Directors' tasks include, among others:

- confirming Arion Bank's strategy and organisational chart, deciding on annual business plans and budgets and establishing policies on internal affairs of Arion Bank;
- establishing an effective system of internal control and risk management;
- appointing the CEO and the chief internal auditor and determining their salaries and other remuneration;
- confirming the appointment of the compliance officer and the chief risk officer, each of whom reports directly to the CEO, and their respective deputies, if applicable;
- assessing Arion Bank's capital requirement with respect to risk (ICAAP) and deciding on Arion Bank's risk appetite on the basis of a recommendation from the Board Risk Committee, the CEO and the chief risk officer;

- approving an incentive scheme based on a proposal from the Board Remuneration Committee, if applicable;
- proposing a dividends policy at the Annual General Meeting and submitting a proposal on the payment of dividends at the Annual General Meeting, if applicable;
- arranging, with the CEO, the preparation of financial statements and signing such financial statements; and
- notifying the FME immediately of any issues which are of crucial importance for the continued operation of Arion Bank.

The Board of Directors is required to annually assess its work, practices and procedures, Arion Bank's activities and the work of its committees as well as the work of the CEO, the chief internal auditor and other employees, as applicable. No later than two months after the Annual General Meeting, it is decided how the performance assessment should be performed, including whether an outside party shall be brought in to perform the assessment. The Board of Directors is also required to evaluate continuously the performance of Arion Bank. For this purposes, members of the Board of Directors meet the executive management on a regular basis.

The Board of Directors is required to meet at least ten times a year. In the year ended 31 December 2017, the Board of Directors met on 17 occasions.

Committees of the Board of Directors

The Board of Directors is permitted to establish committees to discuss particular areas of Arion Bank's operations. No later than one month after the Annual General Meeting, the Board of Directors appoints members to the committees and assesses whether it is necessary to appoint external members to certain committees to bring in a greater level of expertise. The CEO attends meetings of committees and has the right to debate and submit proposals, unless the committee decides otherwise in particular instances. The same rules on eligibility, independence and potential conflicts of interest apply to committee members as to members of the Board of Directors. Committees of the Board of Directors regularly inform the Board of Directors of their activities and members of the Board of Directors have access to all material used by the sub-committees and their minutes.

The Board of Directors currently has four committees: the Board Risk Committee, the Board Audit Committee, the Board Credit Committee and the Board Remuneration Committee. The Board of Directors has historically not had a special nomination committee, because nominations to the Board of Directors have been the responsibility of Arion Bank's shareholders. However, rules of procedure for a Nomination Committee have been established, and following the Offering, members of the Nomination Committee will be elected at the Annual General Meeting or at an extraordinary meeting of shareholders. See "—*Corporate Governance—Nomination Committee*".

The table below sets forth the membership on each of the committees of the Board of Directors as of the date of this Prospectus.

Director / Alternate Director	Board Audit Committee	Board Credit Committee	Board Remuneration Committee	Board Risk Committee
Eva Cederbalk		X (chairman)		
Brynjólfur Bjarnason	X (chairman)	X		
Herdís Dröfn Fjeldsted	X		X	
John P. Madden III			X	X
Måns Höglund		X		X (chairman)
Steinunn Kristín Thórdardóttir		X		X
Ólafur Örn Svansson				
Sigurbjörg Ásta Jónsdóttir				
Thórarinn Thorgeirsson				
Heimir Thorsteinsson(1)	X			

(1) Appointed by the Board of Directors as an external member of the Board Audit Committee to bring in a greater level of expertise.

Board Audit Committee

The Board Audit Committee assists the Board of Directors in meeting its responsibilities in ensuring an effective system of internal controls and compliance and for meeting its external financial reporting obligations under applicable laws and regulations. The Board Audit Committee supervises accounting procedures, the organisation and function of the Bank's internal controls, and the auditing of the annual accounts and the Bank's consolidated accounts.

The Board Audit Committee must consist of at least three members, at least two of whom must be members of the Board of Directors. Members of the Board Audit Committee are required to be independent of the Chief Internal Auditor and the external auditor and the majority of members of the Board Audit Committee are also required to be independent of the Bank. The CEO, managing directors and other employees of the Bank cannot be members of the Board Audit Committee. As of the date of this Prospectus, the Board Audit Committee consists of Brynjólfur Bjarnason (chairman), Herdís Dröfn Fjeldsted and Heimir Thorsteinsson. Heimir Thorsteinsson is not a member of the Board of Directors and is independent of Arion Bank and its significant shareholders. The Board Audit Committee, which was previously known as the Board Audit and Risk Committee, met on eight occasions during the year ended 31 December 2017.

Board Credit Committee

The Board Credit Committee is Arion Bank's highest authority with respect to the granting of credit. The Board Credit Committee makes decisions on credit, debt cancellations, investments and underwriting in accordance with its authority framework, as determined by the Board of Directors. In addition, the Board Credit Committee decides the maximum limits to the CEO's framework for the granting of credit and debt cancellation and the CEO's framework for investments and underwriting.

The Board Credit Committee must consist of at least three members, who are appointed by the Board of Directors. As of the date of this Prospectus, the Board Credit Committee consists of Eva Cederbalk (chairman), Brynjólfur Bjarnason, Måns Höglund and Steinunn Kristín Thórdardóttir. The Board Credit Committee met on 16 occasions during the year ended 31 December 2017.

Board Remuneration Committee

The main task of the Board Remuneration Committee is to advise the Board of Directors on the terms of remuneration of the CEO and other employees hired directly by the Board of Directors. Accordingly, the Board Remuneration Committee prepares and implements proposals on remuneration and negotiates with Arion Bank's day-to-day management. The Board Remuneration Committee's regular tasks at its meetings are to review the remuneration policy, the human resources policy, salary distribution and the incentive system, if applicable. Arion Bank's remuneration policy is examined and approved annually at the Annual General Meeting.

The Board Remuneration Committee must consist of at least three members appointed by the Board of Directors. A majority of members of the Board Remuneration Committee must be independent of the Bank's significant shareholders. The CEO, managing directors, or other employees of the Bank cannot be members of the Committee. As of the date of this Prospectus, the Board Remuneration Committee consists of Herdís Dröfn Fjeldsted and John P. Madden III. The Board Remuneration Committee met on five occasions during the year ended 31 December 2017.

Board Risk Committee

The Board Risk Committee provides guidance on the alignment of the Bank's risk policy and high-level strategy, and risk-appetite and risk management structure. The majority of the Board Risk Committee shall be independent of the Bank. The chair shall be independent of the Bank and should neither be the chair of the Board of Directors nor the chair of any other committee of the Board of Directors. The Board Risk Committee furthermore plays a supervisory role, on behalf of the Board of Directors, as regards the forming of the risk policy and risk appetite of the Bank. The Board Risk Committee's role is also to assist the Board of Directors and the Board Audit Committee in meeting its responsibilities in ensuring an effective system of internal controls and compliance and for meeting its external financial reporting obligations under applicable laws and regulations.

The Board Risk Committee must consist of at least three members, at least two of whom must be members of the Board of Directors. The CEO, managing directors, or other employees of the Bank cannot be members of the Board Risk Committee. As of the date of this Prospectus, the Board Risk Committee consists of Måns Höglund (chairman), John P. Madden III and Steinunn Kristín Thórdardóttir. The Board Risk Committee, which was previously known as the Board Audit and Risk Committee, met on 10 occasions during the year ended 31 December 2017.

Executive Committee

Overview

Pursuant to the Corporate Governance Guidelines, the CEO is responsible for the day-to-day management and operations of Arion Bank and is required, in this connection, to follow the policies and instructions established by the Board of Directors. The Corporate Governance Guidelines require the CEO to conduct his work at all times with integrity and take into account the interests of Arion Bank. The CEO must ensure that Board of Directors is regularly provided with accurate information and data on Arion Bank's finances, development and operation to enable the Board of Directors to perform its duties. Such information and data should be available to the Board of Directors in advance of the meetings of the Board of Directors as well as between such meetings. Moreover, such information and data must be available when needed and be as up-to-date and accurate as possible. The Corporate Governance Guidelines also require the CEO to submit any other projects undertaken by him, which are unrelated to Arion Bank, to the Board of Directors for discussion.

Pursuant to the Rules of Procedure, the CEO can make decisions on unusual or major arrangements if it is impossible to await the decision of the Board of Directors without considerable inconvenience for Arion Bank's operations. In such instances, the CEO must present the issue at the next meeting of the Board of Directors. As part of the CEO's responsibility for the day-to-day management and operations of Arion Bank, the CEO is responsible for:

- ensuring that the Board of Directors and auditors have all necessary information on the operations of Arion Bank which they may request and are entitled to receive by law;
- ensuring that Arion Bank's accounts are prepared in accordance with law and standard practice;
- ensuring that Arion Bank's assets are handled in a secure manner;
- hiring employees; and
- establishing Arion Bank's management structure, subject to the confirmation by the Board of Directors, that ensures clear lines of responsibility and accountability throughout Arion Bank and complements an effective system of internal control.

The CEO may establish special management committees to make or advise on key management decisions or to improve the operations of Arion Bank. The Rules of Procedure require such key management decisions to be made with the involvement of more than one member of the senior management. The Board of Directors is required to be informed of any decisions to establish or abolish key management committees. The CEO also approves specific rules of procedure for each key management committee, which set out the main tasks of such management committee, rules for appointment of members as well as reporting obligations and specific working procedures of such management. The CEO is required to inform the Board of Directors as appropriate and necessary of the work and the effectiveness of the management committees.

The CEO may not be a member of the board of directors of a commercial undertaking or participate in other business operations in other respects, including participation through ownership which confers direct influence on the management of the undertaking. However, the CEO is permitted to be a member of the board of directors or otherwise participate in the management of subsidiaries of Arion Bank. The Board of Directors may grant an exemption from this prohibition if it considers the participation compatible with the interests of Arion Bank and if it is not likely to cause conflicts of interest.

The CEO is required to ensure that members of the senior management are qualified to discharge their duties and fulfil at all times applicable conditions of eligibility with respect to reputation and financial status. Furthermore, the CEO is required to give special consideration to special eligibility of members of Executive Committee with respect to conflicts of interest.

The CEO also decides who may be a member of the board of directors of subsidiaries and affiliated companies of Arion Bank. The CEO is required to submit annually to the Board of Directors a list of members of such boards of directors on behalf of Arion Bank.

Members of the Executive Committee

The table below sets forth the members of the Executive Committee, their year of birth and the year in which they were appointed to their current positions on the Executive Committee.

Name	Position	Year of birth	Appointed
Höskuldur H. Ólafsson . .	Chief Executive Officer	1959	2010
Gísli S. Óttarsson	Chief Risk Officer	1963	2009
Ida Brá Benediktsdóttir .	Managing Director of Retail Banking	1976	2017
Jónína S. Lárusdóttir . . .	Managing Director of Legal Division	1970	2010
Lýdur Thór Thorgeirsson	Managing Director of Investment Banking Acting Managing Director of Corporate Banking	1976	2017
Margrét Sveinsdóttir . . .	Managing Director of Asset Management	1960	2009
Rakel Óttarsdóttir	Chief Information Officer	1973	2016
Stefán Pétursson	Chief Financial Officer	1963	2010
Sture Stölen	Head of Investor Relations	1967	2017

Höskuldur H. Ólafsson, CEO

Born in 1959, Höskuldur was appointed as the CEO in June 2010. Höskuldur was employed at Eimskip between 1989 and 2005, holding a range of management positions, including deputy chief executive officer and managing director. From 2006 until his appointment as the CEO of Arion Bank, Höskuldur served as the chief executive officer of Valitor. He has also served on the boards of directors of various companies and organisations in Iceland and abroad, including the Chamber of Commerce of Iceland, and is currently chairman of the board of directors of the Icelandic Financial Services Association. Höskuldur graduated with a cand. oecon. degree in business administration from the University of Iceland in 1987 and holds a diploma in shipping and business studies from the London School of Foreign Trade.

Gísli S. Óttarsson, Chief Risk Officer

Born in 1963, Gísli was appointed as the Chief Risk Officer in April 2009. Gísli was employed as the manager of software development for the multibody dynamics and motion analysis software at Mechanical Dynamics, Inc. in Michigan, United States between 1996 and 2001. He was the director and chief executive officer at Gleipnir ehf., engineering software consulting company, between 2001 and 2006. Gísli was the head of research and development in Kaupthing's risk management division between 2006 and 2008. He is the director of the Reykjavík Junior College Alumni Association and the director of the Icelandic-American Foundation, which is the Icelandic charter of the American Scandinavian Foundation. Gísli graduated with a Bachelor of Science degree in civil engineering from the University of Iceland in 1986 and received a Master of Science degree in applied mechanics in 1989 and a Ph.D. in mechanical engineering in 1994 from the University of Michigan. He is also a certified securities broker in Iceland.

Ida Brá Benediktsdóttir, Managing Director of Retail Banking

Born in 1976, Ida was appointed managing director of the Retail Banking division in June 2017. Ida started her career at Kaupthing in 1999, when she joined the research division of Kaupthing, during which time she held various positions, including the head of financial institutions. Upon establishment of Arion Bank in 2008, Ida continued working as the head of financial institutions until September 2010, when she became the head of communications, investor relations and public relations. In 2013, Ida became the head of the Private Banking subdivision and in 2016 was appointed as the managing director of the Investment Banking division. Ida has served on the boards of directors of numerous companies, including Sparisjódur Ólafsfjardar, AFL, Landfestar and HB Grandi. Ida graduated with a cand. oecon. degree in business administration from the University of Iceland in 1999 and received a Master of Science degree in financial management from the Rotterdam School of Management in 2004. Ida is a certified securities broker in Iceland.

Jónína S. Lárusdóttir, Managing Director of Legal

Born in 1970, Jónína was appointed as the managing director of the Legal division in November 2010. Jónína started her career at the law firm A&P Árnason in 1996. She moved to the Ministry of Industry and Commerce in 2000, where she was a specialist in the financial markets department. Jónína was appointed director of the general office of the Ministry of Industry and Commerce in 2004. In 2007, she became permanent secretary of the Ministry of Economic Affairs, where she was employed until 2010. Jónína has served on and chaired the boards of directors of various committees and organisations, including serving as a chairman of the Depositors' and Investors' Guarantee Fund in 2003 and 2004. She is currently the chairman of the Association of Icelandic Lawyers (*Lögfrædingafélag Íslands*) and a member of the Icelandic Bar Association (*Lögmannafélag Íslands*). Jónína has also worked as a lecturer in several institutions, including the faculty of law of the University of Iceland. Jónína graduated with a cand. jur. degree from the University of Iceland in 1996 and received a Master of Laws degree, including in European competition law, from the London School of Economics in 2000. Jónína qualified as a district court attorney in Iceland in 1997.

Lýdur Thór Thorgeirsson, Managing Director of Investment Banking

Born in 1976, Lýdur was appointed managing director of the Investment Banking division in October 2017 and currently serves as acting managing director of the Corporate Banking Division. From 2010 to 2017 he worked for GAMMA Capital Management hf., first as a fund manager of institutional investor funds and from 2013 as managing director of Alternative Investments. Lýdur worked for Kaupthing from 2009 to 2010, where he was manager of international corporate loans. Prior to that he was at Arion Bank and its predecessor in the Corporate Finance division from 2007. Between 2000 and 2005 Lýdur worked for Íslandsbanki in both in its Leveraged Finance and Risk Management departments. Lýdur has served on the boards of directors of numerous companies. Lýdur graduated with a Bachelor of Science degree in electronic and computer engineering from the University of Iceland and received a Master of Business Administration degree from the MIT Sloan School of Management. Lýdur is a certified securities broker in Iceland.

Margrét Sveinsdóttir, Managing Director of Asset Management

Born in 1960, Margrét was appointed as the managing director of the Asset Management division in February 2009. Margrét has more than 30 years of experience in the financial sector, having worked in credit analysis, customer relationship management and asset management. She started her career in the credit department of the Industrial Bank of Iceland in 1985. Margrét then moved to Íslandsbanki Securities Ltd VÍB, later the asset management division of Glitnir, where she was the executive director of securities advisory unit and a member of the management team of the asset management division. Between 2007 and 2009, Margrét worked as the executive director of the financial institutions team within the Treasury division of Glitnir, with emphasis on relationship management with international banks. Margrét has served on the boards of directors of various companies and organisations, including the Depositors' and Investors' Guarantee Fund on behalf of the Icelandic Financial Services Association, Okkar Life Insurance and several funds in Luxembourg. Margrét graduated with a cand. oecon. degree in business administration from the University of Iceland in 1986 and received a Master of Business Administration degree from the Babson College in Massachusetts, United States in 1990. Margrét is a certified securities broker in Iceland.

Rakel Óttarsdóttir, Chief Information Officer

Born in 1973, Rakel was appointed as the Chief Information Officer in January 2016. Rakel started her career at Kaupthing in 2005, when she joined the information technology division of Kaupthing, where she was employed as the project manager between 2005 and 2006 and as the account manager between 2006 and 2010. Rakel was employed as the head of the project office in the Corporate Development and Marketing division of Arion Bank between 2010 and 2011 and as the managing director of the Corporate Development and Marketing division of Arion Bank between 2011 and 2015. Rakel graduated with a Bachelor of Science degree in computer science from the University of Iceland in 1997 and received a Master of Business Administration degree from Duke University in North Carolina, United States in 2002.

Stefán Pétursson, Chief Financial Officer

Born in 1963, Stefán was appointed as the Chief Financial Officer in August 2010. Stefán was employed as the head of administration services at the Icelandic Fisheries Laboratories Institute between 1986 and 1989. Stefán started his career at Landsvirkjun (the National Power Company), the largest power producer in Iceland, serving as the treasurer between 1995 and 2002 and as the head of funding between 2002 and 2005. He was appointed as the chief financial officer of Landsvirkjun in 2002 and was a member of Landsvirkjun's negotiation committee with energy-intensive industries. Stefán was on leave from Landsvirkjun in 2008, while serving as the chief executive officer of the investment company HydroKraftInvest hf. He has served on the boards of directors of various companies and organisations, including the Depositors' and Investors' Guarantee Fund and the Chamber of Commerce of Iceland. Stefán graduated with a cand. oecon. degree in business administration from the University of Iceland in 1986 and received a Master of Business Administration degree from Babson College in Massachusetts, United States in 1991.

Sture Stölen, Head of Investor Relations

Born in 1967, Sture was appointed as the Head of Investor Relations in February 2017. Sture served as the head of investor relations at SAS AB in Sweden from 2001 to 2013. From 1993 to 2001, Sture held various positions in treasury and finance in SAS AB. Since 2013, Sture has been senior adviser and partner at Wildeco

Ekonomisk Information AB in Sweden, a position he currently holds. Sture was a board member of Forex Bank AB in Sweden from 2013-2014. He has served as head of investor relations in TF Bank AB (publ) since January 2016. Sture holds a Master of Science in Finance from the Norwegian School of Business in Oslo, Norway from 1993.

Conflicts of Interest

John P. Madden III, who is a member of the Board of Directors, and Thórarinn Thorgeirsson, who is an Alternate Director, are employees of Kaupthing. Arion Bank and Kaupthing, as owner of Kaupskil, may have different interests with respect to the financial reorganisations of customers in the event there were any customers who have obligations with both parties. Furthermore, under the Rules of Procedure, a member of the Board of Directors (or alternates) may not be involved in the handling of any issues concerning dealings with himself or herself, or undertakings in which he or she owns a direct or indirect share, where they are members of the board of directors, hold positions of responsibility or have substantial interests at stake in other respects. The same applies to the handling of cases that concern parties who are considered connected to them in another way, whether personally or financially. A member of the Board of Directors shall not participate in deliberations on issues relating to his or her competitors or related parties. In these cases, such members of the Board of Directors are required to leave the meeting.

There are no other conflicts of interest between the duties of the members of the Board of Directors, the Alternate Directors or members of the Executive Committee to Arion Bank and their private interests or other duties.

Other Information on the Board of Directors and the Executive Committee

All members of the Board of Directors and the Executive Committee may be contacted at Arion Bank's address at Borgartún 19, 105 Reykjavík, Iceland or by telephone at +354 444 7000.

There are no family ties between members of the Board of Directors or the Executive Committee, except for Gísli S. Óttarsson, the Chief Risk Officer, and Rakel Óttarsdóttir, the Chief Information Officer, who are in a registered partnership.

No member of the Board of Directors or the Executive Committee has been involved in bankruptcy, mandatory liquidation or bankruptcy administration in the past five years in their respective capacity as member of the Board of Directors or the Executive Committee. No member of the Board of Directors or the Executive Committee has been convicted in any case relating to fraud in the past five years. No member of the Board of Directors or the Executive Committee has in the past five years been banned by any court from membership of a company's administrative, management or control bodies or from holding management or general positions within a company. No member of the Board of Directors or the Executive Committee has any private interest that might conflict with Arion Bank's interests.

Other Directorships

The table below sets forth the companies and partnerships (excluding Arion Bank) in which each member of the Board of Directors, the Alternate Directors and each member of the Executive Committee is, or has been, a member of the administrative, management or supervisory bodies (or partner) at any time in the previous five years and whether she or he is still a member.

Name	Company / partnership	Position	Position still held (Y/N)
Eva Cederbalk	Cederbalk Consulting AB	CEO and owner	Y
	National Bank of Greece Group	Director	Y
	Ikano Group S.A.	Director	Y
	Svolder AB	Director	Y
	Bilia AB	Director	N
	Klarna Holding AB	Director	N
	Klarna AB	Chairman of the board of directors	N
	Gimi AB	Director	N
	TicWorks AB	Chairman of the board of directors	N
	Ida P AB	Chairman of the board of directors	N
	Íslandsbanki hf.	Director	N
	Stockholms Stads Brandkontor	Director	N
	Diakrit International Limited	Chairman of the board of directors	N
	KK-Stiftelsen	Director	N
Brynjólfur Bjarnason	Ferguson ehf.	Alternate director	Y
	Marinvest ehf.	Director	Y

Name	Company / partnership	Position	Position still held (Y/N)
	ISAL hf.	Director	Y
	Reykjavík Playwriting Fund	Director	Y
	Genís hf.	Director	N
Herdís Dröfn Fjeldsted	Icelandic Canadian Chamber of Commerce	Director	Y
	Framtakssjódur Íslands	CEO	N
	Icelandic Group hf.	Chairman of the board of directors	N
	Icelandic Trademark Holding ehf.	Director	N
	Útgerdarfélag Sandgerdis ehf.	Director	N
	Icelandic Nýfiskur hf.	Director	N
	Icelandic Gadus NV	Director	N
	Gadus Fish	Director	N
	Icelandic Group UK Limited	Director	N
	Icelandic Iberica	Director	N
	VÍS hf.	Chairman of the board of directors	N
	Invent Farma	Director	N
	Medicopack A/S	Director	N
	Promens hf.	Vice chairman of the board of directors	N
	Icelandair Group hf.	Director	N
	Copenica AS	Director	N
John P. Madden III	Fairhold Securitisation Limited	Director	Y
	Karen Millen Holdco 1 Limited	Director	Y
	Huurre Group OY	Director	Y
	Noreco ASA	Director	Y
Måns Höglund	None		
Steinunn Kristín Thórdardóttir	Acton Capital AS	Chairman of the board of directors	Y
	Akton AS	Chairman of the board of directors	Y
	Cloud Insurance AS	Director	Y
	Women Empower Women	Chairman of the board of directors	Y
	Norwegian-Icelandic Chamber of Commerce	Director	Y
	British-Icelandic Chamber of Commerce	Director	Y
	Versobank AS	Director	N
Ólafur Örn Svansson	None		
Sigurbjörg Ásta Jónsdóttir	Videntifier Technologies ehf.	Alternate Director	Y
Thórarinn Thorgeirsson	Klakki ehf.	Director / Alternate director	N
	Haukthing ehf.	Alternate director	Y
	Sjávarútvegssjódurinn ehf.	Alternate director	Y
	Seabreeze holding ehf.	Alternate director	Y
	EU fund slhf.	Alternate director	N
Höskuldur H. Ólafsson	Startup Reykjavík Invest ehf.	Chairman of the board of directors	Y
	Chamber of Commerce of Iceland	Director	Y
	Icelandic Financial Services Association	Chairman of the board of directors	Y(1)
	Junior Achievement—Ungirfrumkvödlar	Director	Y
	Chamber of Commerce of Iceland	Director	N
	SA-Business Iceland	Director	N
	European Banking Federation	Director	N
Gísli S. Óttarsson	Icelandic-American Foundation	Alternate director	Y
	Valitor Holding hf.(2)	Alternate director(3)	N
	Valitor hf.(2)	Alternate director(3)	N
	Gleipnir ehf.	Director	N
Ida Brá Benediktsdóttir	Vördur tryggingar hf.(2)	Vice chairman	Y
	Eyrir Sprotar GP	Director	Y
	Stodir hf.	Director	Y
	AICO ehf.	Alternate director	N
	HB Grandi	Director	N
	Landfestar(2)	Director	N
	AFL	Director	N
	Sparisjódur Ólafsfjardar	Director	N
	Spól	Director	N
	LF 1 ehf.	Director	N
	LF 2 ehf.	Director	N
	LF 3 ehf.	Director	N
	LF 5 ehf.	Director	N
	LF 6 ehf.	Director	N

Name	Company / partnership	Position	Position still held (Y/N)
	LF 7 ehf.	Director	N
	LF 11 ehf.	Director	N
	LF 12 ehf.	Director	N
	LF 13 ehf.	Director	N
Jónína S. Lárusdóttir	Valitor hf.(2)	Director	Y
	Valitor Holding hf.(2)	Director	Y
	Association of Icelandic Lawyers	Chairman of the board of directors(4)	Y
Lýdur Thór Thorgeirsson	LTT ehf.	Founder and director	Y
	Samtök skattgreidenda (Icelandic Taxpayers' Association)	Director	Y
	Canadian Icelandic Business Association	Director	Y
	Esjulaug ehf.	Alternate director	N
	Límtré-Vírnet ehf.	Alternate director	N
	C3 ehf.	Alternate director	N
	Árland ehf.	Chairman of the board of directors	N
	H96 ehf.	Director	N
	Opus fasteignafélag ehf.	Director	N
	Almenna SKB ehf.	Alternate director	N
	Atmo Select ehf.	Director	N
	Heild fasteignafélag ehf.	Chairman of the board of directors	N
	Mótás Gardabær ehf.	Alternate director	N
	Opus fasteignir B9B ehf.	Chairman of the board of directors	N
	V2-8 ehf.	Director, alternate director	N
	Agros hádegismóar ehf.	Director	N
	Agros Krókháls 7/Hesthál 15 ehf.	Director	N
	Agros Óseyrarbraut 26 ehf.	Director	N
	Agros Óseyrarbraut 24 ehf.	Director	N
	Agros Óseyrarbraut 20 ehf.	Director	N
	C1 ehf.	Alternate director	N
	Almenna K ehf.	Chairman of the board of directors	N
	SRE-L77 ehf.	Chairman of the board of directors	N
	Agros: Nordlingabraut 10 ehf.	Director	N
	Agros: Móhella 1 ehf.	Director	N
	Eik fasteignafélag hf.	Director	N
	Agros: Fiskislód 37 ehf.	Alternate director	N
	Almenna S21 ehf.	Alternate director	N
	LL06 ehf.	Alternate director	N
	Almenna leigufélagid ehf.	Chairman of the board of directors	N
	Borfélag Íslands ehf.	Director	N
	Upphaf fasteignir ehf.	Alternate director	N
	E—fasteignafélag ehf.	Director	N
	Novus 1 ehf.	Director	N
	AK1533 ehf.	Alternate director	N
	Almenna S23 ehf.	Alternate director	N
	LL04 ehf.	Alternate director	N
	E1 ehf.	Alternate director	N
	S11-13 ehf.	Alternate director	N
	LL08 ehf.	Director	N
	LL09 ehf.	Alternate director	N
	Thróunarfélagid ehf.	Alternate director	N
	RED ehf.	Alternate director	N
	Almenna RED ehf.	Director	N
	Agros: Dvergshöfdi 4 ehf.	Director	N
	Agros: Midhella 1 ehf.	Director	N
	Agros Lækjarmelur 1 ehf.	Director	N
	Agros Óseyrarbraut 26B ehf.	Director	N
	Ratio ehf.	Director	N
	Domus eignir GP ehf.	Alternate director	N
	Agros ehf.	Alternate director	N
Margrét Sveinsdóttir	Katla Fund	Chairman of the board of directors	Y
	Kaupthing Advisory Comp.	Chairman of the board of directors	N
	Kaupthing Investment Fund	Chairman of the board of directors	N
	GIR Capital Investments	Chairman of the board of directors	N
	GIR Fund Management	Chairman of the board of directors	N
	Okkar Life Insurance(2)	Director	N
Rakel Óttarsdóttir	Icelandic Export Center Ltd.	Alternate director	Y
	AFL Sparisjódur	Director	N

Name	Company / partnership	Position	Position still held (Y/N)
Stefán Pétursson	Depositors' and Investors' Guarantee Fund	Director	N
	Chamber of Commerce of Iceland	Director	N
	Valitor Holding hf.[(2)]	Director	Y
	Valitor hf.[(2)]	Director	Y
	Landey ehf.[(2)]	Chairman of the board of directors	N
	Iceland Geothermal	Director	N
	AFL Sparisjódur	Chairman of the board of directors	N
	Startup Reykjavík Invest	Director	Y
	Landfestar ehf.	Director	N
Sture Stölen	Det Norske Samfund	Board member	Y
	Voice ASP ASA	Board member	Y
	Wildeco Ekonomisk Information AB	Board member, partner	Y
	Forex Bank AB	Board member	N

(1) Höskuldur served as the chairman of the board of directors from 2012 until 2014 and was re-appointed as chairman from May 2018.

(2) Subsidiary of the Group.

(3) Gísli was a member of the board of directors of each of Valitor Holding hf. and Valitor hf. from 2010 until 2011, when he was appointed as the alternate director.

(4) Jónína was a member of the board of directors of the Association of Icelandic Lawyers (*Lögfrædingafélag Íslands*) from 2012 until 2015, when she was appointed as the chairman of the board of directors.

External Auditor

Under the articles of association, Arion Bank is required to elect external auditors annually at the Annual General Meeting. Arion Bank's most recent election of external auditor was at the Annual General Meeting held on 15 March 2018, when Deloitte ehf. (Smáratorgi 3, 201 Kópavogi, Iceland), a member firm of Deloitte Global, in its capacity as registered audit firm, with Páll Grétar Steingrímsson and Gunnar Thorvardarson (authorised public accountant and member of FLE, the Icelandic Institute of State Authorised Public Accountants) and as independent auditor, was re-elected for the period until the next Annual General Meeting. Deloitte ehf. has been Arion Bank's auditor since 2015 and Páll Grétar Steingrímsson and Gunnar Thorvardarson have been independent auditor since 2015.

The external audit of the Group Consolidated Financial Statements of Arion Bank is conducted in accordance with International Standards on Auditing (ISA). The external auditor attends at least one meeting of the Board of Directors annually, at which the external auditor reviews the audit for the year and discusses the audit with the members of the Board of Directors, without the CEO or any member of the Executive Committee being present. The auditor receives compensation for its services as determined by the Board of Directors. The external auditor's fees for audit and review of the annual financial statements amounted to ISK 185 million, ISK 140 million and ISK 150 million for the years ended 31 December 2017, 2016 and 2015, respectively. The external auditor's fees for audit related services amounted to ISK 45 million, ISK 11 million and ISK 3 million for the years ended 31 December 2017, 2016 and 2015, respectively.

Corporate Governance

Overview

Arion Bank believes that good corporate governance helps to foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as Arion Bank's employees and the general public. Corporate governance also provides the foundations for responsible management and decision making, with the objective of generating lasting value. The Board of Directors places considerable importance on good corporate governance and re-evaluates its governance practices regularly on the basis of recognised guidelines on corporate governance.

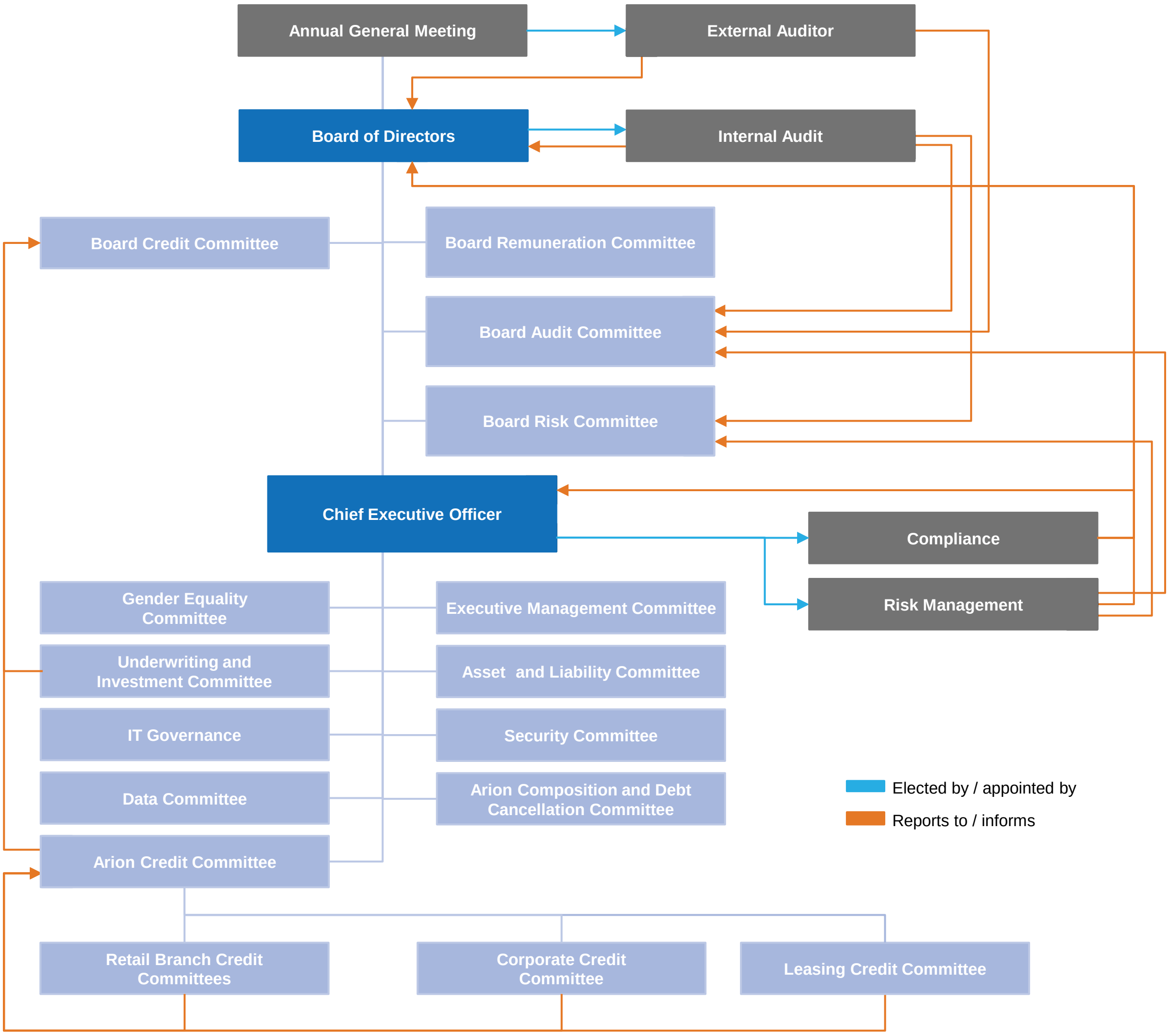
Pursuant to the Financial Undertakings Act, Arion Bank is obligated to comply with recognised guidelines on good corporate governance. Arion Bank complies with the Corporate Governance Guidelines issued by the Iceland Chamber of Commerce, SA—Business Iceland and NASDAQ Iceland and the Guidelines No. 1/2016 on the Internal Governance of Financial Undertakings issued by the FME. The Corporate Governance Guidelines specifically target companies that qualify as 'public interest entities', which includes financial institutions, and that have their shares traded on a regulated market. Such companies must comply with the Corporate Governance Guidelines. Nevertheless, the Corporate Governance Guidelines apply the so-called "comply or explain" principle, providing managers leeway to deviate from specific details of the Corporate Governance Guidelines if they explain and clarify the reasons for such deviation and set forth the measures that were taken instead. Arion Bank complies with the Corporate Governance Guidelines but, because of Arion Bank's shareholder structure, certain deviations were made from the Corporate Governance Guidelines. The specific instances in which Arion Bank has deviated from the Corporate Governance Guidelines are set forth below, together with explanations.

- ***Article 1.1.6.*** states that the board of a company shall post certain information on the candidates to the board on the company's website. Given the current shareholder structure, the information in question has been sent directly to shareholders before the Annual General Meeting and posted on Arion Bank's website following the Annual General Meeting. Arion Bank will seek to post the full notices for general meetings as press releases and on its investor relations website in the future and intends to comply with this requirement going forward.
- ***Article 1.5.*** states that a shareholders' meeting shall appoint a nomination committee or decide how it should be appointed. Kaupskil, Arion Bank's majority shareholder, nominates six out of seven members of the Board of Directors and Attestor Capital LLP nominates the seventh member. Arion Bank had previously not considered it necessary to appoint a nomination committee given its shareholder structure; however, prior to admission to trading of the Shares to NASDAQ Iceland and the SDRs to NASDAQ Stockholm, rules of procedure for a Nomination Committee were established, and following the Offering, members of the Nomination Committee will be elected at the Annual General Meeting or at an extraordinary meeting of shareholders.
- ***Article 5.1.2.*** states that the rules of procedure of sub-committees of the Board of Directors shall be posted on Arion Bank's website. The rules of the Board Credit Committee have not been published on Arion Bank's website due to their nature. Arion Bank does not expect that this will change following admission to trading of the Shares to NASDAQ Iceland and the SDRs to NASDAQ Stockholm.

In addition, because Arion Bank previously issued financial instruments that have been admitted to trading on regulated markets in Iceland, Norway and Luxembourg, it is subject to the disclosure requirements for issuers pursuant to the Securities Transactions Act No. 108/2007 and the rules of the relevant stock exchanges.

In December 2015, Arion Bank was recognised as a company which has achieved excellence in corporate governance. The Icelandic Chamber of Commerce, SA—Business Iceland, NASDAQ Iceland and the Center for Corporate Governance at the University of Iceland have signed a partnership agreement, under which companies are given the opportunity to undergo a formal assessment of their corporate governance. Arion Bank received this recognition following an in-depth survey of corporate governance at Arion Bank performed by KPMG ehf. in the autumn of 2015, including governance by the Board of Directors, committees of the Board of Directors and senior management. The recognition applies for three years unless significant changes are made to Arion Bank's management or ownership.

Arion Bank's Corporate Governance Structure



General Meetings

The supreme authority in the affairs of Arion Bank is in the hands of legitimate shareholders' meetings in accordance with Icelandic laws and Arion Bank's articles of association. Shareholders wield their power to decide upon company affairs at shareholders' meetings and all shareholders are authorised to attend a shareholders' meeting and to speak there. A simple majority of votes decides issues at a shareholders' meeting.

Shareholders are afforded an opportunity to cast votes on matters on the agenda of a shareholders' meeting by letter or electronically. A shareholder may have his representative attend a shareholders' meeting on his behalf. A shareholder is authorised to attend a meeting along with an advisor. An advisor has neither the right to submit proposals nor to vote at shareholders' meetings. A shareholder is authorised to let his advisor speak on his behalf. A representative shall submit a dated, written or electronic power of attorney. According to the Articles of Association, such a power of attorney for a proxy shall be valid only for attendance at one shareholders' meeting unless otherwise clearly stated in the contents of the power of attorney.

The Board of Directors is required to convene shareholders' meetings, including Annual General Meetings, by public notice or by electronic means sent to each shareholder with at least 21 days' notice and no more than 28 days' notice. The NASDAQ Iceland Rules for Issuers of Financial Instruments (the "**NASDAQ Iceland Rules**") require disclosure of notices to attend general meetings of shareholders.

In addition, the NASDAQ Iceland Rules require disclosure of resolutions adopted by the general meeting of shareholders unless such resolutions are insignificant. This requirement applies notwithstanding such resolutions being in accordance with previously disclosed proposals. Where the general meeting has authorised the board of directors to decide later on a specific issue, such resolution by the board of directors shall be disclosed, unless such resolution is insignificant.

An Annual General Meeting is required to be held before the end of April each year, and its agenda is required to include specific items, including (i) a proposal on the disposal of earnings or loss from the preceding operating year, (ii) elections to the Board of Directors, (iii) election of an auditor, (iv) decision on remuneration to the members of the Board of Directors for services rendered; (v) proposals of the Board of Directors regarding remuneration policy and (vi) election of two members of the Nomination Committee.

An extraordinary meeting of shareholders shall be held when the Board of Directors deems necessary. An extraordinary meeting of shareholders shall be called with no less than 21 days' notice and no more than 28 days' notice if the Bank's auditor or shareholders controlling a minimum of 5.0% of the share capital so require in writing, specifying the agenda.

Nomination Committee

The Bank has established rules of procedure for the Nomination Committee, and following the Offering, members of the Nomination Committee will be elected at the Annual General Meeting or at an extraordinary meeting of shareholders. The adoption of these rules of procedure for the Nomination Committee seeks to ensure that members of the Board of Directors have wide and versatile qualifications and experience. The Nomination Committee shall have an advisory role regarding the election of members of the Board of Directors by putting forth a proposal, at each Annual General Meeting or at an extraordinary meeting of shareholders where election to the Board of Directors is on the agenda, of candidates to serve on the Board of Directors along with a proposal on their remuneration.

The Nomination Committee must consist of at least three members, one of whom is a member of the Board of Directors and is appointed by the Board of Directors, and the others are appointed by the shareholders and must be independent of the Bank and its day to day management, and at least one shareholder-appointed member shall be independent of the largest shareholder of the Bank or any group of shareholders acting in concert.

Internal Control, Risk Management, Auditing and Accounting

An active internal control is a procedure formed by the Board of Directors and day-to-day managers. The internal control is inter-linked to Arion Bank's operation and intended to facilitate the Board of Directors' and day-to-day managers' task to supervise its operations. The internal control system also formalises the manner in which Arion Bank works towards its goals, distributes responsibility in its internal activities and explains the responsibility of the Board of Directors in such work. Risk management is a procedure to analyse and measure the risk factors which could prevent Arion Bank from achieving set goals and that remedial action is taken to minimise the anticipated effects of such risk factors.

Under the Corporate Governance Guidelines, the Board of Directors is responsible for establishing an active system of internal controls. This means, among other things, that the arrangement of the internal controls system must be formal and documented and its functionality must be verified regularly. As recommended in the Corporate Governance Guidelines, the Board of Directors defines, at least annually, the most important risk factors Arion Bank has to address.

The Rules of Procedure set forth further specifications with respect to internal controls. Accordingly, the Rules of Procedure require that the internal control units have sufficient independence to carry out their duties diligently. The Board of Directors is also required to ensure the necessary cooperation between the internal control units and Arion Bank's external auditor, as applicable. The internal control units inform the Board of Directors regularly, *e.g.*, with quarterly or more regular reports, of their work and the findings of their supervisory activities. Issues concerning internal control and risk management at Arion Bank are discussed regularly at meetings of the Board of Directors.

The Rules of Procedure further specify that the Board of Directors meets annually with the chief internal auditor, the external auditor, the chief risk officer and the compliance officer, without the CEO present, to review the status of internal control and risk management and take corrective measures, as appropriate. The Board of Directors also assesses, at least annually, the financial position, liquidity and capital adequacy of Arion Bank and ensures that stress tests are performed when deemed necessary. In addition, the Board of Directors is responsible for defining and assessing annually the most important risk factors facing Arion Bank.

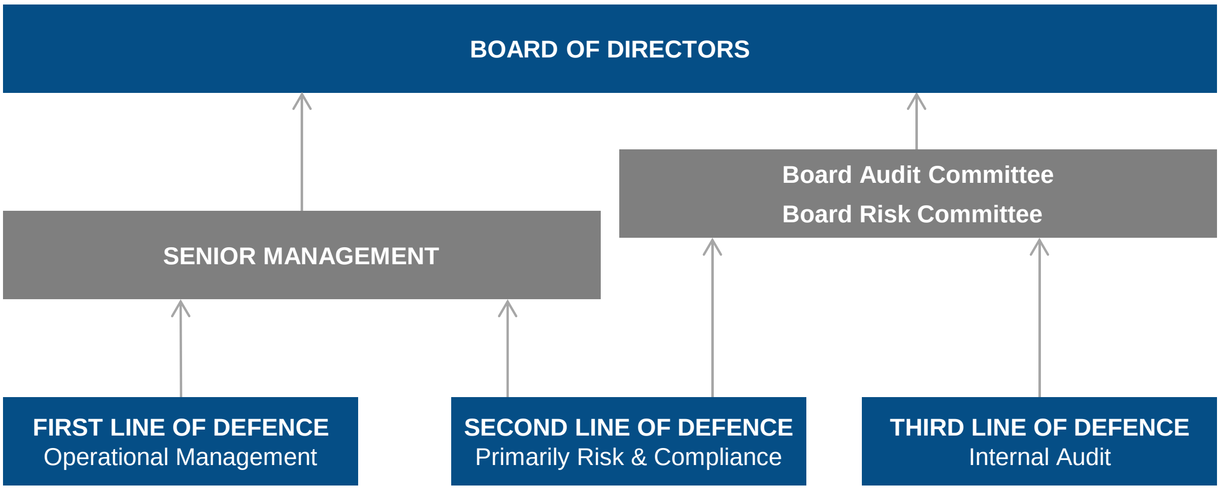
The Bank's internal control units are Internal Audit, Compliance and Risk Management.

Internal Control

Internal control at Arion Bank is organised into three lines of defence, with the aim of ensuring effectiveness, defining responsibility and coordinating risk management. This structure is also designed to foster a sense of risk awareness and responsibility among all employees of Arion Bank.

The framework distinguishes between the following roles:

- people who bear responsibility for risk and manage risk;
- people who monitor and check internal controls; and
- people who perform independent surveys of the effectiveness of internal controls.



The first line of defence consists of people who are responsible for the day-to-day supervision and organisation of Arion Bank's operations. They are responsible for establishing and maintaining effective internal controls and managing risk in day-to-day operations. This involves identifying and evaluating risk and putting in place appropriate countermeasures to reduce risk. The first line of defence is responsible for supervising the implementation of internal rules and processes in compliance with applicable law, regulations and Arion Bank's own strategy. It must ensure that all actions are in compliance with established procedures and that corrective action is taken if any deficiencies are detected.

The second line of defence seeks to ensure that the first line of defence has established adequate internal controls that operate as intended. Risk Management and Compliance are the main participants in the second line of defence, although other units may also be assigned specific monitoring roles.

The third line of defence is Internal Audit, which keeps the Board of Directors and management informed of the quality of corporate governance, risk management and internal controls, including by performing independent and objective audits.

Compliance and Measures Against Money Laundering and Terrorist Financing

Arion Bank seeks to detect any risk of failure to fulfil its legal obligations and has taken appropriate measures to minimise such risks. The Bank employs an independent compliance officer in accordance with a special charter from the Board of Directors. The compliance officer reports directly to the CEO and provides the CEO with regular reports relating to his/her work. The compliance officer may refer cases directly to the Board of Directors if deemed necessary. The main roles of Compliance at Arion Bank are:

- to monitor and regularly assess the adequacy and effectiveness of measures designed to minimise the risk of failure to fulfil Arion Bank's obligations under the Securities Transactions Act and the Act on Measures against Money Laundering and Terrorist Financing;
- to provide Arion Bank's employees with the necessary training and advice to enable them to fulfil both their own and Arion Bank's obligations under the Securities Transactions Act and the Act on Measures against Money Laundering and Terrorist Financing;
- to investigate and notify the authorities of any suspicion of money laundering, terrorist financing or market abuse. The compliance officer also conducts independent investigations if there is any suspicion of a violation of the Competition Act; and

- the compliance officer also undertakes outsourced tasks from Stefnir and certain pension funds.

Risk Management

A central feature of the activities of all financial institutions is carefully calculated risk-taking according to a predetermined strategy. Arion Bank takes risk compatible with its risk appetite, which is regularly reviewed and approved by the Board of Directors. Arion Bank's risk appetite, determined by the Board of Directors, is translated into exposure limits and targets that are monitored by Risk Management. The Board of Directors is responsible for Arion Bank's internal capital adequacy assessment process, the main objective of which is to ensure that Arion Bank understands its risk profile and has systems in place to assess, quantify and monitor its total risk exposure.

Risk Management is headed by the chief risk officer. It is independent, centralised and reports directly to the CEO. Risk management comprises three departments whose role is to analyse, monitor and regularly report to the CEO and the Board of Directors on the risks faced by Arion Bank. For additional information on risk and capital management, see "*Risk Management*".

Internal Audit

The internal auditor is appointed by the Board of Directors and reports directly to the Board of Directors. The Board of Directors sets a charter for the internal auditor, which outlines its responsibilities and scope of work. The main duty of the internal auditor is to provide independent and objective assurance and advice designed to improve Arion Bank's operations. The scope of the audit is Arion Bank, its subsidiaries and any pension funds serviced by Arion Bank.

The audit is governed by the audit charter, directive No. 3/2008 issued by the FME on the internal audit function in financial institutions and international standards on internal auditing. All audit work is completed by issuing an audit report with deadlines for the implementation of audit findings. Implementations are followed up by the internal audit on a quarterly basis.

With respect to 2016 and 2017, the internal auditor's overall conclusion on the effectiveness of the Bank's internal controls and the Bank's risk and control culture was that they were unsatisfactory (Is. *ófullnægjandi*) and should be improved, particularly relating to controls and risk awareness in the Corporate Banking division (as evidenced by the matters relating to United Silicon) and anti-money laundering processes at the Bank generally. To address these conclusions, the Bank has been making improvements and is on target for implementing the recommended anti-money laundering controls, and the Credit Office has been established in part to strengthen the lending process and control of the loan portfolio. See also "*The Bank is exposed to credit risk and its customer loan portfolio contains certain problem and impaired loans*", "*The Bank is exposed to operational risks*" and "*The Bank must comply with anti-money laundering and anti-bribery regulations, and the violation of such regulations may have severe consequences*" in "*Risk Factors*".

Auditing and Accounting

The Finance division is responsible for preparing the accounts in accordance with IFRS. Arion Bank publishes its financial statements on a quarterly basis, and management statements are generally submitted to the Board of Directors ten times a year. The Board Audit Committee examines the annual financial statements and interim financial statements, while the external auditors review and audit the accounts twice a year. The Board Audit Committee gives its opinion on the accounts to the Board of Directors, which then approves and endorses the accounts.

Customers' Ombudsman

The Customers' Ombudsman is appointed by, and responsible to, the CEO. The role of the Customers' Ombudsman is to ensure that the business of customers is handled fairly and objectively, prevent discrimination against customers and make certain that the process for handling cases is transparent and documented. The Customers' Ombudsman examined 162 cases in 2017, compared with 160 cases in 2016 and 185 cases in 2015.

Code of Ethics and Corporate Social Responsibility

The management and employees of Arion Bank are conscious of the fact that the activities of Arion Bank affect different stakeholders and society at large. The code of ethics is designed to serve as a key to responsible decision-making at Arion Bank. The code of ethics is approved by the Board of Directors and reviewed at least annually. The code of ethics is applied by the Board of Directors, Arion Bank's management, and other employees of the Bank. It is the responsibility of the CEO to make sure that the code of ethics is adhered to.

Arion Bank demonstrates sustainable banking by making a difference to its customers and performing its role as a financial institution conscientiously and responsibly. Arion Bank takes an active role in its society and development. Financial institutions are one of the pillars of society and their role is to help our customers, both individuals and companies, reach their goals. Arion Bank places great importance on doing things fairly with the interests of its customers, employees, shareholders and the community at heart.

In 2017 the Bank continued to implement its policy on sustainability, which was approved by the Board of Directors in late 2016 and presented to employees. In late 2017 Arion Bank became a signatory to the United Nations Principles on Responsible Investment and since 2016 has been a signatory to the UN Global Compact.

Remuneration of Members of the Board of Directors and Executive Committee

Overview

The main objective with regard to employee remuneration is that Arion Bank offers competitive salaries to be able to attract and retain outstanding employees as well as to ensure that jobs at Arion Bank are sought after by qualified people. When devising a remuneration policy, Arion Bank seeks to ensure that the remuneration policy does not encourage excessive risk taking, but rather supports Arion Bank's long-term goals and its healthy operation. The policy is an integral part of Arion Bank's strategy to protect the long-term interests of its shareholders, employees, customers and other stakeholders in an organised and transparent manner.

Pursuant to Article 79a of the Public Limited Companies Act and rules on good corporate governance, the Board of Directors approves Arion Bank's remuneration policy with respect to salaries and other payments to members of the Board of Directors, the CEO, managing directors, compliance officer and internal auditor. The Board Remuneration Committee advises the Board of Directors on remuneration for the CEO, managing directors, compliance officer and internal auditor as well as on Arion Bank's bonus scheme and other work-related payments. The CEO proposes a salary framework for managing directors, the compliance officer and internal auditor in consultation with the Board Remuneration Committee. The remuneration policy is reviewed annually and submitted to the Annual General Meeting for approval or rejection. The Board of Directors is required to discuss the remuneration to the Board of Directors, the CEO and managing directors at the Annual General Meetings.

The remuneration of the CEO is specified in a written employment agreement, stating fixed salary, pension rights, holiday pay and other work-related payments, period of notice and severance payments. The salaries of managing directors and the compliance officer are decided by the CEO, in consultation with the Head of Human Resources, and take into account the size of the relevant division and level of responsibility. The respective remunerations of managing directors are specified in a written employment agreement. Generally speaking, only the terms of an employment agreement are valid with respect to pension payments or severance payments. In exceptional circumstances, the Board of Directors is authorised to enter into a severance agreement with the CEO in accordance with the provisions of the Financial Undertakings Act.

The Board of Directors is authorised to set up a bonus scheme in accordance with proposals of the Board Remuneration Committee. The scheme is required to comply with the provisions of law and regulations applicable to such bonus schemes. The bonus scheme may, but does not currently, apply to all employees of Arion Bank and is required to be submitted to the Annual General Meeting for approval before being implemented.

Arion Bank intends to retain a portion of the Shares which it acquired as part of a buyback in February 2018 for a one-time employee incentive bonus, based on authority granted at a meeting of shareholders on 9 May 2018, to be awarded to all employees as a bonus, in the form of a restricted grant of Shares. The award remains conditional on successful completion of the Offering and admission to trading on NASDAQ Iceland and NASDAQ Stockholm (to occur no later than 31 December 2018). Participants in the bonus, who are either (i) permanent full-time or part-time employees (excluding the Board of Directors and surveillance units) or (ii) temporary employees who are permanent full-time or part-time employees on 1 December 2018, may be awarded Shares in an amount corresponding to up to one month's salary, while not exceeding ISK 1 million per employee, at the Offer Price (the "**Stock Grant**"). The Stock Grant will consist of Shares and cash to meet taxes and wage-related expenses. The Bank estimates that the total value of the Stock Grant will be approximately ISK 675 million. The Bank will deduct from the Stock Grant an amount corresponding to the recipient's income tax and wage related duties and assign the net amount in the form of Shares to the recipient.

Although recipients of awards under the Stock Grant shall be entitled to any dividends paid by the Bank, they will not be permitted to transfer any Shares awarded under the Stock Grant until 24 months after the date of the relevant award, which is expected to be 10 days after the commencement of trading of the Shares on NASDAQ Iceland. This lock-up period may be extended to three years if the amount of the total bonus payment for an employee exceeds regulatory limits, which require the Bank to postpone payment of 40% of the bonus for three years.

Board of Directors

Pursuant to Article 79 of the Public Limited Companies Act, members of the Board of Directors receive a fixed monthly payment as determined at the Annual General Meeting.

The table below sets forth the remuneration paid to members of the Board of Directors for the year ended 31 December 2017.

	Year ended 31 December 2017		
	Fixed remuneration(1)	Additional remuneration(2)	Total
	(ISK in millions)		
Monica Caneman(3)	7.3	0.9	8.2
Gudrún Johnsen(4)	7.2	4.2	11.4
Benedikt Olgeirsson(5)	1.0	1.2	2.2
Jakob Már Ásmundsson(6)	4.2	1.2	5.4
Brynjólfur Bjarnason	5.2	4.6	9.8
Kirstín Th. Flygenring(7)	5.0	4.0	9.0
Måns Höglund	10.0	4.6	14.6
John P. Madden III(8)	—	—	—
Eva Cederbalk(9)	10.4	0.2	10.6
Steinunn Kristín Thórdardóttir(10)	0.4	—	0.4
Thóra Hallgrímsdóttir(7)	5.0	4.4	9.4
Herdís Dröfn Fjeldsted(11)	—	—	—
Alternate Directors	3.0	—	3.0
Total remuneration	**58.7**	**25.3**	**84.0**

(1) Fixed remuneration represents compensation paid to members of the Board of Directors for their attendance at the meetings of the Board of Directors.

(2) Additional remuneration represents compensation paid to members of the Board of Directors for their participation in committees of the Board of Directors.

(3) Monica Caneman resigned from the Board of Directors on 10 May 2017.

(4) Gudrún Johnsen resigned from the Board of Directors on 29 November 2017.

(5) Benedikt Olgeirsson did not stand for re-election to the Board of Directors at the Annual General Meeting held on 9 March 2017.

(6) Jakob Már Ásmundsson resigned from the Board of Directors on 30 May 2018 in light of inappropriate personal conduct.

(7) Kirstín Th. Flygenring and Thóra Hallgrímsdóttir did not stand for re-election to the Board of Directors at the Annual General Meeting held on 15 March 2018.

(8) John P. Madden III was appointed to the Board of Directors at a meeting of shareholders held on 15 September 2016. He received no remuneration for serving as a member of the Board of Directors in the year ended 31 December 2016 and the year ended 31 December 2017 and has agreed to waive any fee from Arion Bank for serving as a member of the Board of Directors for so long as Kaupskil has at least a 50.0% ownership in Arion Bank.

(9) Eva Cederbalk was appointed to the Board of Directors at a meeting of shareholders held on 23 June 2017.

(10) Steinunn Kristín Thórdardóttir was appointed to the Board of Directors at a meeting of shareholders held on 30 November 2017.

(11) Herdís Dröfn Fjeldsted was appointed to the Board of Directors at the Annual General Meeting held on 15 March 2018.

At the Annual General Meeting held on 15 March 2018, shareholders approved the fixed monthly salaries in the amounts of ISK 907,423, ISK 680,793 and ISK 453,900 for the chairman of the Board of Directors, vice chairman of the Board of Directors and for other members of the Board of Directors, respectively, to apply until the next Annual General Meeting in 2019. The shareholders also approved a fixed fee to be paid to Alternate Directors for their attendance at the meetings of the Board of Directors in the amount of ISK 229,912 per meeting, up to a maximum of ISK 453,900 per month. The foregoing fixed monthly salaries or fixed fees, as applicable, are doubled for foreign members of the Board of Directors. In addition, the shareholders approved a monthly salary to be paid to members of the Board of Directors who serve on committees up to a maximum amount of ISK 181,560 per month for each committee they serve on and a monthly salary to be paid to the chairman of such committees in the amount of ISK 235,777.

Executive Committee

The table below sets forth the remuneration paid to the Executive Committee for the year ended 31 December 2017.

	Year ended 31 December 2017	
	Salaries	**Performance based payments(1)**
	(ISK in millions)	
Höskuldur H. Ólafsson, CEO	62.0	9.2
Freyr Thórdarson(2)	33.9	3.4
Gísli S. Óttarsson	32.3	—
Ida Brá Benediktsdóttir	31.5	3.5
Jónína S. Lárusdóttir	31.7	4.2
Lýdur Thór Thorgeirsson(3)	6.0	—
Margrét Sveinsdóttir	38.1	5.2
Rakel Óttarsdóttir	31.5	4.8
Stefán Pétursson	38.3	5.3
Sigurjón Pálsson(4)	28.3	3.4
Helgi Bjarnason(5)	24.0	4.4
Sture Stölen(6)	—	—

(1) Performance based payments for the year ended 31 December 2017 are based on the Group's performance in the year ended 31 December 2016 and remaining payment from year ended 31 December 2013.

(2) Managing Director of Corporate Banking until the end of May 2018.

(3) Appointed in October 2017.

(4) Managing Director of Operation until 1 July 2017.

(5) Managing Director of Retail Banking until 1 March 2017.

(6) Engaged on employment-like terms and will remain for a minimum of 12 months after the time of listing.

As of the date of this Prospectus, there were (i) no amounts set aside or accrued by the Bank to provide pension, retirement or similar benefits to members of the Board of Directors and the Executive Committee or (ii) any service contracts between members of the Board of Directors or the Executive Committee, as the case may be, and the Bank providing for any benefits upon termination of employment other than rights arising under applicable law.

PRINCIPAL AND SELLING SHAREHOLDERS

As of the date of this Prospectus, Kaupskil and Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP), as the Selling Shareholders, hold 68.01% of the issued Shares. After completion of the Offering, the Selling Shareholders will continue to hold 38.60% of the issued Shares, assuming that the Over-Allotment Option is not exercised and that the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares.

The table below sets forth certain information with respect to the ownership of the Shares immediately prior to the Offering on an actual basis and immediately after the Offering (i) as adjusted for the Offering assuming that the Over-Allotment Option is not exercised and that the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares and (ii) as adjusted for the Offering assuming that the Over-Allotment Option is exercised in full and that the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares:

	Actual		As adjusted for the Offering if the Over-Allotment Option is not exercised		As adjusted for the Offering if the Over-Allotment Option is exercised in full	
Shareholder	**Number**	**%(1)**	**Number**	**%(1)**	**Number**	**%(1)**
Kaupskil(2)	1,111,401,629	55.57	523,151,629	26.16	434,914,129	21.75
Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP)(3)	248,799,999	12.44	248,799,999	12.44	248,799,999	12.44
Taconic Capital Advisors UK LLP (through TCA New Sidecar III s.à r.l.)	199,999,999	9.99	199,999,999	9.99	199,999,999	9.99
Sculptor Investments s.à r.l. (an affiliated entity of Och-Ziff Capital Management Group)	131,522,115	6.58	131,522,115	6.58	131,522,115	6.58
Goldman Sachs International (through ELQ Investors II Limited)	67,400,000	3.37	67,400,000	3.37	67,400,000	3.37
Arion Bank(4)	190,000,000	9.50	190,000,000	9.50	190,000,000	9.50
Other shareholders(5)	50,876,258	2.54	50,876,258	2.54	50,876,258	2.54
New shareholders(6)	—	—	588,250,000	29.41	676,487,500	33.82
Total	**2,000,000,000**	**100.0**	**2,000,000,000**	**100.0**	**2,000,000,000**	**100.0**

(1) Percentages reflect rounding to the nearest hundredth of a percent.

(2) Kaupskil is a wholly owned subsidiary of Kaupthing. Following the Offering, Immediately upon conclusion of the Offering, Kaupthing is permitted, based upon the FME decision regarding Kaupthing's eligibility as a qualified holder, to determine to hold its interest in the Shares directly rather than through Kaupskil and without the conditions previously imposed by the FME. By virtue of indirect holdings, the shareholders of Arion Bank named above hold the following beneficial interests in the share capital of Arion Bank: Attestor Capital LLP: 4.39%; Taconic Capital Advisors UK LLP: 26.65%; Och-Ziff Capital Management Group: 3.30%; Goldman Sachs International: 1.82%. Consequently, when combined with their direct holding of Shares, the aggregate beneficial ownership of each in the share capital of the Bank is as follows: Attestor Capital LLP: 16.83%; Taconic Capital Advisors UK LLP: 36.64%; Och-Ziff Capital Management Group: 9.88%; Goldman Sachs International: 5.19%.

(3) The registered address of Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP) is Fourth Floor, 3 George's Dock, IFSC, Dublin 1, Ireland. Sale of Offer Securities by Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP) will be dependent on market demand. Any such sale would be in addition to the sale of Offer Securities by Kaupskil, and such sales in aggregate would be within the maximum number of Offer Securities to be sold as disclosed in this Prospectus. The terms of any such sale will be notified to investors in the pricing statement expected to be published on or around 15 June 2018.

(4) In February 2018, Arion Bank acquired 9.5% of its own Shares in a buyback transaction with Kaupskil for ISK 17.1 billion in connection with the First Monetisation Dividend, as defined below. No voting rights are attached to Arion Bank's own shares while held by Arion Bank. Arion Bank is considering cancelling a portion of the Shares it currently holds and has no intention of selling such Shares into the market; however, the Bank intends to retain a portion of such Shares for a one-time employee incentive bonus, based on authority granted at a meeting of shareholders on 9 May 2018, to be awarded to all employees as a bonus, in the form of a restricted grant of Shares. The award remains conditional on successful completion of the Offering and admission to trading on NASDAQ Iceland and NASDAQ Stockholm (to occur no later than 31 December 2018). Arion Bank estimates that the total value of the Stock Grant will be approximately ISK 675 million, or approximately 9,183,673 Shares

assuming an Offer Price at the mid-point of the Offer Price Range. For more details, see "*Shares and Share Capital—Share Capital Information—Buyback of Shares*".

(5) Other shareholders comprise established Icelandic investment funds, which acquired such Shares in a private placement transaction in February 2018. For more details, see "*—Private Placements of Shares—Second Private Placement*".

(6) New shareholders include the Cornerstone Investors. See "*Plan of Distribution—Cornerstone Investments*".

The Selling Shareholders have granted the Over-Allotment Option to the Managers, exercisable, in whole or in part, for 30 days following the first day of trading in the Offer Securities on NASDAQ Iceland or NASDAQ Stockholm, to purchase up to 108,600,000 Over-Allotment Shares from the Selling Shareholders, equal to 15% of the Existing Offer Shares and SDRs sold in the Offering, to cover over-allotments, if any, in connection with the Offering. For additional information on the Over-Allotment Option and stabilisation, see "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*".

Kaupthing

In October 2008, Kaupthing Bank hf. (as Kaupthing was named at the time) was placed into a special resolution regime, following the resignation of its board of directors on 8 October 2008 and the appointment by the FME of a resolution committee on 9 October 2008, which immediately assumed all of the authority of its board of directors and sought to manage and safeguard its asset portfolio. Under this regime, Kaupthing entered into moratorium on 24 November 2008, which ended following a ruling of the District Court of Reykjavík on 22 November 2010, after which Kaupthing entered into a "winding-up" process (a form of temporary administration with retrospective effect as of 22 April 2009).

On 24 November 2015, the requisite majority of Kaupthing's unsecured creditors voted at a creditors' meeting held to approve a composition proposal (at which point it became the Kaupthing Composition Agreement), through which Kaupthing would exit the winding-up proceedings. The Kaupthing Composition Agreement was approved by the District Court of Reykjavík on 15 December 2015 and became final and binding on 23 December 2015. As a prerequisite to Kaupthing being able to fulfil the Kaupthing Composition Agreement, the Icelandic Central Bank granted Kaupthing certain exemptions from the Capital Controls on the basis that Kaupthing, among other things, make a "stability contribution" to the Icelandic Central Bank.

As part of a refinancing of the Bank's debt position undertaken in connection with its stability contribution, the Bank issued on 11 January 2016 the Resettable Notes under the EMTN Programme to Kaupthing. For additional information on the terms of the Resettable Notes, see "*Operating and Financial Review—Funding—Borrowings*". The Bank and Kaupthing reached an arrangement to offset Kaupthing's obligation to pay the purchase price in respect of the Resettable Notes against the Bank's obligation to pay Kaupthing all amounts outstanding under a loan in the amount of ISK 56 billion denominated in foreign currency, taken by the Bank from the Icelandic Central Bank on 22 January 2010 and subsequently purchased by Kaupthing from the Icelandic Central Bank, and to return to Kaupthing certain deposits denominated in foreign currency held by the Bank for the account of Kaupthing. As of the date of this Prospectus, the Bank has repaid the Resettable Notes in full.

As a result of the requirements of the FME from 2010, Kaupthing holds its Shares in the Bank through its wholly owned subsidiary, Kaupskil, which is a private limited liability company with ID No. 580609-0150 in the Icelandic Register of Enterprises, with registered office at Borgartún 26, 105 Reykjavík, Iceland. Kaupthing appoints the members of Kaupskil's board of directors on the condition that two of the three members (including the chairman) must be independent of Kaupthing and/or its shareholders. Furthermore, Kaupskil currently nominates six out of seven members of Arion Bank's Board of Directors on the condition that only one of those can be dependent on Kaupthing and/or its shareholders, although this will no longer be the case following the Offering. Further, under a special representation agreement between Kaupskil and Kaupthing dated 20 April 2010, Kaupthing has agreed to respect the independence of the board of directors of Kaupskil and Kaupskil's duty to promote sound and solid financial operations of the Bank free of external intervention. The board of directors of Kaupskil is required to report to the FME on the implementation of this policy on a quarterly basis.

Kaupthing is required to notify the FME in advance of a proposed transfer of ownership of shares in the Bank or Kaupskil. Upon receipt of any such notification, the FME will carry out a new eligibility assessment of the prospective owners if the change of ownership amounts to a holding of the Shares of 10% or more. The FME officially set out the details of its approval and conditions in a press release dated 18 January 2010. Immediately upon conclusion of the Offering, Kaupthing is permitted, based upon the FME decision regarding Kaupthing's eligibility as a qualified holder, to determine to hold its interest in the Shares directly rather than through Kaupskil and without the aforementioned conditions.

In addition, a shareholders' proceeds apportionment agreement is in place between Kaupthing and the Icelandic Central Bank (the rights and obligations of which have been transferred to the Icelandic Ministry of Finance) whereby the proceeds from any sale or disposal of Kaupthing's indirect stake in the Bank will be divided between Kaupthing and the Icelandic Central Bank (or such other persons as may be designated to receive such amounts by the Icelandic Central Bank) in proportions which will vary depending on the proceeds of any such sale (when aggregated with the proceeds of all prior sales of Shares by Kaupskil in the Private Placements described below under "*—Private Placements of Shares*"), and will form part of Kaupthing's stability contribution. In addition, under the shareholders' proceeds apportionment agreement, the Ministry of Finance has the right to acquire all, but not some, of any Shares which Kaupthing or Kaupskil determines to sell, should the price for such sale be equal to or less than an agreed discount to the book value of Arion Bank (determined with respect to the total shareholders' equity based on the latest published consolidated statement of financial position of the Bank at the time of such offer), at such price and on the same terms (the "**Step-in Right**"). The Ministry of Finance has varied the Step-in Right such that it does not apply with respect to the Shares to be sold by Kaupskil in the Offering. The Step-in Right continues to apply with respect to any future sell-downs by Kaupskil or Kaupthing.

As part of the stability contribution, Kaupthing issued a secured note in an amount of ISK 84 billion in January 2016 to the government of Iceland, secured by the Resettable Notes, as well as the proceeds thereof, and shares in Kaupskil, among other things. According to the relevant pledge agreement, this security can only be enforced to the extent necessary for the payment of the outstanding amount of the secured note. The secured note carries 5.5% interest per annum and has a repayment schedule of two equal instalments payable on the second and third anniversary of the bond. Prepayments are allowed, but Kaupthing can only use (i) proceeds from sale of Shares by Kaupskil, and (ii) any dividends which are paid upon or in connection with the sale of, or initial public offering with subsequent listing and trading of, Shares held by Kaupskil, in order to make principal prepayments on the secured note. To date, Kaupthing has applied proceeds of all prior sales of Shares by Kaupskil, the First Monetisation Dividend (as described in "*Shares and Share Capital—Dividends and Dividend Policy—Dividends Paid*"), as well as its own funds, in the amount of approximately ISK 56,716 million, toward the payment of interest and prepayment of principal on the secured note. As a result of the Offering, Kaupthing will make a further stability contribution payment to the Icelandic Treasury of an amount, depending on the gross proceeds of the Offering, in excess of ISK 28,300 million plus accrued interest, to repay the secured note in full. Kaupthing does not consider its ownership of the Bank to be of a long-term strategic nature. However, upon expiration of the lock-up arrangements, Kaupthing will not be under any obligation to sell any of its Shares (subject always to remaining qualified as an owner of the Shares by the FME as set out in more detail in "*—Private Placements of Shares—First Private Placement*" below) and could retain all or some of its Shares for a longer period of time if it determined that to do so was in the best interest of its shareholders.

Shareholders' Agreement

On 3 September 2009, Arion Bank, the Icelandic Ministry of Finance (on behalf of the Icelandic government) and Kaupskil entered into a shareholders' agreement (the "**Original Shareholders' Agreement**) to regulate the shareholders' relationship with each other and the affairs of, and their dealings with, Arion Bank. On 13 January 2016, the Original Shareholders' Agreement was supplemented by an amendment agreement (the "**Amendment Agreement**" and, together with the Original Shareholders' Agreement, the "**Shareholders' Agreement**") among the parties to the Original Shareholders' Agreement (with the Icelandic State Financial Investments, a separate state institution under the Ministry of Finance and Economic Affairs of Iceland ("**ISFI**"), stepping in for the Icelandic government) and Kaupthing.

In February 2018, when Kaupskil exercised the call option to purchase all of the Shares held by ISFI, the Shareholders' Agreement terminated automatically as ISFI no longer holds any interest direct or indirect, in Arion Bank. See "*—Exercise of Call Option on Stake of ISFI*".

The Shareholders' Agreement is governed by Icelandic law.

Private Placements of Shares

First Private Placement

In March 2017, Kaupskil sold 582,922,113 of its Shares, at a price of ISK 83.811 per Share, to Attestor Capital LLP (acting through Trinity Investments Designated Activity Company), Taconic Capital Advisors UK LLP (acting through TCA New Sidecar III s.à r.l.), Sculptor Investments s.à r.l. (an affiliated entity of Och-Ziff Capital Management Group) and Goldman Sachs International (acting through ELQ Investors II

Limited), each of which already held an indirect interest in Arion Bank by their ownership interests in Kaupthing (the "**First Private Placement**").

Under the terms of the First Private Placement, Kaupskil granted the purchasers options in respect of a further 437,191,585 Shares held by Kaupskil, which were exercisable at a premium to the price paid in the Private Placement (calculated at a price per Share as the product of 0.85 and total shareholders' equity based on the latest public consolidated statement of financial position of the Bank, divided by the number of Shares then in issue). These options expired in September 2017, prior to which Trinity Investments Designated Activity Company exercised its options in respect of 8,800,000 Shares.

Each of Kaupthing, Trinity Investments Designated Activity Company and TCA New Sidecar III s.à r.l. has applied to the FME to be permitted to acquire Shares in an amount of 10% or more of the issued share capital of the Bank. As of the date of this Prospectus, Trinity Investments Designated Activity Company has been so approved for holdings of Shares up to 20% of the issued share capital of the Bank, and Kaupthing and TCA New Sidecar III s.à r.l. have each been approved with effect from admission of the Shares to trading on a regulated market. The FME has determined that Kaupthing and TCA New Sidecar III s.à r.l. and associated entities are acting in concert within the meaning of art. 1.a, point 25.d of the Financial Undertakings Act based upon the latter's holding in Kaupthing of more than 20%. Their combined qualifying holdings in the Bank can therefore only be up to 33%.

Second Private Placement

In February 2018, Kaupskil sold 106,876,258 of its Shares, at a price of ISK 89.168 per Share, to Attestor Capital LLP (acting through Trinity Investments Designated Activity Company), Goldman Sachs International (acting through ELQ Investors II Limited) and 24 established Icelandic investment funds (the "**Second Private Placement**").

Exercise of Call Option on Stake of ISFI

In February 2018, Kaupskil exercised its call option to purchase the Shares held by ISFI and purchased the entirety of ISFI's stake, 260,000,000 Shares or 13.0% of the issued share capital of Arion Bank, at a purchase price of ISK 90.203 per Share. Kaupskil sold 190,000,000 of these shares to Arion Bank (see "*Shares and Share Capital—Share Capital Information—Buyback of Shares*") and the remainder as a part of the Second Private Placement.

Lock-Up

After completion of the Offering, the Selling Shareholders will continue to hold 38.60% of the Shares (assuming that the Over-Allotment Option is not exercised and that the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares). The Selling Shareholders, along with each of the other purchasers in the First Private Placement, will agree with the Managers not to divest their remaining Shares (in the case of the purchasers in the First Private Placement, only those Shares acquired in the First Private Placement) for a period of 180 days after the first day of trading in the Offer Securities on NASDAQ Iceland or NASDAQ Stockholm, subject to certain exceptions. See "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*". The Cornerstone Investors will not be subject to a lock-up in respect of their allocations.

SHARES AND SHARE CAPITAL

Share Capital Information

As of 31 March 2018, the authorised share capital of the Bank was ISK 2,000,000,000 represented by 2,000,000,000 Shares, each with a par value of ISK 1.00, and the Bank had 2,000,000,000 Shares issued and 1,810,000,000 Shares outstanding (with 190,000,000 Shares held by the Bank; see "—*Buyback of Shares*").

The Shares have been issued in accordance with Icelandic law, have been fully paid and are denominated in ISK. The rights associated with the Shares, including those set out in the articles of association of the Bank, can only be changed in accordance with the procedures set forth in the Public Limited Companies Act.

The Shares are denominated in ISK. The Shares will be traded in ISK on NASDAQ Iceland under the ISIN code IS0000028157. The SDRs are denominated in SEK. The SDRs will be traded in SEK on NASDAQ Stockholm under the ISIN code SE0010413567.

Application has been made to list and admit all of the Shares to trading under the symbol "ARION" on NASDAQ Iceland and the SDRs to trading under the symbol "ARIONs" on NASDAQ Stockholm.

Buyback of Shares

In February 2018, the Bank acquired 190,000,000, or 9.5%, of its Shares in a transaction with Kaupskil for a price of ISK 90.203 per Share, the amount for which was a part of the release of the Bank's excess capital and was deducted from the proposed dividend of ISK 25 billion which had been approved by the shareholders' meeting on 12 February 2018. The authority to buy back such Shares arose from a temporary provision in the Bank's Articles of Association, which was approved at the same shareholders' meeting and which expired on 15 April 2018.

The Bank is considering cancelling a portion of the Shares it currently holds and has no intention of selling such Shares into the market; however, the Bank intends to retain a portion of such Shares for a one-time employee incentive bonus, based on authority granted at a meeting of shareholders on 9 May 2018, to be awarded to all employees as a bonus, in the form of a restricted grant of Shares. The award remains conditional on successful completion of the Offering and admission to trading on NASDAQ Iceland and NASDAQ Stockholm (to occur no later than 31 December 2018). Participants in the bonus, who are either (i) permanent full-time or part-time employees (excluding the Board of Directors and surveillance units) or (ii) temporary employees who are permanent full-time or part-time employees on 1 December 2018, may be awarded Shares in an amount corresponding to up to one month's salary, while not exceeding ISK 1 million per employee, at the Offer Price by means of the Stock Grant. The Stock Grant will consist of Shares and cash to meet taxes and wage-related expenses. The Bank estimates that the total value of the Stock Grant will be approximately ISK 675 million. The Bank will deduct from the Stock Grant an amount corresponding to the recipient's income tax and wage related duties and assign the net amount in the form of Shares to the recipient.

Although recipients of awards under the Stock Grant will be entitled to any dividends paid by the Bank, they will not be permitted to transfer any Shares awarded under the Stock Grant until 24 months after the date of the relevant award, which is expected to be 10 days after the commencement of trading of the Shares on NASDAQ Iceland. This lock-up period may be extended to three years if the amount of the total bonus payment for an employee exceeds regulatory limits, which require the Bank to postpone payment of 40% of the bonus for three years.

Any cancellation of the Shares held by the Bank would be subject to approval by the shareholders, which would not likely be proposed until the next Annual General Meeting.

Certain Rights Attached to the Shares

General Meetings and Voting Rights

The Annual General Meetings are held before the end of April each year. The supreme authority in the affairs of Arion Bank is in the hands of legitimate shareholders' meetings. One vote is attached to each Icelandic Krona of share capital, and decisions at shareholders' meetings are generally taken by majority vote. No voting rights are attached to the Bank's own shares while held by the Bank.

Preferential Rights

No special rights are attached to the Shares of Arion Bank.

Pre-Emptive Rights and Increases of Share Capital

An increase in the share capital of Arion Bank may be authorised at a meeting of shareholders. Shareholders have pre-emptive rights to an increase in Arion Bank's share capital in proportion to their holdings of the Shares and within the time limits specified in the resolution to increase the share capital. However, a meeting of shareholders can, by a two-thirds majority vote, waive pre-emptive rights to increases of share capital, if there is no discrimination.

Action Required to Change the Rights of the Shareholders

Each shareholder is under the obligation, without the necessity of any specific undertaking, to abide by Arion Bank's articles of association in their current form or as amended from time to time. Shareholders' liability for Arion Bank's affairs is limited to the share contribution of each shareholder. According to Article 20.1 of the articles of association, the articles of association may be amended at a lawfully convened meeting of shareholders.

The notice of the meeting of shareholders is required to state the business of such meeting of shareholders. Any proposals for amendments of Arion Bank's articles of association are required to be included in the notice of the meeting of shareholders. A decision to amend Arion Bank's articles of association requires the approval of two-thirds of the votes cast, if shareholders controlling at least two-thirds of the Shares represented in the meeting of shareholders participate in the vote, on the condition that other voting power is not reserved in the articles of association or in statutory law. This requirement is in accordance with Article 93 of the Public Limited Companies Act. According to article 94 of the Public Limited Companies Act, more stringent rules apply in certain cases.

Repurchases of the Shares

Pursuant to Icelandic law, Arion Bank may only repurchase the Shares within certain limits and in compliance with the following requirements:

- the repurchase of the Shares is required to be pursuant to authority granted to the Board of Directors at a meeting of shareholders, with the resolution granting such authorisation specifying the maximum number of the Shares that may be repurchased, the minimum and maximum price which may be paid for the Shares. A company whose shares are admitted to trading on a regulated securities market or multilateral trading facility is, however, not permitted to repurchase own shares at a higher price than the price in the last independent transaction or the highest existing independent offer in the trading systems where the transactions are carried out, whichever is higher. Such purchases are permitted, however, if made by a market maker;
- the duration of the authorisation to repurchase Shares cannot exceed five years;
- the aggregate nominal value of the Shares repurchased, together with the aggregate nominal value of the Shares already held by Arion Bank and its subsidiaries, may not exceed 10% of Arion Bank's share capital;
- Arion Bank can only repurchase the Shares to the extent that its capital and reserves (equity) exceed its non-distributable reserves and, after deducting repurchased Shares, its share capital must amount to a minimum of EUR 5 million;
- the Shares repurchased are required to be fully paid; and
- prior approval from the FME has been obtained.

Rights to Dividend and Liquidation Proceeds

Payment of dividends is proposed by the Board of Directors and must be approved by the shareholders at a general meeting (whether an annual general Meeting or an extraordinary general meeting). Dividends must be paid no later than six months after the date of the general meeting at which such dividends were approved. Any dividends declared are payable to the shareholders of record at the time of the payment of dividends. However, the general meeting may decide that the dividends will be payable to the shareholders of record on a different date, provided that the alternative date is stipulated in the general meeting's resolution on dividend payment and is notified to the market via NASDAQ Iceland.

There are no provisions in Arion Bank's articles of association regarding the expiration of the right to dividends that have not been collected. As a result, such rights lapse after four years according to Act No. 14/1905 on the Expiry of Debts and Other Claim Rights.

The date for the payment of dividends is decided by the shareholders at the general meeting. The date for the payment of dividends through Euroclear Sweden is the date after payment of dividends in Iceland. Dividends on the Shares registered with Euroclear Sweden are paid by Euroclear Sweden. Dividends are declared at the general meeting and paid in Icelandic Krona. However, payment of dividends on the Shares registered with Euroclear Sweden is made in Swedish Krona. The currency exchange is made on the third day immediately preceding the date of the payment of dividends. The exchange rate is fixed two days before the payment of dividends in Iceland and three days before the payment of dividends in Sweden. As a result, the exchange rate between Icelandic Krona and Swedish Krona may fluctuate from the date of the Annual General Meeting to the date of exchange, which may consequently affect the amount of dividends paid in Sweden.

Arion Bank withholds Icelandic tax on dividends. In addition, Euroclear Sweden withholds Swedish tax on dividends paid to Swedish individuals. See "*Taxation*".

Upon liquidation of Arion Bank, shareholders would be entitled to receive proportionately any assets remaining after the payment of Arion Bank's debt and taxes and the expenses of the liquidation.

Share Capital Development

The Bank has not issued any Shares in the years ended 31 December 2017, 2016 and 2015.

Dividends and Dividend Policy

Dividend Policy

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

Special distributions and dividend capacity

Arion Bank's medium-term target is to reduce its CET1 ratio to approximately 17% from 23.6% as of 31 December 2017. However, the speed and quantum of such special distributions, for example, in the form of a share buyback or extraordinary dividend, would depend on a number of factors, including (but not limited to) management of foreign exchange imbalances, the Bank's liquidity position, access to capital markets for Tier 2 and Additional Tier 1 issuance, capital requirements set by the FME and more. Such returns would likely take place over a number of years.

The Board of Directors formulated the dividend policy as outlined above in connection with the Offering and in order to promote the success of the Offering, and accordingly considered that adopting the dividend policy was in the best interests of Arion Bank.

Dividends Paid

The table below sets forth the amount of dividends paid by Arion Bank for the periods indicated.

	Year ended 31 December		
	2017	2016	2015
	(ISK in millions)		
Dividends paid	—	—	—

The majority shareholder, Kaupskil, and ultimately Kaupthing, have not had an economic benefit of receiving dividend payments since 2015. Arrangements among Kaupskil, Kaupthing and the Icelandic Central Bank, entered into in January 2016 in connection with the composition of Kaupthing, impose certain restrictions on Kaupskil (and ultimately Kaupthing) receiving dividends paid by Arion Bank. In particular, any dividends paid by Arion Bank which are denominated in ISK and ultimately paid to Kaupthing are transferred in full to the Icelandic Central Bank, unless such dividends are paid upon or in connection with the sale of, or initial public offering with subsequent listing and trading of, the Shares held by Kaupskil, in which case, such dividends are applied to the amounts outstanding on its secured note. Since these arrangements were entered into and prior to the First Monetisation Dividend (as defined below), no such dividends were paid.

On 5 February 2018 and in connection with the Offering, the Board of Directors proposed, and on 12 February 2018 a meeting of shareholders of Arion Bank conditionally approved, a dividend to be paid to shareholders as of a record date of 27 February 2018 (the "**First Monetisation Dividend**"). The First Monetisation Dividend amounted to ISK 7.9 billion and was paid on 12 March 2018. Payment of the First Monetisation Dividend was conditional on the occurrence of the Second Private Placement. In connection with the First Monetisation Dividend and as approved at the same meeting of shareholders, Arion Bank purchased from Kaupskil 190,000,000 Shares at a price of 90.203 per Share on 26 February 2018, for a total amount of ISK 17.1 billion. In this respect, the Board of Directors considered that it was in the best interests of Arion Bank to declare the First Monetisation Dividend and to buy back the Shares, as it would contribute to Arion Bank's target of achieving an improved return on equity as described in greater detail in "*Business—Financial Targets*".

For so long as Kaupskil, as a subsidiary of Kaupthing, or Kaupthing directly retains any Shares after the Offering, it will be supportive of Arion Bank's dividend policy as such dividends declared and made pursuant to such policy are now, and will be going forward, considered to be paid in connection with the sale of its Shares.

Legal and Regulatory Requirements

The Public Limited Companies Act provides that it is only permissible to allocate as dividend profit in accordance with approved annual accounts for the immediately preceding fiscal year profit brought forward from previous years and disposable earnings after deducting any losses which have not been met and any moneys which according to Icelandic laws and Arion Bank's articles of association shall be contributed to a reserve fund or for other use.

The Public Limited Companies Act further provides that a shareholders' meeting will decide upon the allocation of dividends after a company's board of directors has submitted proposals in that respect, and prohibits allocation of more dividends than the board of directors proposes or approves. Shareholders holding a total of at least 10.0% of the share capital may at an annual general meeting, provided that the company's board of directors be advised thereof, require an annual general meeting to decide upon the allocation of a sum as dividends amounting to at least 25.0% of the remainder of annual profits after any losses of previous years have been met and any amounts to be contributed to a reserve fund in accordance with Icelandic laws or Arion Bank's articles of association, or which cannot be allocated as dividends for other reasons, have been deducted. It is, however, not permissible to require allocation of more than the equivalent of 2.0% of Arion Bank's capital and reserves (equity).

The date of maturity of dividends shall be no later than six months after a decision relating to the allocation thereof has been made.

The Bank will follow NASDAQ Iceland's proposals on dividend payments, which is that trading in the Shares exclusive of dividends begins the business day immediately following the day the dividend proposal is approved and that payment of dividends will be made no later than 30 days after the record date. With the exception of dividend payments, shareholders are not entitled to any of the Bank's profits.

Restrictions on Ownership and Transfer of the Shares

Arion Bank's articles of association do not contain any limitations on the ability to transfer the Shares, and shareholders may pledge the Shares unless otherwise prohibited by law. Pre-emptive rights to increases in the share capital are transferable according to the Public Limited Companies Act.

However, special rules apply to qualifying holdings in financial institutions pursuant to Articles 40-49.b. of the Financial Undertakings Act. Parties who propose to acquire a qualifying holding in a financial institution must seek in advance the approval of the FME. In addition, the approval of the FME is required when a party, alone or jointly with others, intends to increase its holding to such an extent that the direct or indirect ownership in the share capital, guarantee capital or voting rights reaches or exceeds 20.0%, 33.0% or 50.0% or comprises such a large portion that the financial institution may be regarded as its subsidiary company. A "qualifying holding" is a direct or indirect holding in a financial undertaking which represents 10.0% or more of its share capital, guarantee capital or voting rights or any other holding which enables the exercise of a significant influence on the management of the financial institution. If the owner of a "qualifying holding" intends to reduce its shareholding with the result that such owner will not subsequently own a "qualifying holding", this is required to be reported to the FME in advance together with the shareholding following the reduction. If the shareholding decreases below the specified levels or to such an extent that the financial institution ceases to be a subsidiary of the parent company in question, this is also required to be reported.

A person acquiring the Shares cannot exercise its rights as a shareholder until such person's name has been registered in Arion Bank's share registry or such person has announced and proven the ownership of the Shares. The electronic registration of securities is governed by Act No. 131/1997 on Electronic Registration of Title to Securities (the "**Electronic Registration of Title to Securities Act**") and Regulation No. 397/2000 based on thereon.

A printout from Nasdaq CSD Iceland on the ownership of the Shares is considered a valid registration of the Shares. Arion Bank considers the share registry as full proof of ownership of the Shares and the rights attached to them. Dividends and all announcements to shareholders are sent to the parties registered in Arion Bank's share registry as owner of the Shares. Arion Bank has no liability if payments or announcements do not reach their recipients because a notification of change of address has not been delivered.

Rights to the Shares in electronic form must be registered with Nasdaq CSD Iceland. Share certificates may not be issued or endorsed for registered rights to the Shares in electronic form, and any such attempted transactions are void. Registration of the ownership of the Shares in electronic form with Nasdaq CSD Iceland, subsequent to Nasdaq CSD Iceland's final entry, formally gives a registered owner legal authorisation to the rights to which they are registered. Priority of incompatible rights is determined by the time stamp when a request from Arion Bank's data central on the registration reaches Nasdaq CSD Iceland.

ARTICLES OF ASSOCIATION

Approved at the establishment meeting of Arion Bank (then New Kaupthing banki hf.) on 18 October 2008, with amendments approved at the meetings of shareholders on 14 August 2009 and 23 November 2009, the annual general meeting on 8 January 2010, the meeting of shareholders on 18 March 2010, the annual general meeting on 20 May 2010, the annual general meeting on 24 March 2011, the annual general meeting on 21 March 2013, the meeting of shareholders on 3 February 2017, the meeting of shareholders on 12 February 2018, the annual general meeting on 15 March 2018 and the meeting of shareholders on 25 May 2018.

Article 1. Name of the Company

1.1 The Company is a public limited company with the Icelandic name *Arion banki hf.*

1.2 The Company's foreign trading name is Arion Bank.

Article 2. Head Office of the Company

2.1 The Company's head office is at Borgartún 19, 105 Reykjavík, and its legal venue is Reykjavík. The Company's Board of Directors may establish branches of the company both in Iceland and abroad.

Article 3. Purpose of the Company

3.1 The Company is a financial undertaking. The purpose of the Company is to operate a commercial bank and to pursue any and all activities which a commercial bank may carry out pursuant to the currently applicable Act on Financial Undertakings as specified in the Company's banking license.

3.2 The Company shall furthermore be authorised to pursue any other activities which are normally connected with its purpose. The Company may acquire holdings in other companies for the purpose of pursuing such activities.

Article 4. Share Capital of the Company

4.1 The Company's share capital is ISK 2,000,000,000.00—two billion Icelandic krónur.

4.2 All of the Company's share capital is of a single class and each share is ISK 1 nominal value. Each ISK 1 nominal value of share capital entitles the owner to one vote.

4.3 The Company's share capital may be increased by a resolution of a shareholders' meeting, either through subscription for new shares or by the issuance of bonus shares. A decision to increase share capital shall only be valid if supported by at least 2/3 of votes cast and if approved by shareholders controlling at least 2/3 of the share capital represented by votes at the meeting.

4.4 A shareholders' meeting may, with the approval of 2/3 of votes cast, as well as the approval of shareholders controlling at least 2/3 of the share capital represented by votes at the meeting, waive the pre-emptive rights of shareholders to new shares pursuant to the third paragraph of Article 34 of Act No. 2/1995 on Public Limited Companies. A motion to this effect must be clearly specified in the announced agenda for the shareholders' meeting.

4.5 Shareholders shall have pre-emptive rights to new shares in direct proportion to their shareholdings. Should a shareholder fail to exercise its pre-emptive rights to new shares, the entitlement of other shareholders shall be increased proportionally in its stead.

4.6 Should a subscriber to the Company's share capital fail to pay its subscribed share capital on the due date, penalty interest may be demanded from the subscriber, with the base rate as determined by the Central Bank of Iceland plus inflation indexation, on the debt from that date forth. Furthermore, the Company shall be authorised to apply any default remedies currently provided for by law, including cancelling the subscription of the subscriber in question, in which case the Company's Board may grant other shareholders pre-emptive rights to the share capital of the cancelled subscription. The Company's Board of Directors shall, however, before cancelling a subscription for shares, grant the original subscriber a time limit of four weeks to deliver its payment.

4.7 Only a shareholders' meeting can take a decision to reduce share capital.

4.8 By a shareholders resolution the Board of Directors is authorised, for the period until the annual general meeting in 2019, on one or several occasions, with deviation from any shareholders preferential rights, to issue convertible notes that meet Additional Tier 1 requirements according to article 84 b of the Act on Financial Undertakings, no. 161/2002. Loan amounts and conditions for conversion shall be set so that the total number of shares which may be issued upon conversion of Additional Tier 1 Notes, by virtue of this authorization, may not exceed 400,000,000 shares or 20% of outstanding shares at the time of issue of Additional Tier 1 Notes (or the corresponding number due to any bonus issue, share issue, conversion of convertibles, share split or reversed share split or similar corporate events). Additional Tier 1 Notes shall mandatorily convert into shares under the conditions stated in the terms and conditions of the Additional Tier 1 Notes but not be convertible at the option of the holders. 1. The Board of Directors resolves on all other terms and conditions for issuance according to this authorisation.

Article 5. Register of Shares and Electronic Registration of Title

5.1 The Company's Board of Directors shall keep a register of shares as provided for by law. The register of shares shall specify the shareholder's name, identification / registration number, address and shareholding. Furthermore, it shall record changes in ownership and the date of registration of shareholders' holdings. Finally, information on shareholders' voting rights shall be entered in the register of shares, together with information on any group connections between the Company and its shareholders.

5.2 The register of shares shall be accessible to all the Company's shareholders and available for their inspection at the Company's offices.

5.3 The Company's shares are electronically registered in a securities depository as provided for by Act No. 131/1997 on Electronic Registration of Title to Securities.

5.4 The confirmation of a securities depository of title to shares in the Company shall be deemed a satisfactory basis for the register of shares and proof of the shareholder's holding.

5.5 Registration of ownership of shares in a securities depository shall be regarded by the Company as fully valid proof of ownership rights to shares in the Company. Any dividend payments, as well as bonus shares, announcements of meetings and all notifications, shall be sent to the party currently recorded in the Company's register of shares as the owner of the respective shares, cf. Art. 5.4. The Company shall bear no responsibility for payments or notifications which may go astray as a result of failure to notify it of changes in ownership or residence.

5.6 The shareholder is responsible for ensuring that the register of shares contains correct information on the shareholder, apart from such details as can be obtained on the shareholder from the National Registry; this information is updated automatically.

Article 6. Changes in Ownership of Shares, Pledging etc.

6.1 No restrictions are placed on transactions with shares in the Company. Transactions with qualifying holdings are subject to limitations under the Act on Financial Undertakings. Shares in the Company may be assigned or pledged unless otherwise provided for by law. Registration of lien rights and changes in ownership and their implementation are subject to currently existing legislation on electronic registration of title to securities.

6.2 Changes in share ownership, whether resulting from a sale, gift, inheritance, estate settlement or execution, must always be notified as soon as effected; the register of shares shall be revised accordingly.

6.3 A party who has acquired shares in the Company may not exercise its rights as shareholder unless its name has been entered in the Company's register of shares or it has given notification and proof of its ownership of the shares.

6.4 The Company may not grant loans or other credit against security in the form of shares issued by the Company itself.

Article 7. Electronic Communications Between the Company and Shareholders

7.1 The Company may utilise electronic communications and e-mail for communications between the Company and shareholders who so request instead of sending or submitting documents on paper. This authorisation shall apply to any and all types of communications between the Company and shareholders, such as announcements of shareholders' meetings, dividend payments or other notifications which the Board may decide to send shareholders. Such electronic communications are equivalent to communications on paper. The Board of Directors shall adopt rules on the procedures for electronic communications with shareholders and the requirements set for software to be used by shareholders for such communications; these rules shall be published on the Company's website. Those shareholders intending to avail themselves of electronic communications with the Company in this manner must confirm their requests to this effect in accordance with rules adopted by the Board of Directors.

Article 8. Shareholders' Obligations

8.1 All shareholders are required, without special obligation, to comply with the Company's articles of association, as they now stand or as subsequently amended in lawful manner.

8.2 Shareholders bear no responsibility for the Company's obligations above and beyond their holding in the Company unless they assume such obligations through a specific legal instrument.

8.3 No privileges are conferred by shares in the Company.

8.4 Shareholders shall not be subject to redemption of their shares unless so provided for by law.

Article 9. Own Shares

9.1 The Company may purchase and hold its own shares to the extent currently authorised by law.

9.2 Voting rights may not be exercised for those shares owned by the Company itself.

9.3 Notwithstanding Article 9.1, the Company may only, in instances other than those referred to in Articles 56 and 57 of Act No. 2/1995, on Public Limited Companies, purchase and hold own shares if a shareholders' meeting has granted the Board of Directors such authorisation. A shareholders' meeting may not grant such authorisation for a period longer than five years in each instance. If authorisation to purchase and hold own shares is granted by a shareholders' meeting this must be recorded in a special annex to these articles of association and such annex shall be an integral part of the Articles during such time as it is valid.

Article 10. Shareholders' Meetings

10.1 Final authority in Company matters, within the limits prescribed by national law and these Articles of Association, rests with duly constituted shareholders' meetings.

10.2 Shareholders exercise their decision-making powers at shareholders' meetings. All shareholders are entitled to attend a shareholders' meeting, to address the meeting and exercise their voting rights.

10.3 The Company's Board of Directors shall convene shareholders' meetings when it considers this necessary or if the Company's auditor or shareholders controlling 1/20 of the Company's share capital so request in writing. In such case those parties must send a statement to the Board of Directors as to why they request the meeting and the Board of Directors will then notify shareholders of the meeting agenda in the meeting announcement.

10.4 A meeting of the Company's shareholders may be held at a location other than the Company's head office.

10.5 A shareholders' meeting shall be duly constituted, regardless of attendance, if it was lawfully convened and if one or more shareholders attend the meeting.

10.6 A shareholders' meeting must be convened with at least 21 and no more than 28 days' notice, unless shareholders have previously agreed to its convening on shorter notice based on those requirements set in Article 88 of the Public Limited Companies Act, No. 2/1995. A follow-up shareholders' meeting shall be convened in the same manner and with the same notice as other shareholders' meetings.

10.7 A shareholders' meeting shall be convened with an advertisement in one or more mass media and also by electronic or other verifiable means, so that shareholders' are ensured prompt and equal access to the announcement. Reliable media shall be used for the announcement to ensure effective distribution of information to the general public in the European Economic Area.

10.8 The meeting announcement must include at least:

(a) the location, date and time, and draft agenda of the meeting;

(b) clear and precise information concerning participation and voting at the meeting. Among other things, information must be provided concerning:

(i) the right of shareholders to have issues placed on the agenda of the shareholders' meeting, the right of shareholders to submit resolutions and to pose questions, and the time limits allowed them to exercise these rights;

(ii) rules on voting by proxy, forms for such voting and the manner in which the Company is prepared to approve electronic notifications of the appointment of proxies;

(iii) rules on written or electronic voting, as applicable;

(c) where and how a complete text may be obtained of:

(i) documentation to be presented to the shareholders' meeting;

(ii) motions and / or explanatory notes, as the case may be, from the Company's Board of Directors or its committees or the Company's auditors regarding each item in the draft agenda for the shareholders' meeting;

(iii) motions from share received by the Company;

(d) a website where shareholders can obtain the information to which they are to have access for the shareholders' meeting as provided for by law. Motions from shareholders shall be added to this as promptly as they are received by the Company.

10.9 Twenty-one days prior to the shareholders' meeting and on the date of the meeting the following information shall be accessible to shareholders on the Company's website:

(i) the meeting announcement;

(ii) the total number of shares and votes as of the date the meeting was announced;

(iii) documentation to be presented to the shareholders' meeting;

(iv) motions and / or explanatory notes from the Company's Board of Directors or its committees, as the case may be, regarding each item on the draft agenda for the shareholders' meeting. Motions from shareholders, as referred to in Article 10.10, shall also be added to the Company's website as promptly as possible after they are received;

(v) as appropriate, forms to be used by proxies for voting or to be used for voting by ballot, or how paper copies of the forms may be obtained, unless they have been sent to each shareholder.

10.10 Each shareholder is entitled to have a specific matter dealt with at a convened shareholders' meeting, if it makes a written or electronic request for such to the Board of Directors with sufficient notice to allow the matter to be placed on the agenda of the meeting, however, no later than 10 days prior to the meeting. The request must be accompanied by grounds for the same or a draft resolution for the Board of Directors. Information on such request must be published on the Company's website no later than three days prior to the meeting together with the proposal and, as the case may be, the revised meeting agenda.

10.11 A shareholder may also request, provided such will not result in substantial losses to the Company in the estimation of the Board of Directors, that the Board and CEO present the shareholders' meeting with information on those issues of significance for assessment of the Company's annual financial statements and its situation in other respects or on issues which could affect shareholders' position on questions which are to be decided at the meeting. Provisions of the Public Limited Companies Act shall apply in other respect to such information disclosure.

10.12 Matters which have not been listed on the agenda of a shareholders' meeting cannot be dealt with for final resolution at the meeting without the consent of all the Company's shareholders but resolutions may be adopted concerning them to serve as direction for the Board. Even if an item was not listed on the meeting agenda, this shall not preclude the calling of an extraordinary general meeting to discuss this item; in addition, an AGM may always finalise those items which it is required to handle by law or the Articles of Association. Supplementary motions or amendments, legally submitted, may be raised at the meeting itself, however, despite not having been available to shareholders beforehand.

10.13 The Board of Directors may decide to hold a shareholders' meeting by electronic means, either in full or in part, provided the technology to be used for the meeting is secure and fulfils the requirements of the Public Limited Companies Act.

10.14 A decision to hold a shareholders' meeting by electronic means shall be stated in the meeting announcement. This shall also provide information on the necessary technical equipment which shareholders require to participate in the meeting, information as to how shareholders are to give notice of their participation, information as to how voting will take place and where shareholders can obtain instructions on telecommunications equipment, passwords for access to the meeting and other relevant information. If a shareholders' meeting is held in part or in full by electronic means a password entered in the specified telecommunications equipment shall be equivalent to the signature of the respective shareholder and shall be considered confirmation of its participation in the shareholders' meeting. If a shareholders' meeting is held in part or in full by electronic means shareholders intending to attend the meeting electronically must notify the Company's office of their participation no later than five days prior to the shareholders' meeting and at the same time submit questions concerning the agenda or documentation provided for which they request answers at the meeting. In other respects such voting is governed by the provisions of Article 80 of Act No. 2/1995, on Public Limited Companies, as subsequently amended.

10.15 Notwithstanding the provision of Article 10.13, the Board of Directors must always give shareholders an opportunity to cast their votes either by ballot or electronically on issues on the agenda of a shareholders' meeting. The meeting announcement must state how voting is to be carried out. Shareholders may request to have ballots sent to them if their written request to this effect is received by the Company's office five days prior to the shareholders' meeting. Shareholders may also pick up their ballots at the Company's offices from that same time forth and cast their votes there.

10.16 Shareholders, their proxies and their advisors are entitled to attend shareholders' meetings in accordance with the rules of the Public Limited Companies Act. A shareholder may have its proxy attend a shareholders' meeting on its behalf and exercise voting rights on the shareholders' behalf. A proxy must present a written or electronic dated power of attorney. The power of attorney shall be presented at the meeting and shall be valid only for attendance at one shareholders' meeting unless otherwise clearly stated in the contents of the power of attorney.

10.17 The Chairman and a majority of the Board of Directors together with the CEO shall attend shareholders' meetings, unless unable to attend. Employees shall be entitled to attend the Company's shareholders' meetings without the right to address the meeting, submit motions or vote, unless they are also shareholders. The Company's CEO and auditor shall have full rights to speak and make motions at shareholders' meetings, despite not being shareholders. The Board of Directors and CEO may invite experts to attend specific shareholders' meetings, if it is considered probable that their opinion will need to be sought or to assist at the meeting.

Article 11. Meeting Chairman, Meeting Secretary and Conduct of a Shareholders' Meeting

11.1 The Chairman of the Company's Board of Directors, or a meeting chairman elected by the meeting, shall direct the meeting.

11.2 The meeting chairman shall have a secretary elected for the meeting to take minutes giving an account of the shareholders attending the meeting, those decisions taken at the meeting, the results of voting and other matters of significance occurring at a shareholders' meeting.

11.3 The chairman shall determine whether the meeting is legally constituted and declare his/her conclusion in this regard to the meeting. He/she shall direct discussion and voting. If a shareholders' meeting is held electronically the chairman shall confirm that the equipment used satisfies the requirements of the Public Limited Companies Act.

11.4 The meeting chairman shall ensure compliance with provisions of the Public Limited Companies Act and the Company's Articles of Association concerning voting rights and voting.

11.5 General rules of procedure shall apply at the Company's shareholders' meetings.

11.6 Once a shareholders' meeting has been called to order, a list shall be compiled of those shareholders and proxies attending the meeting, to make it clear how many shares and votes each of them represents.

11.7 The majority of votes shall determine the outcome at shareholders' meetings, unless otherwise provided for by law or these Articles. A tie vote shall mean that a motion is rejected. If two persons receive an equal number of votes in an election, the outcome shall be decided by lot.

11.8 Voting shall be by ballot if so requested by any person attending unless the chairman is of the opinion that the arrangements for voting will not influence the outcome.

11.9 Minutes of meetings shall be recorded in the meeting record book and be considered fully valid proof of what took place at the shareholders' meeting. The minutes shall be read aloud prior to the conclusion of the meeting and any comments raised concerning them shall be recorded. The meeting chairman and meeting secretary shall sign the minutes but not meeting attendees.

11.10 Shareholders shall have access to the minutes in the meeting record book or to a certified copy of the minutes at the Company's office no later than 15 days after the shareholders' meeting. The meeting record book shall be preserved securely at the Company's office.

Article 12. Decisions by a Shareholders' Meeting Requiring Consent of All Shareholders

12.1 Notwithstanding the provision of Article 11.7, the following decisions by a shareholders' meeting shall only be deemed to be adopted if approved by all the Company's shareholders:

(i) decisions reducing shareholders' rights to a dividend or other distribution from the Company, to the benefit of parties other than shareholders;

(ii) decisions which increase shareholders' obligations towards the Company;

(iii) decisions which restrict shareholders' authorisations to make use of their shares or which oblige shareholders to be subject to partial or full redemption of their shares beyond what is provided for by law, unless the Company is at the same time wound up or its share capital written off in full.

12.2 A decision to amend the Company's Articles of Association which reduces shareholders' rights to dividends or other distribution from the Company's assets, without item i) of Art. 12.1 applying, however, is only valid if shareholders controlling more than 9/10 of the share capital represented by votes at a shareholders' meeting approve it.

Article 13. The Company's Annual General Meeting

13.1 The Company's annual general meeting (AGM) shall be held before the end of April each year. The Company's Board of Directors shall announce the AGM in the same manner as other shareholders' meetings.

13.2 The following items shall be on the agenda of the AGM:

(i) the report of the Board of Directors on the Company's operations, activities and financial situation during the last financial year;

(ii) adoption of the Company's annual financial statements and consolidated financial statements and a decision as to how any profit or loss by the Company during that financial year shall be dealt with, as well as contributions to reserves, together with discussion on any issues raised by the Company's auditors concerning its accounts;

(iii) a decision on payment of a dividend;

(iv) election of the Company's Board of Directors;

(v) election of an auditing firm;

(vi) a decision on remuneration to the Board of Directors and compensation to members of the Board's sub-committees for their work in the coming operating year;

(vii) a proposal from the Board of Directors concerning the Company's remuneration policy;

(viii) appointment of two members of the Company's Nomination Committee;

(ix) motions for amendments to the Company's Articles of Association, if any have been received;

(x) motions from shareholders which should be placed on the agenda;

(xi) other business.

13.3 If so requested in writing at an AGM by shareholders controlling at least one-third of share capital, a decision on item ii) of Art. 13.2 shall be postponed to a follow-up AGM, to be held no sooner than one month and no later than two months after the AGM. A further postponement cannot be requested.

13.4 The Board of Directors shall submit to the AGM a brief summary of the holdings of individual shareholders and their voting rights and give an account of any changes which have taken place during the year. Similar information shall be provided concerning the group to which the Company belongs, as applicable.

Article 14. Board of Directors

14.1 The Company's Board of Directors shall be comprised of five to eight individuals and up to three alternates, all of whom shall be elected at a shareholders' meeting for a one-year term. Statutory provisions shall apply concerning eligibility of directors. Election to the Board of Directors shall generally be by ballot if more persons are nominated than are to be elected.

14.2 The composition of the Board of Directors shall, apart from what is stated in Article 14.1, be such to ensure that directors individually and jointly have sufficient expertise, qualifications and experience to be able to understand the activities carried out by the Company and the risk they involve.

14.3 Care shall be taken in electing the Board to ensure at least 40% representation of each gender among directors and alternates. If the outcome of elections to the Company's Board of Directors, or its alternate Directors, is such that the above-mentioned gender representation is not achieved, the elections shall be deemed invalid. Until a legitimate election has taken place, resulting in the required gender representation, the previous Directors and/or alternates as the case may be shall continue. The election to the Board of Directors shall be repeated immediately after information is available as to the unsatisfactory outcome of an election. If the condition on gender representation is not satisfied in the latter election, the election to the Board of Directors shall be postponed to a follow-up meeting, which shall be held within one month. The follow-up meeting shall be convened in the same manner as other shareholders' meetings. There the election to the Board of Directors shall be repeated until the required gender representation is obtained. At the follow-up meeting those parties who were candidates at the previous meeting shall be eligible for election unless they have withdrawn as candidates; in addition, parties who have announced their candidacy for election at the follow-up meeting shall also be eligible for election. The latter candidates must comply with provisions of Article 14.4 with respect to their candidacy. If elections to the Board of Directors have been repeated three times at the follow-up meeting, without the outcome resulting in a satisfactory conclusion in accordance with the above, it shall be assumed that the candidate of the gender needed to achieve a satisfactory conclusion who has received the greatest number of votes of those candidates of the same gender who were not elected as directors is deemed to be lawfully elected a director. Furthermore, the candidate of the opposite gender who was elected with the lowest number of votes shall then step down in favour of the director thus elected. If more than one person of either gender is needed to achieve the above-mentioned gender representation the above rule shall apply to the person of the gender needed who has received the next highest number of votes of those candidates of that gender who were not elected and so on.

14.4 Those individuals who intend to stand for election as directors must give notice of their candidacy in writing to the Board of Directors no later than five days prior to the commencement of the shareholders' meeting at which the election is to take place. In their notification candidates must provide details including their name, identification number, address, principal employment, other directorships held, education, experience and holding in the Company. Disclosure shall also be made of interest connections with the Company's principal customers and competitors, as well as with shareholders holding more than 10% in the Company.

14.5 The Board of Directors shall review candidates' notifications and give candidates by verifiable means the option of rectifying any flaws which they may contain within a specified time limit, which may not be longer than 24 hours. Should a candidate fail to comply with the instructions from the Board of Directors to rectify a notification of candidacy the Board shall take a decision on the validity of his/her candidacy. The decision of the Board of Directors may be referred to a shareholders' meeting of the Company which shall determine finally the validity of the candidacy before elections are held.

14.6 Notifications from candidates to the Board of Directors must be made available to shareholders for inspection at the Company's office no later than 48 hours prior to the commencement of the shareholders' meeting which is to elect the Board of Directors.

14.7 Election of the Board of Directors shall be made by majority voting between individuals. If shareholders controlling at least 1/10 of the Company's share capital so demand, election of directors shall be by proportional or cumulative voting. Such demand must be received by the Company's Board of Directors at least five days before the commencement of the shareholders' meeting where the Board is to be elected. Should demands be received from more than one shareholder group, for both proportional and cumulative election, cumulative election shall be applied.

14.8 The shareholders' meeting shall elect a Chairman and Vice Chairman. The Board shall divide responsibility for other tasks between members as deemed necessary.

Article 15. Board Meetings

15.1 The Chairman of the Company's Board of Directors shall call and direct meetings. Board meetings shall be held whenever the chairman deems necessary. In addition, the chairman shall call a Board meeting if one or more directors, or the CEO, so request. Board meetings must be convened with at least 72 hours' notice unless all directors agree on shorter notice.

15.2 Although not a director, the CEO attends meetings of the Board of Directors, at which he/she is entitled to speak and make proposals, unless the Board decides otherwise in individual instances. The Company's auditors shall similarly be entitled to attend Board meetings.

15.3 A Board meeting has a quorum if a majority of directors attend. Major decisions, however, may not be taken without all directors having had the opportunity to discuss the matter if at all possible. Directors may participate in meetings by telephone or other multimedia equipment, if necessary, unless such obstructs those tasks which are to be dealt with at the Board meeting.

15.4 In order for a decision to be adopted by a Board meeting it must receive the approval of a majority of directors. In the case of a tie vote on a proposal to be decided upon, the chairman's vote shall be deemed as deciding. In the absence of the chairman, the vote of the vice chairman is decisive. The signature of a majority of directors constitutes an obligation on the Company's part.

15.5 Meetings of the Company's Board of Directors shall as a rule be held at its head office. The chairman of the Board, however, may decide that Board meetings shall be held elsewhere if he/she considers this necessary and it does not make attending the meeting difficult for other Directors.

15.6 The Board of Directors must keep minutes of the proceedings of Board meetings and endorse the substance of the minutes with their signatures. Should any director or the CEO disagree with a decision by the Board the person concerned shall be entitled to have the dissenting opinion recorded in the minutes.

Article 16. Tasks of the Board of Directors

16.1 The Company's Board of Directors exercises supreme authority in its affairs between AGMs. The Board of Directors is the Company's spokesman and obliges the Company. In addition, the Board of Directors determines Company issues and is to ensure that the Company's organisation and activities are generally sound and proper with regard to good business practices and the legislation which applies to the Company's operations. The Company's Board of Directors shall generally ensure that its corporate governance and internal organisation encourages its efficient and prudent management, that separation of operating divisions is enforced and that measures are taken to reduce the risk of conflicts of interest. The Company's Board of Directors is also responsible for its strategy, the drafting and adoption of its risk policy and the existence of an effective internal quality control system in the Company, for instance, with regard to the Company's accounting, handling of finances and risk management. The Board shall also monitor and do its best to ensure the accuracy of notifications and information to be provided by the Company according to law.

16.2 The Company's Board of Directors shall engage a CEO to serve as managing director of the Company as provided for by law, determine the terms of his/her employment within the limits set by the remuneration policy adopted by a shareholders' meeting and dismiss the CEO from his/her position. The Board shall provide effective assessment, criticism and supervision of the CEO's decisions. The Board shall also ensure through effective supervision that the CEO complies with those acts and rules which apply to his/her work.

16.3 It shall also grant authority to oblige the Company.

16.4 The Company's Board of Directors shall adopt its own protocols, prescribing the implementation of its tasks in detail. These protocols shall take into consideration recognised guidelines on corporate governance. The protocols shall prescribe, among other things, the division of responsibilities between directors, convening of Board meetings and arrangements for calling on alternates, communications and handling of information, assessment of directors' eligibility for taking decisions, appointment of sub-committees and other issues which should be codified in rules to encourage the positive work of the Board. These rules shall also discuss in particular the authorisation of the Board to take decisions on individual transactions, the implementation of rules on special eligibility of directors, handling of information on individual clients by the Board, membership of directors on the Boards of subsidiaries and affiliated companies, and the implementation of rules on handling of business dealings with directors.

16.5 In other respects legislation shall provide for the responsibilities, powers and tasks of the Board of Directors.

16.6 The conclusions of sub-committees of the Board, elected as provided for by law and the Board's protocols, shall only serve as guidance for the Board, which shall not be bound by them in deciding on individual issues unless otherwise provided for by law.

Article 17. The CEO

17.1 The CEO and the Board of Directors shall jointly direct the company.

17.2 The CEO shall handle the Company's everyday operations, implementing the policy or instructions provided by the Board of Directors. Everyday operations shall not include measures which are unusual or major in the context of the Company's operations. The CEO may only take such measures in accordance with specific authorisation from the Board of Directors, unless it be impossible to await the decisions of the Board without considerable inconvenience or risk to the company's operations; in such instances the CEO shall consult the Chairman of the Board if at all possible and the Board shall subsequently be notified of the measure without delay.

17.3 The CEO may speak for the Company on issues falling within his/her mandate.

17.4 The CEO is to ensure that the Company's accounts and finances comply with legislation and good accounting practice and that handling of the Company's assets is secure.

17.5 The CEO engages the Company's employees. He/she also dismisses employees if necessary and discusses their salaries.

17.6 The CEO shall meet all the qualification requirements currently prescribed by law.

Article 18. Accounts and Auditing

18.1 The Company's AGM shall elect a certified auditor or auditing firm for the Company for a five-year term. The same party shall be elected as auditor of a parent company, affiliate and subsidiary if at all possible. The auditing firm shall examine the company's accounts and all accounting documents for each year of operation and shall have access to all the Company's accounts and documents for such purpose.

18.2 In other respects the work and eligibility of the Company's auditor shall be governed by legislation.

18.3 The auditor shall prepare an auditor's report to be presented to the AGM as provided for by the Act on Annual Financial Statements. This report shall be received by the Board of Directors at the latest one month prior to the AGM; the annual financial statements and report shall be available for examination by shareholders for at least three weeks prior to the AGM.

Article 19. Company's Operating and Financial Year

19.1 The Company's operating year shall be the calendar year. The Board of Directors shall prepare its annual financial statements and annual report each year. The Company's annual financial statements and annual report shall comprise a single document.

19.2 The annual financial statements, including the consolidated statements, shall be prepared and compiled in accordance with statutory provisions, good accounting practice and the financial reporting standards which the Company has decided to follow, for instance, with regard to assessments of various items in the financial statements, their presentation, breakdown, notes and nomenclature.

Article 20. Amendments to the Company's Articles of Association

20.1 These Articles of Association may be amended at a legally constituted shareholders' meeting by a 2/3 majority of votes cast, and if approved by shareholders controlling at least 2/3 of the share capital represented at the meeting, cf. however Art. 12, provided no other proportion is required by law or these Articles of Association for approval.

20.2 If motions for amendments are to be dealt with at a shareholders' meeting an account must be given of the principal substance of such motions in the meeting announcement.

Article 21. Winding-Up of the Company; Merger; Division

21.1 The provisions of the Public Limited Companies Act and other acts as appropriate shall apply to the Company's winding-up, its merger with other companies or division into two or more legal entities. A decision on such a measure can only be taken by a shareholders' meeting by the same power of votes as is required for amendments to these Articles of Association.

Article 22. Miscellaneous Provisions

22.1 The handling of any aspects not provided for in these Articles of Association shall be governed by the current provisions of the Act on Public Limited Companies and provisions of other legislation, as applicable.

Temporary Provision

Articles 10.6–10.9 (both articles included), as well as article 18.3 shall not enter into force until the Company's shares are admitted to trading on Nasdaq Iceland.

During the aforesaid the following rule shall instead apply regarding the summons of shareholders' meetings:

A shareholders' meeting shall be summoned by a public notice or by electronic means sent to each shareholder with at least one week's notice, but with at least two weeks' notice before the Company's annual general meeting. The time limit may be shortened to one week with the written prior approval of shareholders holding at least 90% of the company's share capital.

This provision is temporary and shall automatically become null and void on the aforesaid date. The Board of Directors shall thereafter ratify and deliver a new copy of these Articles of Association without this provision to the companies' registrar.

Addendum No. 1 to the Articles of Association Pursuant to Clause 9.3 Hereof:

Authority to purchase own shares provided by a shareholders' meeting held on 12 February 2018

A shareholders' meeting of Arion Bank hf., which was convened on 12 February 2018, hereby empowers and authorises the Board of Directors of the Bank to purchase, whether in one transaction or many, during the validity period of this authority, up to an aggregate maximum of 10% (ten per cent) or 200 million shares (each with a nominal value of ISK 1), whichever is lower, of the Bank's issued, registered and fully paid up shares. The Board of Directors is further empowered and authorised to enter into such transactions at any time and with any party (including some, but not all shareholders of the Bank) without the (other) shareholders of the Bank being entitled to demand equal treatment in that they are permitted, in connection with, or as a result of such a transaction, to require the Bank to purchase some or all of their respective shareholdings of the Bank.

The maximum price per share which the Board of Directors of the Bank may pay by way of consideration for shares thus acquired may not exceed ISK 94.177 per share. The minimum price per share which the Board of Directors of the Bank may pay for these purposes shall be ISK 1 per share.

This authority is provided on the basis of Art. 55 of Limited Liability Companies no. 2/1995.

This authority shall be valid until 15 April 2018.

GENERAL TERMS AND CONDITIONS OF THE SWEDISH DEPOSITORY RECEIPTS

This "General Terms and Conditions of the Swedish Depository Receipts" is, in all essential respects, a translation of the Swedish General Terms and Conditions of Swedish Depository Receipts representing shares in Arion bank hf., Iceland, deposited with Skandinaviska Enskilda Banken AB (publ) (Allmänna villkor för svenska depåbevis i Arion bank hf.). In the event of any difference between this translation and the Swedish original, the Swedish version shall govern.

Arion bank hf. (hereinafter referred to as the "**Company**") has commissioned Skandinaviska Enskilda Banken AB (publ) (hereinafter referred to as "**SEB**"), on behalf of depository receipt holders, to hold shares (hereinafter referred to as the "**Shares**") in the Company in a custody account and to issue one Swedish Depository Receipt (hereinafter referred to as the "**SDR**") for each deposited Share in accordance with these General Terms and Conditions. The SDRs shall be registered at Euroclear Sweden AB, (hereinafter referred to as "**Euroclear**") and listed on Nasdaq Stockholm AB (hereinafter referred to as "**Nasdaq Stockholm**").

1. Deposit of Shares and registration, etc.

1.1 The Shares are deposited on behalf of depository receipt holders, as defined below, in a custody account with a bank appointed by SEB which conducts business in Iceland and is permitted under Icelandic law to hold Shares (the "**Sub-Custodian**"). SEB is the registered owner of the Shares in its custody on behalf of Depository Receipt Holders, as evidenced by the entry of SEB's name in the Company's register of shareholders. These General Terms and Conditions shall govern the deposit of Shares and the issuance of SDRs. "**Depository Receipt Holder**" as set forth in these General Terms and Conditions means an owner of SDRs or his nominee.

1.2 For each deposited Share, SEB shall issue one SDR. SEB will not accept deposits of fractions of Shares or of an uneven number of fractional rights.

1.3 SEB and the Sub-Custodian may refuse to accept Shares for deposit under these general Terms and Conditions whenever notified that the Company has restricted transfer of such Shares to comply with any ownership or transfer restrictions under Swedish, Icelandic or any applicable law.

1.4 The SDRs shall be registered in a Swedish CSD register maintained by Euroclear (hereinafter referred to as the "**VPC Register**") in accordance with the Central Securities Depositories and Financial Instruments Accounts Act (SFS 1998:1479). Thus, physical securities representing the SDRs will not be issued.

2. Deposit and withdrawal of Shares

2.1 Shares may be deposited under these General Terms and Conditions by delivery to SEB or the Sub-Custodian together with appropriate instructions to SEB as to the shareholder's name, address and VPC Account number in which the SDRs are to be registered as well as any other information and documentation required under Swedish, Icelandic or any other applicable law. Upon payment to SEB by the shareholder depositing the Shares of all taxes, charges, fees and costs in connection with a deposit of Shares, the corresponding number of SDRs will be registered in the VPC register.

2.2 Upon payment of all taxes, governmental charges, fees and costs payable in connection with a withdrawal of Shares, and subject to the provisions of the Company's Articles of Association, Swedish, Icelandic or any other applicable law, Shares may be withdrawn from the safe custody only if such withdrawal is not prohibited under Swedish, Icelandic or any other applicable law or by a decision of a governmental authority. Shares will be delivered to a custody account designated by the Depository Receipt Holder or as agreed between the Depository Receipt Holder and SEB provided the corresponding number of SDRs have been surrendered to and cancelled by SEB in the VPC Register.

2.3 Deposit and withdrawal of Shares pursuant to this Section 2 may only be made via SEB in Sweden.

2.4 Deposit and withdrawal of Shares pursuant to this Section 2 is not allowed during such period decided by SEB in consultation with the Company as informed to the Depository Receipt Holders.

2.5 SEB is entitled to compensation from a Depository Receipt Holder for all fees and costs in connection with deposit and withdrawal of Shares pursuant to this Section 2, in accordance with the price list applied by SEB from time to time.

2.6 Registrations in the VPC Register resulting from deposits or withdrawals of Shares may be temporarily suspended or withheld, during any period when the transfer books of Euroclear or the Company are closed.

3. Transfer and pledging, etc.

3.1 Deposited Shares may only be transferred or pledged through a transfer or pledge of SDRs. With respect to transfers and pledges of SDRs, the provisions set forth in Chapter 6 of the Central Securities Depositories and Financial Instruments Accounts Act shall apply.

4. Trading in SDRs

4.1 Trading in SDRs shall take place on Nasdaq Stockholm. Where the SDRs are de-listed from Nasdaq Stockholm or in the event that the trading shall be transferred to another Swedish regulated market or a multilateral trading facility (MTF) in Sweden or any equivalent market, the Company shall as soon as possible inform SEB and the Depository Receipt Holders. Information to the Depository Receipt Holders shall be given in accordance with the provisions of Section 12 below.

5. Record Date

5.1 SEB shall, in consultation with the Company, decide upon the date ("**Record Date**") which shall be applied by SEB for the determination of those Depository Receipt Holders who are entitled to receive cash dividends or other property, to participate and vote at shareholders meetings, to receive Shares in connection with bonus issues, to subscribe for Shares, convertibles, warrants and other rights in connection with new issues and to otherwise exercise those rights which normally accrue to shareholders in the Company. It is the Company's and SEB's intention, where practically feasible, that the Record Date for dividends and other rights in Sweden shall be the same date as the record date in Iceland.

6. Dividends and taxes, etc.

6.1 The payment of dividends shall take place in Swedish kronor ("**SEK**") to those persons who, on the Record Date, are registered in the VPC Register as Depository Receipt Holders or rights holders in respect of dividends.

6.2 In conjunction with every distribution, SEB shall, in consultation with the Company, determine the date of the payment of dividends ("**Payment Date**"). Payment of dividends to Depository Receipt Holders or holders of other rights to the dividend, shall take place on the Payment Date through Euroclear and in accordance with the rules and regulations applied by Euroclear from time to time.

6.3 SEB shall convert dividends in foreign currency into SEK in accordance with the exchange rates applied by SEB from time to time, which shall be set in accordance with public market rates, prior to payment taking place. The conversion of foreign currency into SEK shall take place three (3) banking days before the Payment Date. The dividend amount distributed per SDR will be rounded down to the nearest whole öre. Surplus amounts, which as a consequence of a rounding are not paid, shall be repaid by SEB to the Company.

6.4 The payment of dividends to Depository Receipt Holders shall be made without any deduction of any costs, fees, or equivalents thereto which are related to the Company, SEB, the Sub-Custodian or any of their respective agents. However, deductions shall be made for Swedish preliminary income tax, withholding tax or other taxes which are to be withheld pursuant to Swedish law or agreements with foreign tax authorities as well as for any taxes which may be imposed pursuant to Swedish, Icelandic or applicable provisions of another country.

6.5 In conjunction with payment of dividends to Depository Receipt Holders, the Company, SEB, the Sub-Custodian or any other party shall withhold and pay to the tax authorities in Iceland any required tax amount, should there be any such taxes imposed. In the event the Company, SEB or the Sub-Custodian or representatives or agents of the foregoing determine that dividends in cash, shares, rights, or other property are subject to taxation or other public fees which must be withheld, the Company, SEB or representatives or agents of any of the foregoing shall be entitled to withhold cash amounts or sell all or part of the property as is financially and practically necessary to sell in order to be able to pay those taxes and fees. The remaining proceeds, following deduction of taxes and fees, shall be paid by SEB to the Depository Receipt Holders who are entitled thereto. Depository Receipt Holders shall be liable for deficiencies which may arise in conjunction with sale pursuant to the above.

6.6 SEB shall attempt to provide the Depository Receipt Holders with any information SEB has in its possession and which the Depository Receipt Holders might reasonably request in order to enjoy such benefits as are granted pursuant to the applicable double taxation treaty. SEB shall upon request inform any recipient resident in Sweden of any Icelandic tax credit to which the recipient may be entitled and of any Icelandic withholding tax.

6.7 SEB shall, in consultation with the Company, determine the manner in which dividends in property other than cash shall be provided to the Depository Receipt Holders. This may entail that the property is sold and that funds from the sale following deduction for sales costs and taxes shall be paid to the Depository Receipt Holders, as described in Section 6.5 above. If the shareholders have the right to choose dividends in cash or in any other form, and it is not practically feasible to give the Depository Receipt Holders such opportunity, SEB shall have the right to decide, on account of the Depository Receipt Holders, that such dividend shall be paid in cash.

6.8 SEB and the Company shall be deemed to have fulfilled their respective obligations notwithstanding that a person who is paid dividends to was not an authorised recipient. The aforementioned shall not, however, apply where SEB or the Company was aware that the dividend was paid to a person who was not authorised to receive the dividend or where SEB or the Company failed to exercise normal or reasonable care which, in consideration of the circumstances, should have been exercised, or where payment cannot be claimed as a result of the recipient being a minor or due to the fact that a guardian had been appointed for the recipient pursuant to the Code on Parents, Guardians and Children and such guardianship included the receipt of dividends.

7. Bonus issues, splits, or reverse splits of Shares

7.1 SEB shall, as soon as possible, accept receipt of Shares through its registered Sub-Custodian in conjunction with bonus issues and issue corresponding number of SDRs to Depository Receipt Holders so entitled and shall carry out any adjustments to the SDRs to reflect, pro rata, any splits or reverse splits of Shares through taking necessary registration measures on VPC Accounts belonging to the Depository Receipt Holders to ensure that they receive the benefit of all such entitlements.

7.2 Persons who, on the Record Date, are registered in the VPC Register as Depository Receipt Holders or rights holders with respect to the measure in question shall be entitled to participate in the bonus issue, split, and reverse split. Where such persons are not authorised recipients, the provisions set forth in Section 6.8 shall apply in a corresponding manner.

7.3 Applicable taxes shall be addressed in the manner set forth in Section 6.

8. New issues, etc.

8.1 Where the Company resolves to issue new Shares, convertibles, warrants or other rights to which the Company's shareholders generally have pre-emptive rights, the Company shall commission SEB or any other agent to provide notice to the Depository Receipt Holders in accordance with Section 12 of the material terms and conditions governing the new issue based on the information received from the Company. The aforementioned shall apply to other offers, which the Company directs to the shareholders. Application forms shall, if applicable, be appended to the information whereon the Depository Receipt Holders can instruct SEB or any other agent to subscribe for Shares, convertibles, warrants or other rights on behalf of the Depository Receipt Holder. Where, in accordance with the instructions of the Depository Receipt Holder, SEB subscribes for and allocates such Shares, convertibles, warrants, or rights, equivalent registration on the respective Depository Receipt Holder's VPC Account shall take place as soon as possible following the issue, to the extent practically possible.

8.2 Where a Depository Receipt Holder does not instruct SEB or any other agent to exercise any of the rights set forth above and such rights are possible to sell, SEB shall be entitled to sell such rights on behalf of the Depository Receipt Holder and to pay the proceeds to the Depository Receipt Holder following deduction for costs and any fees and taxes.

9. Fractional rights

9.1 Where, in accordance with Sections 6–8, a Depository Receipt Holder is entitled to a fraction of a Share or any other fractional rights which do not entitle the Depository Receipt Holder to a whole number of Shares, SEB shall sell such excess Shares or fractional rights, etc., and pay the proceeds of such sale to the Depository Receipt Holder following deduction for costs and any fees and taxes.

10. Participation at shareholders' meetings, etc.

10.1 The Company shall at the latest 21 calendar days before and not earlier than 28 calendar days prior to the shareholders' meeting inform SEB of the shareholders' meeting. As soon as practicable thereafter the Company shall notify the Depository Receipt Holders of the shareholders' meeting. Such notification shall be published through a notice in at least one Swedish daily newspaper with nationwide coverage. The notification shall include i) the Company's name and registration number, ii) the type of shareholders' meeting to be held, iii) the time and location of the shareholders' meeting, iv) information on how to find the convening notice in full and the agenda of the shareholders' meeting on the Company's website, v) the Record Date for the Depository Receipt Holders determined in accordance with Section 5, and vi) instructions regarding any measures to be taken by the Depository Receipt Holder in order to be able to vote at the shareholders' meeting by attending the meeting in person or to authorise a person to attend and vote for him or by instructing SEB to vote by proxy form. Only Depository Receipt Holders registered in the VPC Register five (5) calendar days before the shareholders' meeting and who have, no later than five (5) calendar days before the meeting, notified SEB or its representative that they shall attend and vote at the meeting or have instructed SEB to vote by proxy form, are entitled to attend the meeting either in person or by an authorised attorney or vote by proxy form. SEB, as registered owner of the Shares on behalf of Depository Receipt Holders, shall appoint as proxies, all those Depository Receipt Holders who have notified SEB or its representative of their intention to be represented at the shareholders' meeting. Such proxies shall be presented to the Company together with a list of the Depository Receipt Holders for whom proxies have been issued. The Company shall upon request from a Depository Receipt Holder, send the material for the shareholders' meeting provided through the Company's website by mail.

10.2 SEB and the Sub-Custodian undertake not to represent Shares for which the Depository Receipt Holder has not notified its intention to participate at the shareholders' meeting either in person or by proxy.

11. Information

11.1 SEB shall, on the instructions of the Company, send the information which SEB has obtained from the Company to the Depository Receipt Holders in the manner set forth in Section 12, or a summary provided by the Company of the information if the Company deems it sufficient or appropriate in each individual case. As a general rule, the information shall be presented in English unless the Company deems that, in each individual case, a translation of a document into Swedish to be appropriate with regard to the contents or the purpose of the document. The English version of the information shall govern.

11.2 The Company shall, on request from a Depository Receipt Holder, ensure that the Company's annual report is sent to the Depository Receipt Holders. The Company shall also publish stock market information in accordance with the requirements for trading on Nasdaq Stockholm or any other applicable marketplace.

11.3 Information regarding the Company and its Investor Relation Services are available on the Company's website, www.arionbanki.is/english.

12. Notices

12.1 SEB shall ensure that notices to Depository Receipt Holders pursuant to these General Terms and Conditions are provided to the Depository Receipt Holders and other rights holders who are registered in the VPC Register as entitled to receive notices in accordance with the Central Securities Depositories and Financial Instruments Accounts Act.

12.2 Written notices shall be sent by mail to authorised persons in accordance with Section 12.1 to the address listed in the VPC Register. SEB and the Company may, in lieu of mailing notices, publish the notice in at least one Swedish daily newspaper with nationwide coverage.

13. Fees and costs

13.1 SEB's costs and fees for administration of the Shares shall be borne by the Company unless otherwise set forth in these General Terms and Conditions.

14. Replacement of custodian bank

14.1 In the event the Company decides to retain another securities institution as custodian bank in lieu of SEB, SEB shall transfer all of SEB's rights and obligations vis-à-vis the Depository Receipt Holders pursuant to these General Terms and Conditions and deliver the Shares to the new custodian bank. The identity of any replacement of a custodian bank must be submitted by the Company to Euroclear for approval and such replacement shall be carried out not earlier than three (3) months following the time at which notification to the Depository Receipt Holders regarding the replacement of the custodian bank is sent in accordance with Section 12 or an announcement to that effect was published in a Swedish daily newspaper with nationwide coverage according to Section 12. When a change of custodian bank is made in the manner set forth in this

Section 14, Depository Receipt Holders shall be deemed to have agreed to a transfer of the rights and obligations between the Depository Receipt Holders and SEB to the Depository Receipt Holders and the new custodian bank.

15. Amendments to these General Terms and Conditions

15.1 SEB shall be entitled to amend these General Terms and Conditions where such amendment is necessary in order for the General Terms and Conditions to comply with Swedish, Icelandic or other applicable law, decisions by Swedish or other applicable governmental authorities or amendments to Euroclear's, Nasdaq Stockholm's or any applicable marketplace's rules and regulations. SEB and the Company are entitled to jointly agree to amend these General Terms and Conditions where, for other reasons, it is deemed appropriate or necessary, provided in all cases that the Depository Receipt Holders' rights are in no way materially prejudiced. SEB shall notify the Depository Receipt Holders regarding decisions to amend in the manner set forth in Section 12.

16. Information regarding Depository Receipt Holders

16.1 SEB retains the right to request information from Euroclear regarding the Depository Receipt Holders and their holdings and to submit such information to the Company and to the Sub-Custodian.

16.2 SEB and the Company are entitled to provide information regarding the Depository Receipt Holders and their holdings to such parties who perform share registration duties or to governmental authorities, provided that the obligation to submit such information is prescribed by Swedish or foreign law, statute, regulatory decree or agreement with governmental authorities. The Depository Receipt Holders are obligated, following demand, to submit such information to SEB.

16.3 SEB and the Company shall be entitled to provide information regarding the Depository Receipt Holders and their holdings to governmental authorities in connection with repayment or refunding of paid taxes or when subject to any tax audit to the extent such is necessary.

16.4 SEB and the Company are entitled to provide and publish information regarding the Depository Receipt Holders to the extent required by Nasdaq Stockholm or any applicable marketplace or to the extent required pursuant to applicable rules and regulations in Sweden or in any other country.

17. Limitation of liability

17.1 Neither SEB, the Sub-Custodian nor the Company shall be liable for damage which is due to Swedish or foreign legislation, the actions of Swedish or foreign public authorities, acts of war, strikes, blockades, boycotts, lockouts, or other similar circumstances. The reservation with respect to strikes, blockades, boycotts, and lockouts shall apply notwithstanding that SEB, the Sub-Custodian or the Company itself adopts, or is an object of, such measures.

17.2 In other cases than as set forth in Section 17.1, SEB, the Sub-Custodian or the Company shall not be liable to compensate damage where SEB, the Sub-Custodian or the Company has acted with normal care. SEB, the Sub-Custodian or the Company shall not be liable for any indirect or consequential loss or damage.

17.3 Where SEB, the Sub-Custodian or the Company is prevented from effecting payment or other measures due to circumstances as set forth in Section 17.1, such measure may be postponed until the impediment ceases.

18. Termination, etc.

18.1 SEB is entitled to terminate the deposit of Shares by notice of termination to a Depository Receipt Holder pursuant to Section 12 where:

i) the Company adopts a resolution according to which the Shares in the Company shall no longer be represented by SDRs governed by these General Terms and Conditions;

ii) the Company adopts a resolution according to which the SDRs shall no longer be listed on a Swedish regulated market or traded on a multilateral trading facility (MTF) in Sweden or any equivalent market;

iii) Euroclear terminates the Agreement regarding registration of Swedish depository receipts;

iv) the Company applies for reorganisation, bankruptcy, liquidation, or other similar procedure, or where such a procedure commences upon application by third parties;

v) the Company has failed to fulfil payment of expenses and fees according to Section 13 hereof for more than 30 days;

vi) the Custodian Agreement between the Company and SEB is terminated and a new depository has not been retained as provided in Section 14 within six months after termination; or

vii) the Company materially breaches its obligations vis-à-vis SEB.

18.2 In case of termination in accordance with Section 18.1 i) or ii), the listing of or the trading in the SDRs shall cease at the earliest three (3) months after the day of notice of termination was sent or published in a Swedish daily newspaper with nationwide coverage in accordance with Section12 above, provided the SDRs have not been de-listed from a Swedish regulated market or the trade has ceased on a multilateral trading facility (MTF) in Sweden or any equivalent market prior thereto.

18.3 In the event that SEB terminates the deposits in accordance with Section 18.1, these General Terms and Conditions shall continue to apply to the date decided by SEB, in consultation with the Company if practically possible. Such notice of termination shall be sent by mail to the Depository Receipt Holders entitled to receive notices in accordance with Section 12.1 to the addresses listed in the VPC Register or be published in accordance with Section 12.

18.4 In cases other than those set forth in Section 18.1, SEB is entitled to terminate the deposits of Shares through notification to the Depository Receipt Holders, which notice shall take effect on the date agreed between SEB and the Company and which is informed in the notice of termination.

18.5 In the notice of termination, SEB shall set forth the Record Date upon which SEB shall de-register all the SDRs in the VPC Register and transfer the Shares to a custodian account as instructed by the Depository Receipt Holder or as otherwise agreed with the Depository Receipt Holder. In the event (i) the Depository Receipt Holder has not provided a transfer instruction with a designated custodian account, (ii) it is not practically possible to transfer the Shares in accordance with the transfer instruction by the Depository Receipt Holder or (iii) an agreement has otherwise not been reached, SEB is entitled to sell the underlying Shares. The Depository Receipt Holder shall be entitled to the proceeds of the sale following deduction for fees, taxes and reasonable costs. The amount shall be paid to the cash account linked to respective VPC Account of the Depository Receipt Holder concerned or in the absence of such cash account, in the form of a payment notice. No interest shall accrue on the amount.

19. Applicable law, etc.

19.1 These General Terms and Conditions shall be interpreted and applied in accordance with Swedish law.

19.2 Disputes regarding these General Terms and Conditions or related to the legal relationships shall be adjudicated by a court of general jurisdiction and the action shall be brought before the Stockholm District Court (*Stockholms tingsrätt*), Sweden.

DESCRIPTION OF ARRANGEMENTS TO SAFEGUARD THE RIGHTS OF HOLDERS OF THE SWEDISH DEPOSITORY RECEIPTS

*The following text should be read in conjunction with the terms and conditions of the SDRs as set forth under "General Terms and Conditions of the Swedish Depository Receipts" ("**SDR T&Cs**") and capitalised terms defined therein and used in the following text shall have the same meaning.*

The Custodian

The Custodian is Skandinaviska Enskilda Banken AB (publ) ("**SEB**" or the "**Custodian**"), a banking association organised under the laws of Sweden. The Custodian is primarily regulated by the Swedish FSA. Its registered office is at Kungsträdgårdsgatan 8, SE-106 40 Stockholm, Sweden. The Custodian was incorporated in 1971.

Rights of Depository Receipt Holders

Relationship of Depository Receipt Holders with the Custodian

The rights of Depository Receipt Holders against the Custodian are governed by the SDR T&Cs and the Custodian Agreement, which are governed by Swedish law. The Custodian and the Bank are parties to the Custodian Agreement and have agreed that any disputes under the Custodian Agreement or the SDR T&Cs shall be resolved by proceedings in the Stockholm District Court, Sweden. Depository Receipt Holders have contractual rights against the Custodian under the SDR T&Cs.

Voting

The SDR T&Cs provide that the Bank shall at the latest 21 calendar days before and not earlier than 28 calendar days prior to the shareholders' meeting inform the Custodian of the shareholders' meeting and that as soon as practicable thereafter the Bank shall notify the Depository Receipt Holders of the shareholders' meeting. Such notification shall be published through notice in at least one Swedish national daily newspaper with nationwide coverage. Such notification shall include information set out in the SDR T&Cs, including regarding the time and location of the meeting and the meeting's agenda. Only Depository Receipt Holders registered in the VPC Register five calendar days before the shareholders' meeting and who have, no later than five calendar days before the meeting, notified the Custodian or its representative that they shall attend and vote at the meeting, are entitled to attend the meeting either in person or by an authorised attorney or vote by proxy form. The Custodian, as registered owner of the deposited Shares, underlying the issuance of the SDRs (the "**Deposited Shares**"), on behalf of the Depository Receipt Holders, shall appoint as proxies, all those Depository Receipt Holders who have notified the Custodian or its representative of their intention to attend and participate at the shareholders' meeting. Such proxies shall be presented to the Bank together with a list of the Depository Receipt Holders for whom proxies have been issued. The Bank shall upon request from a Depository Receipt Holder, send the material for the shareholders' meeting provided through the Bank's website. The Custodian and the Sub-custodian undertake not to represent Shares for which the Depository Receipt Holder has not notified its intention to participate at the shareholders' meeting either in person or by proxy.

Cancellation of SDRs and Withdrawal of Shares

Upon payment of all taxes, governmental charges, fees and costs payable in connection with a withdrawal of Shares, and subject to the provisions of the Articles of Association of the Bank, Swedish, Icelandic or any other applicable law, Shares may be withdrawn from the safe custody only if such withdrawal is not prohibited under Swedish, Icelandic or any other applicable law or by a decision of a governmental authority. Shares will be delivered to a custody account designated by the Depository Receipt Holder or as agreed between the Depository Receipt Holder and the Custodian provided the corresponding number of SDRs have been surrendered to and cancelled by the Custodian in the VPC Register.

Rights of the Company

The Bank has broad rights to remove the Custodian under the terms of the Custodian Agreement, but no specific rights under the Custodian Agreement which are triggered in the event of the insolvency of the Custodian.

Insolvency of the Custodian

Applicable insolvency law

If the Custodian becomes insolvent, the insolvency proceedings will be governed by Swedish law applicable to the insolvency of banks.

Effect of applicable insolvency law

Under current Swedish law, it is expected that any cash which is held for Depository Receipt Holders by the Custodian as banker under the SDR T&Cs would constitute an unsecured obligation of the Custodian. Depository Receipt Holders would therefore only have an unsecured claim in the event of the Custodian's insolvency for such cash, and such cash would also be available to general creditors of the Custodian.

Customers who hold funds at banks and credit institutions that are covered by the Swedish Deposit Insurance Act (1995:1571) are guaranteed compensation in their account up to a maximum of SEK 950,000. The compensation is administrated by Swedish National Debt Office.

The Custodian is obliged under Swedish law to separate the SDRs from securities belonging to the Custodian and such SDRs therefore would not form part of the bankruptcy estate of the Custodian.

Default of the Custodian

If the Custodian fails to pay cash or deliver non-cash assets to Depository Receipt Holders in the circumstances required by the SDR T&Cs, the Custodian will be in breach of its contractual obligations under the SDR T&Cs. In such case, Depository Receipt Holders will have a claim under Swedish law against the Custodian for the Custodian's breach of its contractual obligations under SDR T&Cs, unless otherwise stated in section 17 of the SDR T&Cs.

The Sub-custodian

The Sub-custodian is Íslandsbanki, a bank incorporated under the laws of Iceland. The Sub-custodian and the Custodian are parties to a subcustody agreement, which is governed by Icelandic law. The Sub-custodian will hold an account with Nasdaq CSD Iceland for the Deposited Shares, each of which will be registered in the share register of the Bank in the name of the Custodian as registered owner of the Deposited Shares on behalf of the Depository Receipt Holders.

The Sub-custodian may resign or be discharged from its duties by prior notice. The Custodian may discharge the Sub-custodian at any time upon notice to the Sub-custodian being discharged and appoint a substitute or an additional Sub-custodian. If upon resignation or removal of the Sub-custodian there shall be no Sub-custodian acting under the Custodian Agreement, the Custodian shall promptly appoint a substitute Sub-custodian that is organised under applicable law and reasonably satisfactory to the Bank which shall thereafter be the Sub-custodian. The Custodian shall ensure that any Sub-custodian ceasing to act as Sub-custodian shall deliver all Deposited Shares held by it to a Sub-custodian continuing to act upon the instruction of the Custodian.

Relationship of Depository Receipt Holders with the Sub-custodian

The Depository Receipt Holders do not have any contractual relationship with, or rights enforceable against, the Sub-custodian. The Sub-custodian will hold the Deposited Shares, each of which will be registered in the share register of the Bank in the name of the Custodian as registered owner of the Shares on behalf of the Depository Receipt Holders at Nasdaq CSD Iceland. Under the Custodian Agreement and Icelandic law applicable to custody of securities, all Deposited Shares are held by the Sub-custodian, for the account and to the order of the Custodian (on behalf of Depository Receipt Holders), and must be identified as being held to the account of the Custodian and segregated from all other property held by the Sub-custodian.

Default of the Sub-custodian

Failure to deliver cash, Deposited Shares or other non-cash assets

If the Sub-custodian fails to deliver cash, Deposited Shares or other non-cash assets held for the Custodian as required by the Custodian or otherwise defaults under the terms of the subcustody agreement with the Custodian, the Sub-custodian will be in breach of its obligations to the Custodian. In such case, the Custodian will have a claim under Icelandic law and as further stated in the subcustody agreement against the Sub-custodian for the Sub-custodian's breach of its obligations under the subcustody agreement. The Custodian can also remove the Sub-custodian and appoint a substitute or additional custodians and may exercise such rights if it deems necessary.

The Custodian's obligations

The Custodian has no obligation to pursue a claim for breach of obligations against the Sub-custodian on behalf of Depository Receipt Holders. The Custodian is not responsible for and shall incur no liability in connection with or arising from default by the Sub-custodian due to any act or omission to act on the part of the Sub-custodian, except to the extent that the Custodian failed to use reasonable care in the selection of the Sub-custodian.

Insolvency of the Sub-custodian

If the Sub-custodian becomes insolvent, the insolvency proceedings will be governed by Icelandic law.

Effect of applicable insolvency law in relation to cash

Cash held by the Custodian on deposit with the Sub-custodian may be reimbursed to the Custodian in the event of the Sub-custodian's insolvency if it is allocated in a separate account in the Custodian's name and provided that such reimbursement is approved in the insolvency proceedings. Any remaining cash would form part of the Sub-custodian's insolvent estate and would be available to satisfy the claims of the Sub-custodian's creditors. Generally, there can be no assurance that, in the event of such insolvency, cash will be available for distribution to the Custodian or Depository Receipt Holders.

Effect of applicable insolvency law in relation to non-cash assets

The Custodian will maintain ownership rights in the Deposited Shares held at Nasdaq CSD Iceland in an account managed by the Sub-custodian at the time of its insolvency. Applicable Icelandic rules and regulations provide for and empower the responsible authorities to ensure continuous operations of the Custodian's account at Nasdaq CSD Iceland until another Sub-custodian is appointed by the Custodian to take over management of the account at Nasdaq CSD Iceland.

The Custodian's obligations

The Custodian has no obligation to pursue a claim in the Sub-custodian's insolvency on behalf of the holders of the SDRs. The Depository Receipt Holders have no direct recourse to the Sub-custodian.

Information for retail investors with regard to the holding of SDRs

Investors should seek professional advice in case they have any doubts concerning specific issues in connection with the holding of SDRs.

PERSONS HOLDING BENEFICIAL TITLE TO SDRs OR INTERESTS THEREIN ARE REMINDED THAT THE ABOVE DOES NOT CONSTITUTE LEGAL ADVICE AND IN THE EVENT OF ANY DOUBT REGARDING THE EFFECT OF THE DEFAULT OR INSOLVENCY OF THE SUB-CUSTODIAN OR THE CUSTODIAN, SUCH PERSONS SHOULD CONSULT THEIR OWN ADVISORS IN MAKING A DETERMINATION.

LEGAL CONSIDERATIONS AND SUPPLEMENTARY INFORMATION

General Corporate Information

The Bank is a public limited company established for an indefinite period on 18 October 2008 under the Public Limited Companies Act with ID number 581008-0150 in the Register of Enterprises of Iceland. The Bank was initially named New Kaupthing banki hf. and, on 21 November 2009, its name was changed to Arion banki hf. The Bank's alternative international commercial name is Arion Bank hf. The Bank is domiciled in Iceland, and its registered address is located at Borgartún 19, 105 Reykjavík, Iceland. The Bank's telephone number is +354 444 7000. Arion Bank is a financial institution which operates in accordance with the Financial Undertakings Act.

Significant Subsidiaries and Principal Associates

The Bank is the parent of a number of wholly owned and majority owned subsidiaries. The table below sets forth details of Arion Bank's significant subsidiaries, in which it held a direct interest as of 31 March 2018.

	Operating Activity	Currency	Equity Interest as of 31 March 2018	Country of incorporation
Arion Bank Mortgages Institutional Investor Fund	Retail banking	ISK	100.0%	Iceland
BG12 slhf.	Holding company	ISK	62.0%	Iceland
Bjarnathing ehf.	Real estate	ISK	100.0%	Iceland
EAB 1 ehf.	Holding company	ISK	100.0%	Iceland
Eignarhaldsfélagid Landey ehf.	Real estate	ISK	100.0%	Iceland
Stefnir hf.	Asset management	ISK	100.0%	Iceland
Valitor Holding hf.	Payment solutions	ISK	100.0%	Iceland
VISA Ísland ehf.	Holding company	ISK	100.0%	Iceland
Vördur tryggingar hf.	Insurance	ISK	100.0%	Iceland

In addition to the above, the Bank holds the subsidiary United Silicon, which is classified as a non-current asset and disposal group held for sale. See Note 27 in the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018 in "*Consolidated Financial Statements*".

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

In March 2018, the Bank signed an agreement with its subsidiary Eignarhaldsfélagid Landey ehf. for the acquisition of Eignarhaldsfélagid Landey ehf.'s 100% shareholding in the subsidiary Bjarnathing ehf. The transaction is defined as combination of entities under common control.

The table below sets forth details of Arion Bank's interests in its principal associates as of 31 March 2018.

	As of 31 March 2018
Audkenni hf.[(1)]	25.4%
Farice ehf.[(2)]	35.8%
Reiknistofa bankanna hf.[(3)]	23.0%
220 Fjördur ehf.[(4)]	35.3%

(1) Audkenni hf. offers individuals and organisations diverse solutions that provide security in electronic communications and build trust in businesses.

(2) Farice ehf. operates the FARICE-1 submarine communications cable between Iceland and Scotland with a branch connection to the Faroe Islands and the DANICE submarine communications cable between Iceland and Denmark. The Bank holds 38.4% of the share capital of Farice ehf. but 35.8% of voting rights, based on the different classes of share capital.

(3) Reiknistofa bankanna hf. is an IT service centre for the Icelandic financial market that covers all aspects of IT services, including development, maintenance and operations of IT systems.

(4) 220 Fjördur ehf. is an associate of Eignarhaldsfélagid Landey ehf. and is a property investment company.

Material Contracts

Presented below are material contracts (other than contracts entered into in the ordinary course of business), into which either Arion Bank or its subsidiaries has entered into within the two years immediately preceding the date of this Prospectus, as well as any other contract (other than contracts entered into in the ordinary course of business) that either Arion Bank or its subsidiaries has entered into that contains obligations or entitlements that are material to the Group as of the date of this Prospectus.

Acquisitions and Disposals

For a description of the material acquisitions and disposals by Arion Bank, see "*Business Overview—Business—Asset Portfolio Disposals*" and "*Operating and Financial Review—Key Factors Affecting the Group's Business, Financial Position and Results of Operations—Acquisitions and Disposals*".

Underwriting Agreement

For a description of the underwriting agreement that the Bank, the Selling Shareholders and the Managers intend to enter into in relation to the Offering, see "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*".

Related Party Transactions

The Group has a related party relationship with (i) Kaupskil, which is the controlling shareholder holding, upon completion of the Offering, approximately 26.16% of the issued Shares (21.75% if the Over-Allotment Option is exercised in full), assuming that the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares, (ii) the board of directors of Kaupskil and (iii) Kaupthing, which is the parent company of Kaupskil. In addition, Taconic Capital Advisors UK LLP, through TCA New Sidecar III s.à r.l., and Sculptor Investments s.à r.l., an affiliated entity of Och-Ziff Capital Management Group, by virtue of their shareholdings in the Bank (which shareholdings are managed by Kaupskil), are defined as related parties. In addition, Attestor Capital LLP, through Trinity Investments Designated Activity Company, and Goldman Sachs International, through ELQ Investors II Limited, each manage their own respective shareholdings in the Bank and are defined as related parties.

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

Transactions with all related parties have been conducted on an arm's length basis and are in the normal course of business. There have been no further guarantees provided or received for related party receivables or payables.

For information regarding remuneration paid to the members of the Board of Directors and Executive Committee, see "*Board of Directors, Executive Committee, Auditor and Corporate Governance—Remuneration of Members of the Board of Directors and Executive Committee*".

For additional information in relation to the Bank's related party transactions, see the note titled "*Related party*" in the Annual Financial Statements.

Advisors

Arion Bank's financial advisors in connection with the Offering and the listing of the Offer Securities on NASDAQ Iceland and NASDAQ Stockholm are Arion banki hf., Carnegie Investment Bank AB (publ), Citigroup Global Markets Limited and Morgan Stanley & Co. International plc, who are acting as Joint Global Coordinators and Joint Bookrunners for the Offering, Deutsche Bank AG, London Branch, and Goldman Sachs International, who are acting as Joint Bookrunners for the Offering, and Svenska Handelsbanken AB (publ), Fossar Markadir hf., Íslandsbanki hf. and Landsbankinn hf., who are acting as Co-Lead Managers for the Offering. Nordnet Bank and Avanza Bank are acting as retail selling agents in connection with the public offering in Sweden. For information on certain services, among others, which the Managers have provided and may provide in the future to the Bank and the Selling Shareholders, see "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*".

White & Case LLP and Logos slf. are Arion Bank's legal advisors in connection with the Offering and the listing of the Offer Securities on NASDAQ Iceland and NASDAQ Stockholm. Allen & Overy LLP and LEX are the Managers' legal advisors in connection with the Offering and the listing of the Offer Securities on NASDAQ Iceland and NASDAQ Stockholm.

Costs Related to the Offering

Arion Bank's costs associated with the Offering and the listing of the Offer Securities on NASDAQ Iceland and NASDAQ Stockholm are expected to amount to approximately ISK 1 billion. Such costs primarily relate to costs for auditors, attorneys, printing of this Prospectus, costs related to investor presentations and similar items.

Documents on Display

Copies of the following documents will be on display during ordinary office hours on weekdays for twelve months following the date of this Prospectus at Arion Bank's offices at Borgartún 19, 105 Reykjavík, Iceland or on Arion Bank's website at https://www.arionbanki.is/english/about-us/investor-relations/:

1. the articles of association (with an English translation thereof) of the Bank;
2. the audited consolidated financial statements for the financial years ended 31 December 2017, 2016 and 2015 (with an English translation thereof), in each case, together with the audit reports prepared in connection therewith, and the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2018. The Bank currently prepares audited consolidated financial statements on an annual basis and unaudited interim consolidated financial statements on a quarterly basis. The Bank does not currently prepare non-consolidated financial statements; and
3. a copy of this Prospectus.

ICELANDIC SECURITIES MARKET

The following is a description of the Icelandic securities market, including a brief summary of certain provisions of the laws and securities market regulations in Iceland in effect as of the date of this Prospectus. The summary is not intended to provide a comprehensive description of all such regulatory matters and should not be considered exhaustive. Moreover, the laws, rules, regulations and procedures summarised below may be amended or reinterpreted.

NASDAQ Iceland

NASDAQ Iceland is a regulated market in Iceland, a part of the Nordic List and operated by Kauphöll Íslands hf., and is the only Icelandic market on which shares, bonds, derivatives and other securities are traded. Shares trade on NASDAQ Iceland and all transactions, except for interest-bearing financial instruments, are executed through INET. Companies on the Nordic List are divided into three segments: large cap, mid cap and small cap. Companies with a market capitalisation in excess of EUR 1 billion are included in the large cap segment. Companies with a market capitalisation between EUR 150 million and EUR 1 billion are included in the mid cap segment. Companies with a market capitalisation less than EUR 150 million are included in the small cap segment. The segments are normally revised at year-end and the segments are reset, effective on the first trading day in January, based on average market capitalisation in November of the previous year. Companies with a market capitalisation of more than 50.0% of the minimum or maximum threshold for a segment will be transferred into a new segment with immediate effect. Companies with a market capitalisation of less than 50.0% of the minimum or maximum threshold for a segment have a transitional period until the next review (*i.e.*, at least 12 months) and, therefore, are subject to an additional review before being transferred into a new segment. Furthermore, listed companies are divided into industry sectors in accordance with the global standard, the Industry Classification Benchmark. This classification is based on the listed company's main operations, *i.e.*, the business area that generates the most revenue for such listed company.

Trading in Securities on NASDAQ Iceland

Trading on NASDAQ Iceland is conducted on behalf of customers by duly authorised Icelandic and foreign banks and other securities brokers as well as the Icelandic Central Bank. While banks and brokers are permitted to act as principals in trading both on and off NASDAQ Iceland, they generally engage in transactions as agents. Clearing and settlement of trades take place through an electronic account-based security system administered by Nasdaq CSD Iceland.

Trading through INET comprises all securities listed on NASDAQ Iceland, except for certain interest-bearing financial instruments, such as bonds. Member firms of NASDAQ Iceland are able to operate from remote locations via computer access. The brokers' representatives are able to trade securities via workstations that have been developed by NASDAQ Iceland or via their own electronic data processing systems that are linked to INET. The round lot for all securities traded on NASDAQ Iceland is one security. In INET, bids and offers are entered in the relevant order book and automatically matched to trades when price, volume and other order conditions are met. INET continuously broadcasts all trading information. The information is displayed in real time in the form of order books, market summaries, concluded trades, index information and different kinds of reports. A two-day settlement schedule (T+2) applies to securities trading.

NASDAQ Iceland's trading hours in respect of equity securities are 09:30 a.m. to 3:30 p.m. GMT on business days.

In addition to official trading on NASDAQ Iceland through automatic order matching in INET, securities may also be traded off NASDAQ Iceland (*i.e.*, outside INET) during and outside the official trading hours ("**manual trades**"). Manual trades during official trading hours must normally be entered into at a price within the volume weighted average spread reported in INET at the time of the trade or, for manual trades during the closing call, at the time prior to the closing call auction. Manual trades outside the official trading hours must normally be effected at a price within the volume weighted average spread reported in INET at the close of trading hours. However, in the absence of a spread and in situations where there is a change in the market conditions during the closing call or after the close of trading hours, as the case may be, manual trades outside the official trading hours must be effected at a price that takes into account the market situation at the time of the trade. Manual trades that qualify as large scale (EUR 50,000 to EUR 500,000, depending on the average daily turnover in the relevant security) may be effected without regard to any spread.

All manual trades must normally be reported in INET within three minutes from the time of the trade, although manual trades outside the official trading hours must be reported during the pre-trading session on the following exchange day and not later than 15 minutes prior to the opening of the trading hours.

Securities Market Regulations

The Nordic List is regulated under European Union directives, primarily MiFID, which has been implemented through the Securities Transactions Act. Kauphöll Íslands hf. is authorised pursuant to the Stock Exchanges Act to operate a regulated market under the supervision of the FME. The FME is a governmental agency responsible for, among other things, supervising and monitoring the Icelandic securities market and market participants. The FME also issues regulations that supplement Icelandic securities market laws and participates in preparing draft legislation. For additional information regarding pending and proposed legislative changes, see "*Regulatory Overview—Principal Legislation and Regulations*" and "*Regulatory Overview—Principal Governmental Authorities—FME*". Furthermore, pursuant to the Stock Exchanges Act, Kauphöll Íslands hf. is required to have its own rules that govern the trading on NASDAQ Iceland. The NASDAQ Iceland Rules, based on European standards and European Union directives such as MiFID and the Transparency Directive, set forth listing requirements and disclosure rules for companies listed on NASDAQ Iceland. The objective of the regulatory system governing trading on and off NASDAQ Iceland is to achieve transparency, objectivity and equality of treatment among market participants. NASDAQ Iceland records information with respect to the banks and brokers involved, the issuer, the number of shares, the price and the time of each transaction. Each bank or broker is required to maintain records indicating trades carried out as agent or as principal. All trading information reported in INET is publicly available. Through its surveillance activities, NASDAQ Iceland ensures that securities issuers and NASDAQ Iceland members work in accordance with exchange rules. NASDAQ Iceland is also obligated under the Stock Exchanges Act to inform the FME if it suspects any violations of securities market legislation.

The Securities Transactions Act, implementing in part Directive (2003/6/EC) (the "**Market Abuse Directive**"), provides sanctions for insider trading and unlawful disclosure of insider information. The Securities Transactions Act also contains provisions prohibiting market manipulation, making illegal any actions (in connection with trading on the securities market or otherwise) intended to affect unduly the market price or other conditions of trade in financial instruments or otherwise mislead buyers or sellers of such instruments, such as through spreading false or misleading information. Market manipulation may also constitute fraud under Icelandic law. The FME, in cooperation with NASDAQ Iceland, enforces compliance with the Securities Transactions Act and other insider trading rules. Criminal offences are enforced in court by the Icelandic District Prosecutor (*Héradssaksóknari).* Moreover, the FME may cause the operating licence of a bank or broker to be revoked, if the bank or broker has engaged in improper conduct, including market manipulation. NASDAQ Iceland monitors trading data for indications of unusual market activity and trading behaviour.

Securities Registration

Shares are registered in the account-based electronic securities system operated by Nasdaq CSD Iceland, a central securities depository and clearing organisation authorised under the Electronic Registration of Title to Securities Act. Among other things, Nasdaq CSD Iceland maintains the register of shareholders in Icelandic companies listed on NASDAQ Iceland. Shares administered by Nasdaq CSD Iceland are registered in book-entry form on securities accounts (*i.e.*, VS accounts) and no share certificates are issued. Title to shares is ensured exclusively through registration with Nasdaq CSD Iceland. All transactions and other changes to accounts are entered in the system of Nasdaq CSD Iceland through banks or other securities institutions that have been approved as account operators by Nasdaq CSD Iceland.

Shares may be registered on VS accounts and subsequently entered in the register of shareholders, either in the name of the beneficial owner (owner registered shares) or in the name of a nominee authorised by Nasdaq CSD Iceland (nominee registered shares), in which case a note thereof is made in the securities system. The relationship between the nominee and the beneficial owner is governed by agreement. To exercise certain rights, such as participation at a general meeting of shareholders, shareholders whose shares are registered in the name of a nominee must temporarily re-register the shares in their own names. Nominees are also required to report the holdings of underlying beneficial owners to Nasdaq CSD Iceland on a regular basis.

The rights attaching to shares that are eligible for dividends, rights issues or bonus issues accrue to those holders whose names are recorded in the register of shareholders as of a particular record date, and the dividends are normally distributed to bank accounts as specified by the holders registered with Nasdaq CSD Iceland. The relevant record date must be specified in the resolution declaring a dividend or capital increase, or any similar matter in which shareholders have preferential rights. Where the registered holder is a nominee, the nominee receives, for the account of the beneficial owner, dividends and other financial rights attaching to the shares, such as subscription rights in conjunction with rights offerings, as well as new shares subscribed through the exercise of subscription rights. Dividends are remitted in a single payment to the nominee who is responsible for the distribution of such dividends to the beneficial owner. A similar procedure is applied for subscription rights and newly issued shares.

Compensation Scheme for Investors

Commercial banks, savings banks, companies providing investment services and other parties engaging in securities trading pursuant to Icelandic law and established in Iceland shall be members of the Depositors' and Investors' Guarantee Fund according to the Deposit Guarantees Act. Investor compensation is payable only if an institution is in the FME's opinion unable to render payment of the amount of securities or is declared bankrupt and it is impossible for the investor to recover its securities or cash. The investor compensation does not cover financial loss due to changes in value of shares and other securities.

Investor compensation covers securities handled by securities companies, securities brokers and some other institutions on behalf of customers in the course of providing investment services, such as the purchase, sale and deposition of financial instruments. For the purposes of the scheme, securities refers to securities that are either in the custody or under the administration or supervision of a member company of the compensation scheme, which is under obligation to effect refunding or return thereof in accordance with existing laws or contracts.

There is no cap on the compensation that can be obtained by investors in securities, provided that the securities department of the compensation scheme is adequately financed. In the event that the assets are insufficient to pay the total amount of guaranteed securities and cash in the member companies concerned, payments from the securities department shall be divided among the claimants as follows: each claim up to EUR 20,887 will be paid in full (but only if sufficient funds are available to pay all claims up to EUR 20,887 and, if not, then claims will be paid in equal proportions) and any amount in excess of EUR 20,887 shall be paid in equal proportions depending on the extent of the department's assets. No further claims can be made against the Depositors' and Investors' Guarantee Fund at a later stage even if losses suffered by the claimants have not been compensated in full.

Transactions and Ownership Disclosure Requirements

Under the Securities Transactions Act, which implements the Transparency Directive in part, a shareholder is required to notify both the company in which it holds shares and the FME, when its voting rights attached to the shares (including options for shares) reach, exceed or fall below 5.0%, 10.0%, 15.0%, 20.0%, 25.0%, 30.0%, 35.0%, 40.0%, 50.0%, 66 $^{2}/_{3}$% or 90.0% of the total number of votes in a company. For the purposes of calculating a person's or entity's shareholding, not only the shares and financial instruments directly held by the shareholder are included, but also those held by related parties. The Securities Transactions Act contains a list of related parties whose shareholding must be aggregated for the purposes of the disclosure requirements. Related parties include, but are not limited to, subsidiaries, proxies and parties to shareholders' agreements.

Mandatory Bids and Squeeze-Out Proceedings

Pursuant to the Securities Transactions Act, any Icelandic or foreign legal entity or natural person who holds less than 30.0% of the total voting rights in a company listed on a regulated market in Iceland must make a bid for the acquisition of all the remaining shares issued by the target company (a mandatory takeover bid) should such legal entity or natural person alone, or together with a related party, obtain 30.0% or more of the total voting rights in the company. This applies where the increased holding is the result of a purchase, subscription, conversion or any other form of acquisition of shares in the target company (other than a public offer) or the result of the establishment of a certain close relationship. In this context, a related party can be an entity within the same corporate group as the buyer, a spouse, co-habitant or minor child, as well as any person or entity that cooperates with the buyer to obtain control over the company or with whom an agreement has been reached regarding the coordinated exercise of voting rights with the object of achieving a long-term controlling influence on the company's management.

The public offer must be made within four weeks after the acquisition that triggered the mandatory bid requirement. An authorisation from the FME is required to permit the acquirer (or the related party) to reduce its level of voting share ownership within such time to below 30.0%.

Under the Securities Transactions Act and the Public Limited Companies Act, a shareholder with shares representing more than 90.0% of all shares in a company has the right to redeem remaining shares in such company. In respect of companies with shares traded on a regulated market, such as NASDAQ Iceland, the redemption value must correspond to the market value, unless special reasons (such as following a takeover bid) require otherwise. In addition, any minority shareholder that possesses shares that may, pursuant to the Securities Transactions Act and the Public Limited Companies Act, be redeemed by a majority shareholder is entitled to require such majority shareholder to redeem its shares.

SWEDISH SECURITIES MARKET

The following is a description of the Swedish securities market, including a brief summary of certain provisions of the laws and securities market regulations in Sweden in effect as of the date of this Prospectus. The summary is not intended to provide a comprehensive description of all such regulatory matters and should not be considered exhaustive. Moreover, the laws, rules, regulations and procedures summarised below may be amended or reinterpreted.

NASDAQ Stockholm

NASDAQ Stockholm is a regulated market in Sweden, operated by NASDAQ Stockholm AB, and is the principal Swedish market on which shares, bonds, derivatives and other securities are traded. One list, the Nordic List, is used for trading shares on NASDAQ Stockholm and all transactions, except for interest-bearing financial instruments, are executed through INET. Companies on the Nordic List are divided into three segments: large cap, mid cap and small cap. Companies with a market capitalisation in excess of EUR 1 billion are included in the large cap segment. Companies with a market capitalisation between EUR 150 million and EUR 1 billion are included in the mid cap segment, while companies with a market capitalisation below EUR 150 million are included in the small cap segment. The segments are normally revised at year-end and the segments are reset, effective on the first trading day in January, based on average market capitalisation in November in the prior year. Companies with a market capitalisation of more than 50% of the minimum or maximum threshold of a segment will be transferred into a new segment with immediate effect. Companies with a market capitalisation of less than 50% of the minimum or maximum segment threshold will have a transitional period until the next forthcoming review (or at least 12 months) and, therefore, will be subject to one more review before transferring into a new segment. Furthermore, listed companies are divided into industry sectors in accordance with the global standard, the Industry Classification Benchmark. This classification is based on a company's main operations, *i.e.*, the business area that generates the most revenue for the company.

Trading in Securities on NASDAQ Stockholm

Trading on NASDAQ Stockholm is conducted on behalf of customers by duly authorised Swedish and foreign banks and other securities brokers as well as the Swedish Central Bank. While banks and brokers are permitted to act as principals in trading both on and off NASDAQ Stockholm, they generally engage in transactions as agents. Clearing and settlement of trades take place through an electronic account-based security system administered by Euroclear Sweden, a central securities depository and clearing organisation authorised under the Swedish Central Securities Depositories and Financial Instruments Accounts Act (Sw. *lagen (1998:1479) om värdepapperscentraler och kontoföring av finansiella instrument)* and the Swedish Securities Market Act. See "*—Registration of Shares*".

Trading through INET comprises all securities listed on NASDAQ Stockholm, except for interest-bearing financial instruments, such as bonds. Member firms of NASDAQ Stockholm are able to operate from remote locations via computer access. The brokers' representatives are able to trade securities via workstations that have been developed by NASDAQ Stockholm or via their own electronic data processing systems that are linked to INET. The round lot for all securities traded on NASDAQ Stockholm is one security. In INET, bids and offers are entered in the relevant order book and automatically matched to trades when price, volume and other order conditions are met. INET continuously broadcasts all trading information. The information is displayed in real time in the form of order books, market summaries, concluded trades, index information and different kinds of reports. A two-day settlement schedule (T+2) applies to securities trading.

NASDAQ Stockholm's trading hours in respect of equity securities are 09:00 a.m. to 5:25 p.m. CET on business days. Before the trading hours, there is a pre-open session (8:00 a.m. to 09:00 a.m. CET), during which orders can be placed, but where no automatic order matching occurs. The trading hours start with a so-called opening call uncross, where each equity security is assigned its opening price and then becomes subject to continuous trading. At 5:25 p.m. CET, continuous trading is halted followed by a pre-close session (5:25 p.m. to approximately 5:30 p.m. CET). During the pre-close session, orders can still be placed but no automatic order matching occurs. The pre-close session ends with a so-called closing call uncross, which is carried out in respect of each equity security in the same order as the opening call uncross. The price generated at the closing call uncross (or, in absence thereof, the last trading price) is the official closing price. The trading hours are followed by a post-trading session (5:30 to 6:00 p.m. CET) in which changes to, and cancellations of, orders as well as off-hours transactions, are permitted.

In addition to official trading on NASDAQ Stockholm through automatic order matching in INET, securities may also be traded off NASDAQ Stockholm, (*i.e.*, outside INET), during and outside the official trading hours (“**manual trades**”). Manual trades during trading hours must normally be entered into at a price within the volume weighted average spread reported in INET at the time of the trade or, for manual trades during the closing call, at the time prior to the closing call auction. Outside the official trading hours, manual trades must normally be effected at a price within the volume weighted average spread reported in INET at the close of trading hours. However, in the absence of a spread and in situations where there is a change in the market conditions during the closing call or after the close of trading hours, as the case may be, manual trades must take place at a price that takes into account the market situation at the time of the trade. Manual trades that qualify as large scale (EUR 50,000 to EUR 500,000, depending on the average daily turnover in the relevant security) may be effected without regard to any spread. Trading on NASDAQ Stockholm tends to involve a higher percentage of retail clients while trading off NASDAQ Stockholm, whether directly or through intermediaries, often involves larger Swedish institutions, banks arbitraging between the Swedish market and foreign markets and foreign buyers and sellers purchasing shares from, or selling shares to, Swedish institutions.

All manual trades must normally be reported in INET within three minutes from the time of the trade, although trades outside the official trading hours must be reported during the pre-trading session on the following exchange day and not later than 15 minutes prior to the opening of the trading hours.

Securities Market Regulations

The Nordic List is regulated under European Union directives, primarily MiFID, which has been implemented through the Securities Market Act of 2007 of Sweden (Sw. *lagen (2007:528) om värdepappersmarknaden*) (the “**Swedish Securities Market Act**”). NASDAQ Stockholm AB is authorised pursuant to the Swedish Securities Market Act to operate a regulated market under the supervision of the FSA. The FSA is a governmental agency responsible for, among other things, supervising and monitoring the Swedish securities market and market participants. The FSA also issues regulations that supplement Swedish securities market laws. Furthermore, pursuant to the Swedish Securities Market Act, NASDAQ Stockholm AB is required to have its own rules that govern the trading on NASDAQ Stockholm. The Rule Book for Issuers of NASDAQ Stockholm, based on European standards and European Union directives, such as MiFID and the Transparency Directive, sets forth listing requirements and disclosure rules for companies listed on NASDAQ Stockholm. The objective of the regulatory system governing trading on and off NASDAQ Stockholm is to achieve transparency and equality of treatment among market participants. NASDAQ Stockholm records information with respect to the banks and brokers involved, the issuer, the number of shares, the price and the time of each transaction. Each bank or broker is required to maintain records indicating trades carried out as agent or as principal. All trading information reported in INET is publicly available. NASDAQ Stockholm also maintains a market supervision unit (the “**Trading Surveillance**”) that monitors trading on a “real time” basis, as described below.

The Regulation (EU) 596/2014 (the “**Market Abuse Regulation**”) and the Swedish Market Abuse Penal Act of 2016 (Sw. *lagen (2016:1307) om straff för marknadsmissbruk vid handel med finansiella instrument)* (the “**Market Abuse Act**”), implementing in part the Market Abuse Directive, provides rules regarding, and sanctions for, insider dealing, unlawful disclosure of inside information and market manipulation. Market manipulation may also constitute fraud under Swedish law. The FSA and the Trading Surveillance enforce compliance with the Market Abuse Regulation and other market abuse rules. Criminal offences are enforced in court by the Swedish National Economic Crimes Bureau (Sw. *Ekobrottsmyndigheten).* Moreover, the FSA may cause the operating licence of a bank or broker to be revoked, if the bank or broker has engaged in improper conduct, including market manipulation.

The Trading Surveillance monitors trading data for indications of unusual market activity and trading behaviour, and continuously examines information disseminated by listed companies, such as earnings reports, acquisition and other investment plans and changes in ownership structure on a daily basis. When the Trading Surveillance becomes aware of inside information, it monitors trading in the shares concerned to ensure that if unusual trading activity develops indicating that persons may be trading on that information, the information is made public as soon as possible.

Registration of Shares

Shares are registered in the account-based electronic securities system operated by Euroclear Sweden AB (Euroclear Sweden). Among other things, Euroclear Sweden maintains the register of shareholders in Swedish companies listed on NASDAQ Stockholm. Shares administered by Euroclear Sweden are registered in book-entry form on securities accounts (VP accounts) and no share certificates are issued. Title to shares is ensured exclusively through registration with Euroclear Sweden. All transactions and other changes to accounts are entered in the system of Euroclear Sweden through banks or other securities institutions that have been approved as account operators by Euroclear Sweden.

Shares may be registered on VP accounts and subsequently entered in the register of shareholders, either in the name of the beneficial owner (owner registered shares) or in the name of a nominee authorised by Euroclear Sweden (nominee registered shares), in which case, a note thereof is made in the securities system. The relationship between the nominee and the beneficial owner is governed by agreement. To exercise certain rights, such as participation at a general meeting of shareholders, shareholders whose shares are registered in the name of a nominee must temporarily re-register the shares in their own names. Nominees are also required to report the holdings of underlying beneficial owners to Euroclear Sweden on a regular basis. A public register of shareholders and a nominee list, both containing information on holders of more than 500 shares in the relevant company (or such lower number of shares that constitute all shares in the relevant company), is produced at the beginning of each quarter of the year and is available to the general public at both Euroclear Sweden and such company's registered office. There is also a separate register maintained by Euroclear Sweden for the recording of persons who have other interests in respect of shares, such as those of a pledgee.

The rights attaching to shares that are eligible for dividends, rights issues or bonus issues accrue to those holders whose names are recorded in the register of shareholders as of a particular record date, and the dividends are normally distributed to bank accounts as specified by the holders registered with Euroclear Sweden. The relevant record date must be specified in the resolution declaring a dividend or capital increase, or any similar matter in which shareholders have preferential rights. Where the registered holder is a nominee, the nominee receives, for the account of the beneficial owner, dividends and other financial rights attaching to the shares, such as subscription rights in conjunction with rights offerings, as well as new shares subscribed through the exercise of subscription rights. Dividends are remitted in a single payment to the nominee who is responsible for the distribution of such dividends to the beneficial owner. A similar procedure is applied for subscription rights and newly issued shares.

Compensation Scheme for Investors

Investor compensation covers financial instruments such as shares, bonds and various types of derivatives, for instance warrants and futures. Investor compensation is payable only if an institution is declared bankrupt and it is impossible for the investor to recover its securities or cash. The investor compensation does not cover financial loss due to changes in value of shares and other securities. Investor compensation covers securities handled by securities companies, securities brokers and some other institutions on behalf of customers in the course of providing investment services, such as the purchase, sale and deposition of financial instruments. For the purposes of the scheme, securities means shares, bonds and various types of derivatives. The scheme also covers funds that an institution receives in conjunction with providing an investment service for which it is accountable. Investors may be compensated for lost assets up to a value of SEK 250,000 per institution.

Transactions and Ownership Disclosure Requirements

The Swedish Financial Trading Act (1991:980) (Sw. *lagen (1991:980) om handel med finansiella instrument*) (the "**Trading Act**"), which implements the Transparency Directive in part, contains, among other things, regulations with respect to issuer and shareholder disclosure obligations. Pursuant to the Trading Act, and due to the fact that Arion Bank's jurisdiction of incorporation is Iceland, Icelandic rules shall apply with respect to ownership disclosure requirements.

Under the Regulation (EU) 236/2012 on short selling and certain aspects of credit default swaps, a person who has a net short position in a share is required to notify the FSA when the position either reaches or falls below the following thresholds: 0.2% of the issued share capital of the company concerned and each 0.1% above that. There is also a requirement of public disclosure when the position reaches or falls below the following thresholds: 0.5% of the issued share capital of the company concerned and each 0.1% above that. The public disclosure is made by the FSA via announcement on its website. Further, an investor who wishes to take an uncovered, or "naked", short position in a particular share will be required either (a) to have borrowed sufficient shares to settle the short trade, (b) to have entered into a binding agreement to borrow the shares or (c) to have an arrangement with a third party under which that third party has confirmed that the shares have been located and has taken measures vis-a-vis third parties necessary to have a reasonable expectation that settlement can be effected when it is due.

Mandatory Bids

Icelandic laws and regulations on mandatory bids apply with respect to Arion Bank.

TAXATION

*The following is a summary of certain tax consequences that may arise from the Offering and is intended as general information only. The statements concerning Icelandic tax laws and U.S. federal income tax laws set forth below, including concerning the Convention and Protocol Between the United States of America and Iceland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (the "**U.S.-Iceland Treaty**"), the Convention Between the Government of Sweden and the Government of the United States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (the "**U.S.-Sweden Treaty**") and the Convention Between the Nordic Countries for the Avoidance of Double Taxation (the "**Nordic Tax Treaty**"), are based on the laws and regulations as of the date of this Prospectus and are subject to any changes in Icelandic, Swedish or U. S. law or in the U.S.-Iceland Treaty, the U.S. Sweden Treaty or the Nordic Tax Treaty, occurring after such date, which changes may have retroactive effect.*

Certain Tax Considerations in Iceland

The comments below are of a general nature based on the Bank's understanding of current law and practice in Iceland. Prospective investors who are in any doubt as to their personal tax position or who may be subject to tax in any other jurisdiction should consult their professional advisers.

Furthermore, prospective investors should note that the holding of beneficial ownership in Shares via an intermediary issuing SDRs or the appointment of any person through which an investor holds the Shares may have tax implications; such holding via an intermediary is not explicitly addressed in Icelandic tax law, resulting in some uncertainties in respect of Icelandic withholding tax on holders of SDRs. Prospective investors are advised to consult their tax advisers as to the consequences, under tax laws of Iceland and the countries of their respective citizenship, residence or domicile, of a purchase of the Shares, including but not limited to, the consequences of receipt of dividend payments in respect of the Shares and disposal or redemption of the Shares.

The summary below is of a general nature based on the laws and practices as in effect in Iceland as of the date of this Prospectus. It should not be construed as providing specific advice regarding Icelandic taxation and is subject to any change in laws or practices in Iceland that may take effect after such date. It relates only to the position of persons who are the absolute beneficial owners of the Shares.

Shareholders Who Are Resident in Iceland for Tax Purposes

Owners of the Shares who are resident in Iceland for tax purposes are subject to income tax in Iceland on any income from the Shares in accordance with Icelandic tax laws. The applicable tax rate depends on the tax status of such owners.

Subject to certain exemptions (*e.g.*, for pension funds), the owners are subject to tax which the Bank is required to withhold at the rate of 22.0% on dividend payments made to the holders of the Shares who are Icelandic residents under Act No. 94/1996 on Withholding of Tax on Financial Income. Such withholding is considered a preliminary tax payment, but does not necessarily constitute the final tax liability of the holder of the Shares.

Individuals who are resident in Iceland for tax purposes are subject to a final 22.0% tax on dividend payments in Iceland.

Limited companies (*e.g.*, ehf. and hf.) enjoy an effective participation exemption, allowing them to deduct the full amount of the dividend payments received. As a result, limited companies may recover the tax on dividend payments withheld upon tax assessment.

Capital gains from the sale of the Shares are subject to the same taxation as dividend payments, although the Bank is not required to withhold any tax in the case of sales of the Shares by the holder.

Shareholders Who Are Not Resident in Iceland for Tax Purposes

Article 3(7) of the Income Tax Act provides that any income received from the Shares by any person or entity residing outside Iceland constitutes taxable income in Iceland. According to Article 70(7) of the Income Tax Act, the current tax rate on taxable income under Article 3(7) of the Income Tax Act amounts to (i) 22.0% for individuals and (ii) 20.0% for legal entities. The Bank is required to withhold the applicable tax on any dividend payments. The tax rate applicable to income from any disposal of the Shares is also (i) 22.0% for individuals and (ii) 20% for legal entities.

The tax liability under Icelandic tax laws may be reduced under certain applicable tax treaties. If a qualifying holder of the Shares would like to take advantage of such applicable tax treaties by relief at source, such holder is required to obtain a confirmation from the Icelandic tax authorities regarding the applicable treaty protection and provide such confirmation to the Bank. The confirmation is obtained via a filing of Icelandic tax form RSK 5.42. The U.S.-Iceland Treaty reduces the Icelandic tax rate on capital gains from any disposal of the Shares to 0.0% and Icelandic tax rate on dividend payments to 15.0% for individuals and legal entities and to 5.0% for legal entities only, if the shareholding of such legal entities amounts to at least 10.0% of the issued Shares. The same reduction applies in case of the Nordic Tax Treaty with the exception that the dividend tax rate applicable to qualifying legal entities holding at least 10% of the issued share capital is reduced to 0.0%.

Relief via a refund in line with an applicable tax treaty is carried out via a filing of Icelandic tax from RSK 5.43.

Irrespective of the availability of any tax treaty protection, limited companies resident in the EEA, a state party to EFTA or in the Faroe Islands enjoy the effective statutory participation exemption which comparable Icelandic entities do, allowing them to deduct the full amount of the dividend payments and capital gains received. This exemption does not apply at source, but requires the filing of a tax return in Iceland to obtain a refund of taxes withheld.

Icelandic tax law does not specifically address the tax treatment of holders of SDRs. Icelandic tax authorities have, in an advance ruling, concluded that an issuer of the SDRs is not classified as the beneficial owner of dividend income of Shares in the Bank. As a result, dividend payments on Shares corresponding to SDRs will be subject to Icelandic tax and withholding as described above. The same should apply to capital gains.

In order to achieve relief as described above via the Icelandic effective participation or via tax treaty protection, the holder of an SDR would need to exercise the same means as described above. However, it must be noted again that such a scenario is not explicitly addressed by Icelandic laws and, therefore, individual holders may need to be addressed on a case by case basis by Icelandic tax authorities when determining if relief is available to holders of SDRs, and such relief may not be available.

There are no estate or inheritance taxes, succession duties or gift taxes imposed by the Icelandic government or any governmental authority in Iceland in respect of the Shares if, at the time of death of the holder of the Shares or transfer of the Shares, such holder or transferor was not a resident of Iceland.

No Icelandic issue tax or stamp duty will be payable in connection with the Shares.

Certain Tax Considerations in Sweden

Unless otherwise stated, the following is a summary of certain tax consequences that may arise from the Offering for individuals or limited liability companies tax resident in Sweden from the time that the SDRs are admitted to trading on NASDAQ Stockholm. This description does not address in a comprehensive manner all tax consequences that may occur in this context. For instance, the summary does not address securities held by partnerships or securities held as current assets in business operations. Moreover, the summary does not address the specific rules on tax-exempt capital gains and dividends, including non-deductibility for capital losses, in the corporate sector that may be applicable when securities are considered to be held for business purposes (Sw. *näringsbetingade andelar*). The following summary also does not address specific rules that could be applicable to holdings in companies that are, or have previously been, closely-held companies or shares acquired on the basis of so-called qualified shares in such companies. Moreover, the following summary does not address shares or other equity-related securities that are held in a so-called investment savings account that are subject to special rules and are taxed on a standardised basis. Special tax rules apply to certain categories of taxpayers, such as investment companies and insurance companies. The tax treatment of an individual investor depends on such investor's particular circumstances. Investors in the SDRs are therefore urged to consult their own tax advisors regarding the specific implications that may arise in their individual case, including the applicability and effect of foreign rules and tax treaties.

From a Swedish tax perspective, SDRs are normally treated as the underlying assets, i.e. as the underlying shares.

Holders of SDRs Who Are Tax Resident in Sweden

Individuals' Dividend Taxation

For individuals holding the SDRs, dividends on the underlying shares are taxed as income from capital at a rate of 30%. The SDRs are intended to be listed once admitted to trading on NASDAQ Stockholm. A preliminary tax of 30% is generally withheld on dividends paid to individuals resident in Sweden. The preliminary tax is withheld by Euroclear Sweden or, in the case of nominee-registered shares, by the Swedish nominee.

Individuals' Capital Gains Taxation

Upon the sale or other disposal of the listed SDRs, which the SDRs are intended to be once admitted to trading on NASDAQ Stockholm, a taxable capital gain or deductible capital loss may arise. Capital gains are, as a general rule, taxed as income from capital at a flat tax rate of 30%. The capital gain or loss is calculated as the difference between the sales proceeds, after deducting sales costs, and the tax basis. The tax basis for all shares of the same class and type is calculated together in accordance with the average cost method. The tax basis for listed shares may alternatively be determined as 20% of the sales proceeds after deducting sales costs under the "**notional rule**".

Capital losses on the SDRs are fully deductible against taxable capital gains on shares and on other listed equity-related securities realised during the same year, with the exception of units in securities funds or special funds that consist solely of Swedish receivables ("**interest funds**"). Up to 70% of capital losses on shares that cannot be offset in this way are deductible against other capital income. If there is a net loss in the capital income category, a tax reduction is allowed against municipal and national income tax as well as against real estate tax and municipal real estate charges. A tax reduction of 30% is allowed on the portion of such net loss that does not exceed SEK 100,000 and of 21% on any remaining loss. Such net loss cannot be carried forward to future fiscal years.

Limited Liability Companies Dividend and Capital Gains Taxation

For a limited liability company, all income, including taxable capital gains and dividends, is taxed as business income at a tax rate of 22%. Capital gains and capital losses are calculated in the same manner as set forth above with respect to individuals. Deductible capital losses on the SDRs may only be deducted against taxable capital gains on other securities that are taxed in the same manner as shares. Under certain circumstances such capital losses may also be deducted against capital gains in another company in the same group, *provided that* the requirements for exchanging group contributions (Sw. *koncernbidragsrätt)* between the companies are met. A capital loss that cannot be utilised during a given year may be carried forward and set off against taxable capital gains on shares and other equity-related securities during subsequent fiscal years without any limitation in time.

Double Tax Treaty Relief

The tax liability under Swedish tax laws may be reduced under certain applicable tax treaties. If a qualifying holder of the Shares would like to take advantage of such applicable tax treaties by relief at source, such holder is required to obtain a confirmation from the Swedish tax authorities regarding the applicable treaty protection and provide such confirmation to the Bank. The confirmation is obtained via filing of a tax residence certificate. The Nordic Tax Treaty reduces the Swedish tax rate on dividend payments to 15.0% for individuals and legal entities and to 0.0% for legal entities only, if the shareholding of such legal entities amounts to at least 10.0% of the issued share capital.

Holders of SDRs Who Are Not Tax Resident in Sweden

Dividend Taxation

Dividends paid to holders not tax resident in Sweden are not subject to Swedish withholding tax. Swedish withholding tax is only levied on dividends on shares of Swedish limited liability companies, European Companies with registered office in Sweden, Swedish investment funds, and Swedish special funds.

Capital Gains Taxation

Holders of SDRs, who are not tax resident in Sweden and are not operating a business from a permanent establishment in Sweden, are generally not liable for Swedish capital gains taxation on the disposal of the SDRs. The holders may, however, be subject to taxation in their country of residence. Under a specific tax rule, individual shareholders who are not tax resident in Sweden may, however, be subject to tax in Sweden on the sale of the SDRs if they have been resident or stayed permanently in Sweden at any time during the calendar year of such disposal or during any of the previous ten calendar years. While the applicability of this rule may be limited by tax treaties between Sweden and other countries, the U.S.-Sweden Treaty does not provide for a reduction of such period.

Certain U.S. Federal Income Tax Considerations

The following is a summary of certain U.S. federal income tax consequences of the acquisition, ownership and disposition of the Offer Securities by U.S. Holders (as defined below) and does not address the effects of any U.S. federal tax laws other than U.S. federal income tax laws (such as estate and gift tax laws) or any state, local or non-U.S. tax laws. This summary is based upon the U.S. Internal Revenue Code of 1986, as amended (the "**Code**"), Treasury regulations issued thereunder (the "**Treasury Regulations**"), and judicial and administrative interpretations thereof, each as in effect on the date hereof, and all of which are subject to change, possibly with retroactive effect.

This summary does not address all of the U.S. federal income tax consequences that may be relevant to a holder in light of such holder's particular circumstances, including the impact of the unearned income Medicare contribution tax, or to holders subject to special rules, such as certain financial institutions, U.S. expatriates, insurance companies, individual retirement accounts, dealers in securities or currencies, traders in securities, U.S. Holders whose functional currency is not the U.S. dollar, tax-exempt entities, regulated investment companies, real estate investment trusts, partnerships or other pass through entities and investors in such entities, persons liable for alternative minimum tax, U.S. Holders that own 10% or more of Arion Bank's voting stock, U.S. Holders that are resident in or have a permanent establishment in a jurisdiction outside the United States and persons holding the Offer Securities as part of a "straddle", "hedge", "conversion transaction" or other integrated transaction. In addition, this summary is limited to U.S. Holders that acquire the Offer Securities pursuant to the Offering and who hold the Offer Securities as capital assets within the meaning of Section 1221 of the Code.

For purposes of this discussion, a "**U.S. Holder**" is a beneficial owner of the Offer Securities that is, for U.S. federal income tax purposes, (i) an individual who is a citizen or resident of the United States, (ii) a corporation or any entity taxable as a corporation created or organised in or under the laws of the United States, any state thereof or the District of Columbia, (iii) any estate the income of which is subject to U.S. federal income taxation regardless of its source or (iv) any trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or if a valid election is in place to treat the trust as a U.S. person.

If any entity treated as a partnership for U.S. federal income tax purposes holds the Offer Securities, the U.S. tax treatment of a partner in the partnership generally will depend upon the status of the partner and the activities of the partnership. A partnership considering an investment in the Offer Securities, and partners in such a partnership, should consult their tax advisors regarding the U.S. federal income tax consequences of the purchase, ownership and disposition of the Offer Securities.

For U.S. federal income tax purposes, U.S. Holders of SDRs generally should be treated as owners of the Shares represented by the SDRs. Accordingly, except as otherwise noted, the U.S. federal income tax consequences below generally should apply equally to U.S. Holders of SDRs.

Prospective purchasers of the Offer Securities should consult their tax advisors concerning the tax consequences of holding Offer Securities in light of their particular circumstances, including the application of the U.S. federal income tax considerations discussed below, as well as the application of other federal, state, local, non-U.S. or other tax laws.

Distributions on the Offer Securities

Subject to the discussion in "*—Passive Foreign Investment Company Rules*", a distribution of cash or property with respect to the Offer Securities (including the amount of any taxes withheld) will generally be treated as a dividend to the extent paid out of Arion Bank's current or accumulated earnings and profits, as determined under U.S. federal income tax principles, and will be includible in the gross income of a U.S. Holder on the date the distribution is actually or constructively received. Arion Bank does not expect to maintain calculations of its earnings and profits under U.S. federal income tax principles and, therefore, U.S. Holders should expect that the entire amount of any distribution generally will be reported as dividend income. Any such dividend income will not be eligible for the dividends-received deduction allowed to corporate U.S. Holders.

Subject to certain holding period requirements and other conditions, dividends paid to non-corporate U.S. Holders may be eligible for preferential rates of taxation if the dividends are "qualified dividends" for U.S. federal income tax purposes. Dividends received with respect to the Offer Securities will be qualified dividends if Arion Bank (i) is eligible for the benefits of a comprehensive income tax treaty with the United States that the Internal Revenue Service ("**IRS**") has approved for the purposes of the qualified dividend rules and (ii) was not, in the year prior to the year in which the dividend was paid, and is not, in the year in which the dividend is paid, a passive foreign investment company ("**PFIC**") for U.S. federal income tax purposes.

The U.S.-Iceland Treaty has been approved for the purposes of the qualified dividend rules and Arion Bank expects that it will generally be eligible for the benefits of the U.S.-Iceland Treaty. In addition, Arion Bank believes that it was not a PFIC for its taxable year ended 31 December 2017 and, although no assurance can be given, it does not anticipate becoming a PFIC for its current taxable year or any foreseeable future taxable year. See "—*Passive Foreign Investment Company Rules*".

Dividends paid in a currency other than U.S. dollars will be included in income in a U.S. dollar amount determined by reference to the exchange rate in effect on the date of actual or constructive receipt by SEB (in the case of the SDRs) or the U.S. Holder (in the case of Shares), whether or not the non-U.S. currency is converted into U.S. dollars at that time. A U.S. Holder's tax basis in the non-U.S. currency received will equal the U.S. dollar amount included in income. Any gain or loss realised on a subsequent conversion or other disposition of the non-U.S. currency for a different U.S. dollar amount will be exchange gain or loss and generally will be treated as U.S. source ordinary income or loss for foreign tax credit limitation purposes. If a dividend paid in non-U.S. currency is converted into U.S. dollars on the day the dividend is received, the U.S. Holder generally will not be required to recognise non-U.S. currency gain or loss in respect of the dividend.

Subject to generally applicable limitations, a U.S. Holder may claim a deduction or a foreign tax credit only for Icelandic tax withheld at a rate not in excess of the maximum rate applicable to such U.S. Holder after any reduction in rates available to such U.S. Holder under the U.S.-Iceland Treaty and not refundable to it by the Icelandic tax authorities. For purposes of calculating the foreign tax credit, dividends paid on the Offer Securities will be treated as income from sources outside the United States and will generally constitute passive category income. The rules governing the foreign tax credit are complex. U.S. Holders should consult their own tax advisors regarding the tax consequences to it if Icelandic tax is withheld from dividends on the Offer Securities, including the availability of the foreign tax credit under its particular circumstances.

Sale, Exchange, Redemption, or Other Taxable Disposition of Offer Securities

Subject to the discussion in "—*Passive Foreign Investment Company Rules*", a U.S. Holder will generally recognise capital gain or loss on the sale, exchange, redemption or other taxable disposition of the Offer Securities in an amount equal to the difference between the amount realised upon the disposition and the U.S. Holder's adjusted tax basis in such Offer Securities. Any such capital gain or loss will be long-term if the U.S. Holder's holding period for the Offer Securities exceeds one year. The deductibility of capital losses may be subject to limitations.

The surrender of SDRs in exchange for Shares (or vice versa) should not be a taxable event for U.S. federal income tax purposes and U.S. Holders should not recognise any gain or loss upon such a surrender.

A U.S. Holder's tax basis in the Offer Securities generally will be the U.S. dollar value of the non-U.S. currency amount paid to purchase the Offer Securities determined by reference to the exchange rate on the date of purchase. If the Offer Securities are treated as traded on an established securities market, a cash basis U.S. Holder (or, if it elects, an accrual basis U.S. Holder) will determine the U.S. dollar value of the cost of such Offer Securities by translating the amount paid at the spot rate of exchange on the settlement date of the purchase.

A U.S. Holder that receives a currency other than U.S. dollars on the sale or other disposition of the Offer Securities generally will realise an amount equal to the U.S. dollar value of the non-U.S. currency received determined by reference to the exchange rate on the date of sale or other disposition (or in the case of the Offer Securities traded on an established securities market that are sold by a cash basis or electing accrual basis taxpayer, the settlement date). A U.S. Holder will recognise foreign currency gain or loss if the U.S. dollar value of the currency received at the spot rate on the settlement date differs from the amount realised. A U.S. Holder will have a tax basis in the currency received equal to the U.S. dollar value of the currency on the settlement date. Any gain or loss realised on a subsequent conversion or other disposition of the non-U.S. currency for a different U.S. dollar amount will be exchange gain or loss and generally will be treated as U.S. source ordinary income or loss for foreign tax credit limitation purposes.

Passive Foreign Investment Company Rules

A non-U.S. corporation is classified as a PFIC for U.S. federal income tax purposes for each taxable year in which (a) 75.0% or more of its gross income is passive income (as defined for U.S. federal income tax purposes) or (b) on average for such taxable year, 50.0% or more (by value) of its gross assets either produce or are held for the production of passive income. For purposes of the PFIC provisions, passive income generally includes dividends, interest, royalties, rents and gains from some securities transactions.

An exception exists for income derived by non-U.S. corporations from the active conduct of a banking business that meets certain requirements described in proposed Treasury Regulations. In this regard, in 1989, the IRS issued a notice (the "**Notice**") that would require a non-U.S. bank to, among other things, derive at least 60.0% of its gross income from "*bona fide*" banking activities, which include accepting deposits from unrelated persons which represent at least 50.0% of its total liabilities for the taxable year and making loans to unrelated persons which represent at least 50.0% of the average principal of all loans outstanding during the taxable year.

Subsequent to the issuance of the Notice, the U.S. Department of Treasury issued proposed Treasury Regulations (the "**Proposed Regulations**") that are not yet in effect, which would markedly modify the Notice and which, if finalised, would apply retroactively to taxable years beginning after December 31, 1994. To be an active bank under the Proposed Regulations, a non-U.S. bank must meet certain licensing, deposit taking, lending and gross income requirements.

Arion Bank believes that it should qualify as an active bank under both the Notice and the Proposed Regulations, assuming that the Proposed Regulations are finalised in their current form, based upon Arion Bank's regulatory status under Icelandic law, its banking activities performed in the ordinary course of business (including lending and accepting deposits), the proportion of its income derived from activities that are "*bona fide*" banking activities for U.S. federal income tax purposes and its securities activities performed in the ordinary course of business. Accordingly, Arion Bank believes that it was not a PFIC for its taxable year ended 31 December 2017 (the latest period for which the determination can be made). Furthermore, based on its current regulatory status under Icelandic law, the nature of its activities and composition of its assets and sources of income, Arion Bank does not expect to be a PFIC for the current taxable year or any foreseeable future taxable year.

Because a PFIC determination is a factual determination that must be made following the close of each taxable year and is based on, among other things, the market value of Arion Bank's assets and because the Proposed Regulations (although retroactive in application) are not currently in force, no assurance can be given that Arion Bank will not be considered a PFIC for the current taxable year or any subsequent year. If Arion Bank were to be a PFIC in any taxable year, materially adverse U.S. federal income tax consequences could result for U.S. Holders. Prospective investors should consult their tax advisors as to the potential application of the PFIC rules as well as the impact of any proposed legislation that could affect them.

Information Reporting Requirements

Dividends on the Offer Securities and proceeds from the sale or other disposition of the Offer Securities by a U.S. paying agent or other U.S. intermediary, or made into the United States, generally will be reported to the IRS unless the holder is a corporation or otherwise establishes a basis for exemption. Backup withholding generally will apply to amounts subject to reporting if the U.S. Holder fails to provide an accurate taxpayer identification number or certification of exempt status. Any amount withheld may be credited against the U.S. Holder's U.S. federal income tax liability, if any, or refunded to the extent it exceeds the U.S. Holder's liability provided the required information is timely furnished to the IRS. Prospective investors should consult their own tax advisors as to their qualification for exemption from backup withholding and the procedure for establishing an exemption.

Certain U.S. Holders may be required to report to the IRS certain information relating to an interest in the Offer Securities unless such Offer Securities are held in accounts maintained by certain financial institutions. A U.S. Holder required to report such information must file a complete IRS Form 8938 (*Statement of Specified Foreign Financial Assets*) with its tax return for each year in which it holds an interest in the Offer Securities. Penalties apply if a U.S. Holder is required to submit such information to the IRS and fails to do so. U.S. Holders should consult their tax advisors regarding the application of these rules in their particular circumstances.

TERMS AND CONDITIONS OF THE OFFERING

General Terms

The Offering applies to already issued shares in Arion Bank held by the Selling Shareholders, to be offered in the form of Existing Offer Shares and SDRs, together constituting the Offer Securities. The Selling Shareholders and the Bank will agree on the final number of the Offer Securities sold in the Offering in close consultation with the Joint Global Coordinators, and in any case the Offering will comprise Offer Securities representing a minimum of 25.0% of the total issued and outstanding share capital of the Bank and a maximum of 40.0% of the total issued and outstanding share capital.

All Offer Securities being sold to investors pursuant to the Offering will be sold at the Offer Price.

The Offering is being made by way of:

- a public offering of the Offer Securities to Icelandic investors in accordance with Article 43(1) of the Securities Transactions Act (see "—Public Offering in Iceland");
- a public offering of the SDRs to Swedish investors (see "—Public Offering in Sweden"); and
- an institutional offer of the Offer Securities: (i) to certain institutional investors outside the United States in reliance on Regulation S and in accordance with locally applicable laws and regulations, and (ii) in the United States, only to QIBs in reliance on Rule 144A or pursuant to another exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act (see "Plan of Distribution and Transfer Restrictions").

Allocation of the Offer Securities among the public offerings in Iceland and Sweden and the institutional offering will be at the sole discretion of Kaupskil, in close consultation with the Joint Global Coordinators and the Bank. When allocating the Offer Securities, the objectives of the Offering will be taken into account, i.e., encouraging increased liquidity of the Offer Securities, creating a more diverse shareholder base, selling the Offer Securities at the best price for the Selling Shareholders and enabling a good secondary market in the Offer Securities. Allocation to employees of the Bank, Kaupthing and Kaupskil may be accorded some priority at the sole discretion of the Selling Shareholders and the Bank.

The offer period in respect of the public offerings in Iceland and Sweden will start on 31 May 2018 at 12:00 p.m. GMT in Iceland (2:00 p.m. CEST in Sweden) and end on 13 June 2018 at 3:00 p.m. GMT in Iceland (5:00 p.m. CEST in Sweden). No orders will be accepted after the offer period has finished (unless the Selling Shareholders specifically decide to postpone the Offering or to extend it and in such cases a supplement to this Prospectus or a new prospectus will be published, as applicable).

The result of the Offering is expected to be published on 15 June 2018, and NASDAQ Iceland and NASDAQ Stockholm will subsequently give an answer to the Bank's applications to have the Shares and SDRs admitted to trading on the regulated markets of NASDAQ Iceland and NASDAQ Stockholm, respectively. Subsequently, information on the allocation of the Offer Securities to investors in the Offering will be sent to investors, expected on 15 June 2018 if a positive answer has been received from NASDAQ Iceland and NASDAQ Stockholm on 15 June 2018, the final due date is then set for 19 June 2018 (18 June 2018 for retail investors in Iceland) and paid Offer Securities will be delivered to the buyer at the latest two business days after payment is received. Pursuant to the above information, the first expected day of conditional trading of the Offer Securities (conditional on admission) is 15 June 2018, and the first expected day of unconditional trading of the Offer Securities on the regulated markets of NASDAQ Iceland and NASDAQ Stockholm is 19 June 2018, being also the expected date of admission. The above dates assume that the Selling Shareholders do not change the offer period, the processing of orders does not take a shorter or longer time than the Selling Shareholders expected and the Bank's applications to NASDAQ Iceland and NASDAQ Stockholm are responded to within the timeframe expected by the Selling Shareholders.

If full payment is not made in due time according to the payment instructions, allotted Offer Securities may be withdrawn and sold to another party. The party who initially received allocation of Offer Securities in the Offering may bear the difference, should the selling price in the event of such a transfer be less than the price in the Offering.

The Selling Shareholders reserve the right to cancel the Offering if orders are not received for at least the minimum number of the Offer Securities in the Offering and will in such an event publish an announcement thereof alongside the announcement of the result of the Offering. The Selling Shareholders will cancel the Offering if (i) NASDAQ Iceland rejects the Bank's application to have all Shares in the Bank admitted to trading on the regulated market of NASDAQ Iceland, (ii) if NASDAQ Stockholm rejects the Bank's application to have up to 2,000,000,000 SDRs admitted to trading on the regulated market of NASDAQ Stockholm or (iii) if either NASDAQ Iceland or NASDAQ Stockholm does not approve the Bank's application by the expected date of unconditional trading. If the Offering is cancelled pursuant to the above, all orders for Offer Securities in the Offering and allocations made on the basis thereof will consequently be invalidated. It will be publicly announced if the Offering is cancelled or if the Offering period is extended or postponed. If the Offering period is extended or postponed, a supplement to this Prospectus will be published explaining the change. All important new information, considered to have an impact on investors' assessment of the Offer Securities, that has come to light since the confirmation of this Prospectus will also be published. The supplement shall be approved within seven working days and published in the same manner as the original Prospectus. In accordance with Article 46 of the Securities Transactions Act, investors who have already agreed to purchase securities before the supplement is published shall have the right to withdraw their orders for a period of at least two working days following the publication of the supplement.

Investors are made aware that the Selling Shareholders reserve the full right to reject some or all of the orders submitted in the Offering (including offers from individual investors in part or in full), without further explanation or reasoning. The Selling Shareholders reserve the right to reject orders from persons who have not made payment for allocated Offer Securities in public offerings previously managed by the Joint Global Coordinators described in this Prospectus.

After the final due date, including after the close of banks on the final due date, investors will be unable to pay the purchase price in accordance with the payment instructions. The Selling Shareholders will, without warning or notification, invalidate allocations which remain uncollected at the end of the final due date and is then entitled to retain Offer Securities which have not been paid for or sell them to a third party at a price decided by the Selling Shareholders. However, if the Selling Shareholders are unable to sell the unpaid Offer Securities to another person at the same or higher price than they were allocated in the Offering, the Selling Shareholders reserve the right to demand that the investor to whom the Offer Securities were originally allocated pay the difference between the sale value of the Offer Securities without the investor being entitled to any compensation in the form of Offer Securities or other valuables. The Selling Shareholders reserve the right not to invalidate unpaid orders and to collect allocations which are not paid satisfactorily and in such case penalty interest from the final due date in addition to the Selling Shareholders' collection costs are added to the purchase price of the uncollected Offer Securities. If payment is not made at the correct time (i.e., on the final due date at the latest) and in the correct manner (i.e., in full compliance with the payment instructions) the debt may be collected, through Icelandic or Swedish courts if applicable, in accordance with the applicable principles of contract law.

The Joint Global Coordinators are responsible for collection and the settlement of all transactions of the Selling Shareholders in connection with the Offering. No special costs will be imposed on the investor in respect of the transaction by the Selling Shareholders, the Joint Global Coordinators or the Bank. Investors are urged to consider whether any costs or fees will be charged by other parties in connection with the transaction.

The Selling Shareholders and the Joint Global Coordinators reserve the right to demand confirmation of the investor's ability to pay and/or collateral for payment from investors before the end of any deadline set by the Joint Global Coordinators. The Joint Global Coordinators have sole discretion to decide whether confirmation of ability to pay and/or collateral is sufficient.

Neither the Bank nor the Selling Shareholders are aware that individual shareholders or members of the Board of Directors or Executive Committee of the Bank intend to purchase shares in the Offering or whether any investor intends to purchase more than 5% of the Offering.

The Bank's employees and persons closely related to employees may participate in the Offering, subject to its rules on dealing for personal account, and such orders should be submitted before 4:00 p.m. GMT on 2 June 2018. Subscriptions submitted by employees, members of the Board of Directors (including Alternative Directors) of the Bank (including subsidiaries), Kaupskil and Kaupthing, in the amount of ISK 3 million purchase value or less, will not be reduced in the event of oversubscription in the Offering. The amount of the subscriptions from the aforementioned persons exceeding ISK 3 million may be accorded some priority at the sole discretion of the Selling Shareholders and the Bank.

Admission of the Offer Securities to Trading

The Board of Directors of Arion Bank has submitted an application for all Shares in the Bank to be admitted to trading on the regulated market of NASDAQ Iceland and for up to 2,000,000,000 SDRs to be admitted to trading on the regulated market of NASDAQ Stockholm. Following the FME's scrutiny and approval of the Prospectus, NASDAQ Iceland and NASDAQ Stockholm will conduct a final review of the Bank's application and make their conclusions public in the European Economic Area. The Bank believes it satisfies all of the requirements for admission to trading pursuant to the requirements of both NASDAQ Iceland and NASDAQ Stockholm. If admitted to trading, the Shares' ticker symbol in the trading system of the NASDAQ Iceland will be ARION and the SDRs' ticker symbol in the trading system of the NASDAQ Stockholm will be ARIONs.

It is expected, although no guarantee can be given to that effect, that NASDAQ Iceland and NASDAQ Stockholm will admit the Offer Securities to trading on their regulated market. If the Offer Securities will be admitted to trading, the first day of trading in the Offer Securities will be announced by NASDAQ Iceland and NASDAQ Stockholm with a minimum of one business day's notice.

The Bank bears all cost associated with the admittance of the Offer Securities to trading. The total cost borne by the Bank is estimated to be ISK 1 billion and consists of costs associated with the scrutiny and approval of the Prospectus, the NASDAQ Iceland and NASDAQ Stockholm listing fees, fees to the advisors along with other cost directly associated with the admittance to trading. The Selling Shareholders bear all costs associated with the marketing and selling of the Offer Securities.

Public Offering in Iceland

In respect of the public offering of the Offer Securities in Iceland, applications for acquisition of Shares should be made with Arion Bank as described below. Applications for acquisition of SDRs must be made only in person at the office of Arion Bank at Borgartún 19, 105 Reykjavík, Iceland.

The maximum size of orders is restricted to Offer Securities with a purchase value of ISK 15,000,000 and the minimum size of orders is restricted to Offer Securities with a purchase value of ISK 150,000.

Application

Orders shall be registered electronically on a special order form via the website of Arion Bank at www.arion.is/ipo. Orders of Shares will not be accepted in any other format. The order form will be available in Icelandic and English. Separate arrangements must be made with Arion Bank at its office at Borgartún 19, 105 Reykjavík, Iceland, in respect of any orders to acquire SDRs in the public offering in Iceland.

In order to submit an order for Shares, investors have to register to the order website, through any of the following user identification numbers:

(1) electronic identification number on a smartphone;

(2) user identification number to Arion Bank's online bank;

(3) identification number or password which was requested through the order website and will be sent as a digital document to the investor's online bank, which may be in any Icelandic retail bank; or

(4) identification number and password which can be obtained from Arion Bank by signing a witnessed application for a password or by any other method of verification which Arion Bank considers satisfactory.

Electronic confirmation from the order website is required as valid proof of order or cancellation of order. Such confirmation will appear at the end of the registration process and also sent to the e-mail address provided by the investor.

Investors are entitled to change an order which they have confirmed and delivered on the order form in the Offering during the Offer period, by submitting an additional order or cancelling an order already submitted. All orders that have not been cancelled during the Offer period are binding for the respective investor at the end of the Offer period. Orders must be completed by the investors themselves or a person who has the required authority or power of attorney from the investor. A person completing an order on the basis of power of attorney shall, should the power of attorney not be recognised by the principal, be deemed to have delivered the order in his/her own name. Participation in the Offering is open to persons (individuals as well as legal entities) legally competent to manage their financial affairs and has the power to decide over their financial estate, with restrictions that may be imposed by law. The above conditions stipulate that if the person's estate has been declared bankrupt and such proceedings have not been completed before the end of the offer period, that person may not participate in the Offering. Persons who are not otherwise legally competent to manage their financial affairs may not participate in the Offering.

Orders will be deemed to be a request for a service regarding execution only, as per Article 16 (4) of the Securities Transactions Act and that the Joint Global Coordinators are not obliged to assess whether participating in the Offering and buying Offer Securities in the Issuer is suitable for the investor and the investor does not enjoy protection in accordance with Article 16 of the Securities Transactions Act.

By the order form investors must declare that they have agreed to the terms of the Offering as set out in this Prospectus, read the information in this Prospectus, read and understood the information on Arion Bank's rules on conflicts of interest and they are aware of the conflicts of interest specified in the Prospectus and confirm that their participation in the Offering does not violate Icelandic law.

Financial institutions which offer asset management services pursuant to Article 3 (6.c) of Act No. 161/2002 on Financial Undertakings are granted certain exemptions with respect to subscriptions in the Icelandic retail offering. They are given the opportunity to submit subscriptions on behalf of investors on a special subscription form which can be obtained from Arion Bank. A precondition for such a subscription is that Arion Bank has received a satisfactory statement from a financial institution, on a form that can be obtained from the Bank, stating that it has the required authority or power of attorney from the investor in accordance with authority provided in a valid asset management agreement with the investor and a statement saying that the financial institution guarantees the payment of the purchase price. The financial institution shall specify in such subscriptions whether it wants to receive a bill for the price paid by the investor or whether it wants the price paid to be deposited into the custody account of the investor at Arion Bank. It is a precondition of the latter alternative that the investor has a custody account at Arion Bank. Cancellation of subscriptions submitted by financial institutions as described above must be communicated to Arion Bank by e-mail, utbod-eignastyringar@arionbanki.is.

Investors in the public offering in Iceland can obtain information on the Offering and the order website from Arion Bank at tel. +354 444-7000 or arion-utbod@arionbanki.is. Investors can obtain this information by phone or e-mail between 9:00 a.m. and 4:00 p.m. during the offer period.

Allocation

Allocation is expected to take place on 15 June 2018. Shortly thereafter, a notification will be sent to those investors that have received allocation in the Offering. Those persons who have not been allotted Offer Securities will not be notified. The information on allocation to participants in the public offering in Iceland and payment instructions regarding allocated Offer Securities will be sent to the e-mail address specified by the investor in the order form. Investors are responsible for ensuring that the e-mail address provided is valid and able to receive the necessary documentation.

In the event of oversubscription in the Offering, allocation may take place with a lower number of Offer Securities than the application concerns, at which the sole discretion of the Selling Shareholders (which means that the Selling Shareholders, the Bank or the Joint Global Coordinators are not obliged to reveal how the reduction or rejection was decided and the counterparty will not be given the opportunity to object to the decision or its application). Allocation to those persons receiving Offer Securities will occur, in the first place, so that a certain number of Offer Securities are allotted per application. In addition thereto, allocation in respect of the public offering in Iceland takes place with a certain, same-for-all percentage share of the excess number of Offer Securities that the application concerns.

Subscriptions submitted by employees, members of the Board of Directors (including Alternative Directors) of the Bank (including subsidiaries), Kaupskil and Kaupthing, in the amount of ISK 3 million purchase value or less, will not be reduced in the event of oversubscription in the Offering. The amount of the subscriptions from the aforementioned persons exceeding ISK 3 million may be accorded some priority at the sole discretion of the Selling Shareholders and the Bank.

Payment

Payment will not be accepted by any other means than those stated in the above mentioned payment instructions. Full payment must be made no later than on final due date as stated in the payment instructions, expected to be on 19 June 2018.

Payment shall be made at the latest before the closing time of banks in Iceland on the final due date. Note that the general opening hours of banks and other financial institutions is until 4:00 p.m. on weekdays and that after 4:15 p.m. it is not possible to make a payment exceeding ISK 10 million, however lower payments are possible via online banks until 9:00 p.m., provided that the amount is below other limits which may apply.

Registration of Allotted and Paid-up Offer Securities

Offer Securities will be delivered to the buyer when satisfactory payment has been received from the investor with delivery taking place one business day after payment has been received, at the latest. Shares will be delivered electronically via Nasdaq CSD Iceland. Arion Bank will request that the custodian, the investor specifies in its subscription, deposits the Shares in a custody account held by the investor with the custodian. Separate arrangements must be made with Arion Bank in respect of delivery of any SDRs acquired in the public offering in Iceland.

If the investor does not own a custody account with the custodian specified in the subscription, Arion Bank will open a custody account in the name of the investor at Arion Bank (and at the Nasdaq CDS Iceland) so that it is possible to deposit the investor's Shares in a custody account in accordance with the above and the Bank reserves the right to collect a fee from the investor for storing the Shares as per Arion Bank's list of fees and charges, which can be found on its website, https://www.arionbanki.is/english/individuals/information/rates/. The investor will not be able to trade or move the Shares delivered into the custody account opened as described above in their name unless they have already provided the material and information requested by Arion Bank to open a custody account.

Public Offering in Sweden

In respect of the public offering of the SDRs in Sweden, applications for acquisition of SDRs should be made with Carnegie or Nordnet Bank and Avanza Bank as selling agents as described below. The maximum size of orders is restricted to SDRs with a purchase value of SEK 1,000,000 and the minimum size of orders is restricted to SDRs with a purchase value of SEK 10,000. If more than one application form is submitted by the same applicant, only the first form registered will be considered.

Application via Carnegie

Applicants applying to acquire SDRs with Carnegie via the Offering must have a securities account or an investment savings account with Carnegie. As regards customers with an investment savings account with Carnegie, if the application results in allotment, Carnegie acquires a corresponding number of SDRs in the Offering and sells the SDRs to the customer at the Offer Price. Application can be made through contact with the customer's adviser at Carnegie.

Application via Nordnet Bank

Custody account holders and internet customers at Nordnet Bank can submit applications via Nordnet Bank's Internet service. Instructions are available on http://www.nordnet.se. Applications via Nordnet Bank's Internet service may be made commencing 31 May 2018 up to and including 13 June 2018.

Application via Avanza Bank

Custody account holders and internet customers at Avanza Bank can submit applications via Avanza Bank's Internet service. Instructions are available on http://www.avanza.se. Applications via Avanza Bank's Internet service may be made commencing 31 May 2018 up to and including 13 June 2018.

Allocation

Allocation is expected to take place on 15 June 2018. Shortly thereafter, a contract note will be sent to those investors that have received allocation in the Offering. Those persons who have not been allotted SDRs will not be notified.

In the event of oversubscription in the Offering, allocation may take place with a lower number of SDRs than the application concerns, at which allocation will be at the sole discretion of the Selling Shareholders and the Bank. Allocation to those persons receiving SDRs will occur, in the first place, so that a certain number of SDRs are allotted per application. In addition thereto, allocation in respect of the public offering in Sweden takes place with a certain, same-for-all percentage share of the excess number of SDRs that the application concerns and will only take place in even lots of 2,000 SDRs. Allocation may also be made to employees of the Managers, however, without them being prioritised. In such cases, the allocation takes place in accordance with the rules of the Swedish Securities Dealers Association (Sw. *Svenska Fondhandlarföreningen*) and the FSA's regulations.

Payment for Shares allotted via Carnegie

Custody account customers and customers with an investment savings account at Carnegie can be expected to have their allotted but not yet paid for SDRs available on a designated securities account or investment savings account on 15 June 2018. Funds for payment must be available on the designated custody account or investment savings account on 19 June 2018.

Payment for shares allotted via Nordnet Bank

Custody account customers at Nordnet Bank can be expected to have their allotted but not yet paid for shares available on their securities account on 15 June 2018. Funds for payment for allotted shares must be available on the securities account during the period commencing 13 June 2018 up to and including 23:59 CEST on the settlement date, 19 June 2018.

Payment for shares allotted via Avanza Bank

Custody account customers at Avanza Bank can be expected to have their allotted but not yet paid for shares available on their securities account on 15 June 2018. Funds for payment for allotted shares must be available on the securities account during the period commencing 13 June 2018 up to and including 23:59 CEST on the settlement date, 19 June 2018.

Registration of Allotted and Paid-up SDRs

Registration with Euroclear Sweden of allotted and paid-up SDRs is expected to take place on or about 19 June 2018, after which Euroclear Sweden will distribute a notice stating the number of SDRs that have been registered in the recipient's securities account. Shareholders whose holdings are nominee-registered will be notified in accordance with the procedures of the respective nominee.

Additional Information on Nominee Accounts and the SDRs Registered with Euroclear Sweden

All of the Shares are issued electronically at Nasdaq CSD Iceland and are registered with Nasdaq CSD Iceland under the name of the relevant shareholder. The SDRs are registered with Euroclear Sweden. The registered address of Euroclear Sweden is Box 191, 101 23 Stockholm, Sweden. The registered address of Nasdaq CSD Iceland is Laugavegur 182, 105 Reykjavík, Iceland.

Act No. 33/2003 on Securities Transactions, the Electronic Registration of Title to Securities Act and the Public Limited Companies Act govern nominee accounts. Article 31 of the Public Limited Companies Act provides that persons who own shares cannot exercise their rights, unless the ownership has been registered in the share register. This does not include the right to dividends or other payments and the right to new shares in the case of a new share issue. According to Article 31 of the Public Limited Companies Act, a shareholder does not have voting rights at a meeting of the shareholders, unless such shareholder is registered in the share register. The same applies to financial institutions which are registered as nominees, as the shareholder does not have the right to issue a proxy to exercise the voting right. Therefore, shares held by a nominee do not give the beneficial owner the right to vote at the meetings of shareholders. If a shareholder who holds the Shares in a nominee account wishes to exercise the voting right at a meeting of the shareholders, such shareholder is required to notify Arion Bank's share registry, so that the Shares can be moved from the nominee account and registered under the name of such shareholder.

Arion Bank has the right to obtain information from Euroclear Sweden regarding the holders of the Shares registered with Euroclear Sweden, including information on the number of the Shares held by each shareholder. Shareholders who wish to trade their shares on NASDAQ Iceland are required to register the Shares with Nasdaq CSD Iceland in a securities account in their name or in a nominee account other than the one holding the Shares registered with Euroclear Sweden.

According to the Central Securities Depositories and Financial Instruments Accounts Act (SFS 1998:1479), only shares registered with Euroclear Sweden may be traded on NASDAQ Stockholm. Euroclear Sweden operates under the supervision of the FSA as a central securities depository and clearing organisation. Holders of SDRs who have the SDRs registered with Euroclear Sweden and want to trade such SDRs on NASDAQ Iceland are required to deregister their SDRs with Euroclear Sweden. In such deregistration, the Shares will be transferred either to a custodian or to a securities account at an Icelandic account operator. A fee of approximately ISK 36,000 per conversion is charged independently of the number of SDRs deregistered. Shares that can be traded on NASDAQ Iceland and, therefore, are not registered with Euroclear Sweden, may not be traded on NASDAQ Stockholm until they have been registered with Euroclear Sweden again as SDRs.

PLAN OF DISTRIBUTION AND TRANSFER RESTRICTIONS

Plan of Distribution

On 31 May 2018, the Bank, the Selling Shareholders and the Managers entered into a placing agreement (the "**Placing Agreement**") with respect to the Offer Securities to be offered and sold by the Selling Shareholders in the Offering. Subject to certain conditions set forth in the Placing Agreement, the Selling Shareholders has agreed to sell to the purchasers procured by the Managers or, failing which, to the Underwriters (comprising the Managers other than Fossar Markadir hf.), and each of the Managers, severally, has agreed to procure purchasers for, or failing such procurement, each of the Underwriters has agreed to purchase from the Selling Shareholders, as the case may be, the percentage of the Offer Securities listed opposite such Underwriter's name below.

Manager	Percentage Offered in the Offering
Morgan Stanley & Co. International plc	31.25%
Citigroup Global Markets Limited	23.08%
Carnegie Investment Bank AB (publ)	16.83%
Arion banki hf.	5.77%
Deutsche Bank AG, London Branch	12.02%
Goldman Sachs International	5.77%
Svenska Handelsbanken AB (publ)	3.37%
Fossar Markadir hf.(1)	—
Íslandsbanki hf.	0.96%
Landsbankinn hf.	0.96%
Total	**100.0%**

(1) Fossar Markadir hf. is acting as Manager but not Underwriter.

The Placing Agreement provides that the obligations of the Managers to procure purchasers for, or failing which, for the Underwriters to purchase, the Offer Securities are subject to certain conditions and may be subject to termination by the Managers under certain customary circumstances pursuant to the Placing Agreement. If the Managers elect to terminate their several commitments, the Offering may be cancelled and, if cancelled, no Offer Securities will be delivered.

The Placing Agreement provides that the Bank will indemnify the Managers against certain liabilities and related costs or will contribute to payments that the Managers may be required to make because of any such liabilities. Pursuant to the Placing Agreement, the Selling Shareholders will grant to the Managers an Over-Allotment Option, which is exercisable by the Managers on one or more occasions in whole or in part for a period of 30 days following the first day of trading in the Shares on NASDAQ Iceland or NASDAQ Stockholm, to procure purchasers for, or failing which, to purchase up to 108,600,000 additional Over-Allotment Shares (equal to 15% of the total number of the Existing Offer Shares and the SDRs to be sold in the Offering) at the Offer Price on the closing date of the Over-Allotment Option (less agreed commissions). If the Over-Allotment Option is exercised, each Manager will be obligated, subject to certain conditions set forth in the Placing Agreement, to procure purchasers for, or failing which, to purchase a number of Over-Allotment Shares proportionate to such Manager's initial percentage of Offer Securities reflected in the table above, and the Selling Shareholder will be obligated to sell the Over-Allotment Shares.

In connection with the Over-allotment Option, Citigroup Global Markets Limited, as Stabilising Manager, expects to enter into a stock lending agreement with either the Bank or Kaupskil, depending on the number of Offer Securities to be sold in the Offering, on or around the date the Offer Price is determined. Pursuant to this agreement, the Stabilising Manager will be able to borrow Shares representing up to a maximum of 15% of the total number of Offer Securities (excluding the Offer Securities subject to the Over-allotment Option) for the purposes, amongst other things, of allowing the Stabilising Manager to settle, on the date of respective commencement of unconditional trading in the Shares and SDRs on NASDAQ Iceland and NASDAQ Stockholm, over-allotments, if any, made in connection with the Offering. If the Stabilising Manager borrows any Shares pursuant to the stock lending agreement, it will be required to return equivalent Shares to the Bank by no later than the third business day after the date that is the 30th day after the commencement of conditional trading of the Offer Securities.

The Underwriters will receive a commission of up to 3.41% (comprising a base commission of 2.08% and a discretionary commission of 1.33%) of the gross proceeds from the Offering, including the sale of any

Over-Allotment Shares. Fossar Markadir hf. will be entitled to a fee in its role as Manager of 0.04% of the gross proceeds from the Offering, including the sale of any Over-Allotment Shares, plus a discretionary commission. Payment of any discretionary commission will be at the sole discretion of the Selling Shareholders. The Bank estimates that the total fees and expenses of the Offering payable by the Selling Shareholders to be up to approximately ISK 1.474 million assuming that the Over-Allotment Option is not exercised, the number of Existing Offer Shares and SDRs sold is the mid-point between 22.63% and 36.20% of the total number of issued Shares and the Offer Price is set at the mid-point of the Offer Price Range.

Application has been made to admit the Shares for trading on NASDAQ Iceland and the SDRs for trading on NASDAQ Stockholm, and conditional trading in the Offer Securities is expected to commence on or about 15 June 2018, *provided that* the announcement of the Offer Price and allocation has been published through NASDAQ Iceland no later than 10:30 a.m. (GMT) on 15 June 2018 and through NASDAQ Stockholm no later than 12:30 p.m. (CEST) on 15 June 2018.

The admission to listing and trading of the Shares on NASDAQ Iceland is subject to, among other things, NASDAQ Iceland's approval of the distribution of the Existing Offer Shares. The admission to listing and trading of the SDRs on NASDAQ Stockholm is subject to, among other things, NASDAQ Stockholm's approval of the distribution of the SDRs. The Offer Securities are expected to be delivered to investors' accounts on or about 19 June 2018. The Offer Securities will be accepted for delivery to investors' securities accounts with Nasdaq CSD Iceland or Euroclear Sweden, as the case may be, against payment in immediately available funds. All dealing in the Offer Securities prior to settlement will be for the account and at the sole risk of the parties involved.

The Offer Price is expected to be announced no later than 15 June 2018. Prior to the Offering, there has been no public market for the Shares. No assurance can be given that an active trading market will develop for the Shares or that the Shares will trade in the public market after the Offering at or above the Offer Price. See "*Risk Factors—Risks Relating to the Offering and the Shares—The market price of the Shares may fluctuate and may decline below the Offer Price*".

In connection with the Offering, the Managers and any affiliates acting as investors for their own account may take up the Offer Securities and in that capacity may retain, purchase or sell the Offer Securities for their own account and may offer or sell Shares otherwise than in connection with the Offering, in each case, in accordance with applicable law. The Managers do not intend to disclose the extent of any such investment or transaction otherwise than in accordance with any legal or regulatory obligation to do so.

No action has been or will be taken in any jurisdiction other than Iceland and Sweden that would permit a public offering of the Offer Securities, or the possession, circulation or distribution of this Prospectus or any other material relating to the Bank or the Offer Securities in any jurisdiction where action for that purpose is required. Accordingly, the Offer Securities may not be offered or sold, directly or indirectly, and neither this Prospectus nor any other offering material or advertisement in connection with the Offer Securities may be distributed or published, in or from any country or jurisdiction except in compliance with any applicable rules and regulations of such country or jurisdiction.

The distribution of this Prospectus or any offering material and the offer, sale or delivery of the Offer Securities is restricted by law in certain jurisdictions. Therefore, persons who may come into possession of this Prospectus or any offering material are advised to consult with their own legal advisors as to what restrictions may be applicable to them and to observe such restrictions. This Prospectus may not be used for the purpose of an offer or invitation in any circumstances in which such offer or invitation is not authorised. See "*—Selling and Transfer Restrictions*".

The Bank will agree that it will not, without the prior written consent of the Managers, during the period ending 180 days after the first official day of trading of the Offer Securities on NASDAQ Iceland or NASDAQ Stockholm, (i) offer, pledge, allot, issue, sell, contract to sell, sell any option or contract to purchase, purchase any option to sell, grant any option, right or warrant to purchase, or otherwise transfer or dispose of, directly or indirectly, any Shares or any convertible into or exercisable or exchangeable for the Shares or (ii) enter into any swap or other arrangement that transfers to another, in whole or in part, the economic risk of ownership of the Shares, whether any such transaction described above is to be settled by delivery of the Shares or other securities, in cash or otherwise, or (iii) publicly announce such an intention to effect any such transaction.

Each of the Selling Shareholders will agree that it will not, without the prior written consent of the Managers, such consent not to be unreasonably withheld or delayed taking into account the purpose of the lock-up arrangement, during the period ending 180 days after the first official day of trading of the Offer Securities on NASDAQ Iceland or NASDAQ Stockholm, (i) offer, pledge, allot, issue, sell, contract to sell, sell any option or contract to purchase, purchase any option to sell, grant any option, right or warrant to purchase, or otherwise transfer or dispose of, directly or indirectly, any Shares or any securities convertible into or exercisable or exchangeable for the Shares or (ii) enter into any swap or other arrangement that transfers to another, in whole or in part, the economic risk of ownership of the Shares, or try to take any such measures, whether any such transaction described above is to be settled by delivery of the Shares or other securities, in cash or otherwise, or (iii) publicly announce such an intention to effect any such transaction. In respect of Trinity Investments Designated Activity Company and ELQ Investors II Ltd., such lock-up arrangement shall not apply to any Shares each holds in excess of 10.44% and 2.57%, respectively, of the issued share capital of the Bank (being the proportion of the issued share capital which each held prior to the Second Private Placement).

Furthermore, each of the Selling Shareholders will agree that it will not, without the prior written consent of the Managers, such consent not to be unreasonably withheld or delayed taking into account the purpose of the lock-up arrangement, during the period ending 180 days after the first official day of trading of the Offer Securities on NASDAQ Iceland or NASDAQ Stockholm, propose at any general meeting of the Bank, or convene or take any action to convene any general meeting for the purposes of proposing, any resolution of the Bank authorising any of the actions or matters referred to in the paragraph above or vote for any such resolution.

Prior to the Offering, there has been no public market for the Shares. The Offer Price will be determined by Kaupskil, following consultation with the Managers, on the basis of a number of factors, including the following:

1. the orders, in terms of price and quantity, received from potential institutional and retail investors;
2. the prevailing market conditions;
3. the Bank's historical, operational and financial performance;
4. estimates of the Bank's business potential and earning prospects; and
5. the market valuation of publicly traded common stock of comparable companies.

The Managers and their affiliates have engaged in transactions with and performed various investment banking, commercial banking and other services for the Bank, the Selling Shareholders and their respective subsidiaries and affiliates in the past and may do so from time to time in the future and may be paid fees in connection with such services from time to time. However, all services provided by the Managers, including in connection with the Offering, have been provided as an independent contractor and not as a fiduciary to the Bank or the Selling Shareholders. See "*Presentation of Financial and Other Information—Potential Conflict of Interest*".

In connection with the Offering, Citigroup Global Markets Limited, as Stabilising Manager, or any of its agents may (but will be under no obligation to), to the extent permitted by applicable law, over-allot Shares and/or SDRs or effect other transactions with a view to supporting the market price of the Shares and/or SDRs at a higher level than that which might otherwise prevail in the open market. The Stabilising Manager is not required to enter into such transactions and such transactions may be effected on any securities market, over-the-counter market, stock exchange or otherwise and may be undertaken at any time during the period commencing on the first day of trading in the Shares and SDRs on NASDAQ Iceland or NASDAQ Stockholm and ending no later than 30 calendar days thereafter. However, there will be no obligation on the Stabilising Manager or any of its agents to effect stabilising transactions, and no assurance can be given that stabilising transactions will be undertaken. Such stabilisation, if commenced, may be discontinued at any time without prior notice. In no event will measures be taken to stabilise the market price of the Shares and/or SDRs above the Offer Price. Except as required by law or regulation, neither the Stabilising Manager nor any of its agents intends to disclose the extent of any over-allotments made and/or stabilisation transactions conducted in relation to the Offering.

Cornerstone Investments

Miton Asset Management Limited and Lansdowne Partners (UK) LLP, as Cornerstone Investors, have each agreed to acquire at the Offer Price (and at any such price throughout the Offer Price Range) a number of Offer Securities equivalent to US$ 22.5 million and US$ 38.0 million, respectively, converted into ISK at the mid-rate of the Icelandic Central Bank on, in the case of Miton, the date the Offer Price is set and, in the case of Lansdowne, 30 May 2018. The Cornerstone Investors' undertakings are conditional on, among other things, commencement of unconditional trading of the Offer Securities occurring no later than 29 June 2018. If such conditions are not satisfied, the Cornerstone Investors will not be required to acquire any Offer Securities. In addition, the Cornerstone Investors' undertakings have not been secured through a bank guarantee, blocked funds, pledge of collateral or similar arrangement. The Cornerstone Investors will not be subject to a lock-up in respect of their allocations.

Selling and Transfer Restrictions

No action has been or will be taken in any jurisdiction other than Iceland and Sweden that would permit a public offering of the Offer Securities, or the possession, circulation or distribution of this Prospectus or any other material relating to the Bank or the Offer Securities in any jurisdiction where action for that purpose is required. The distribution of this Prospectus and the offer of the Offer Securities in certain jurisdictions may be restricted by law.

Persons into whose possession this Prospectus comes should inform themselves about and observe any such restrictions, including those in the paragraphs that follow. Any failure to comply with these restrictions may constitute a violation of the securities laws of any such jurisdictions.

United States

The Offer Securities have not been and will not be registered under the U.S. Securities Act or with any securities regulatory authority of any state of the United States for offer or sale as part of their distribution and may not be offered or sold within the United States unless the Offer Securities are registered under the U.S. Securities Act or an exemption from the registration requirements of the U.S. Securities Act is available. In the United States, the Offer Securities will be sold only to persons reasonably believed to be QIBs as defined in, and in reliance on, Rule 144A under the U.S. Securities Act or pursuant to another exemption from, or in a transaction not subject to, the registration requirement under the U.S. Securities Act and applicable state securities laws. All offers and sales of the Offer Securities outside the United States will be made in compliance with Regulation S under the U.S. Securities Act and in accordance with applicable law.

In addition, until the end of the 40th calendar day after commencement of the Offering, an offer or sale of the Offer Securities within the United States by a dealer that is not participating in the Offering may violate the registration requirements of the U.S. Securities Act if such offer or sale is made otherwise than in accordance with Rule 144A under the U.S. Securities Act.

The Offering of the Offer Securities is being made in the United States through U.S. broker-dealer affiliates of the Managers.

Notice to U.S. Investors

Each purchaser of the Offer Securities within the United States will be deemed to have represented and agreed as follows:

A. the purchaser is authorised to consummate the purchase of the Offer Securities in compliance with all applicable laws and regulations;

B. the purchaser (i) is, and the time of its purchase of any Offer Securities will be, a QIB or a broker-dealer acting for the account of a QIB and (ii) is acquiring the Offer Securities for its own account or for the accounts of one or more QIBs for which it is acting as duly authorised fiduciary or agent with sole investment discretion with respect to each such account and with full authority to make the acknowledgments, representations and agreements herein with respect to each such account (in which case, it hereby makes such acknowledgements, representations and agreements on behalf of such QIBs as well), in each case, for investment and not with a view to any resale or distribution (within the meaning of the United States securities laws) of any such Offer Securities;

C. the purchaser understands and acknowledges that the Offer Securities have not been and will not be registered under the U.S. Securities Act or with any securities regulatory authority of any state of the United States and are being offered in the United States only in transactions not involving any public offering in the United States within the meaning of the U.S. Securities Act or which are exempt from the registration requirements of the U.S. Securities Act;

D. the purchaser acknowledges that sellers of the Offer Securities may be relying on the exemption from the registration requirements of Section 5 of the U.S. Securities Act provided by Rule 144A thereunder and that the Offer Securities may not be offered, sold, pledged or otherwise transferred, directly or indirectly, other than in accordance with paragraph (F) below;

E. the purchaser and each other QIB, if any, for whose account it is acquiring the Offer Securities, in the normal course of business, invests in or purchases securities similar to the securities offered hereby, has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of purchasing any Offer Securities for an indefinite period of time and is able to bear such risk for an indefinite period;

F. the purchaser has (i) conducted its own investigation with respect to the Bank and the Offer Securities, (ii) received all information that it believes is necessary or appropriate in connection with an investment in the Offer Securities and (iii) made its own assessment and has satisfied itself concerning the relevant tax, legal and other economic considerations relevant to an investment in the Offer Securities;

G. the purchaser understands and agrees that the Offer Securities may be offered, sold, delivered, hypothecated, pledged or otherwise transferred only (i) pursuant to an effective registration statement under the U.S. Securities Act, (ii) to a person whom the seller and any person acting on its behalf reasonably believe is a QIB purchasing for its own account or for the account of a QIB in a transaction meeting the requirements of Rule 144A, (iii) outside the United States, in an "offshore transaction" in compliance with Regulation S (and not in a pre-arranged transaction resulting in the resale of such Offer Securities into the United States) or (iv) in accordance with Rule 144 under the U.S. Securities Act, and, in each case, in accordance with all applicable securities laws of the United States, any state or territory thereof and any other relevant jurisdiction. The purchasers is aware that the Offer Securities are "restricted securities" within the meaning of Rule 144(a)(3) and that no representation is made as to the availability of the exemption provided by Rule 144 for resales of any Offer Securities;

H. the purchaser understands that for so long as the Offer Securities are "restricted securities" within the meaning of the U.S. federal securities laws, no such Offer Securities may be deposited into any American depositary receipt facility established or maintained by a depositary bank, other than a Rule 144A restricted depositary receipt facility, and that such Offer Securities will not settle or trade through the facilities of The Depositary Trust Company or any other United States clearing system;

I. the Bank will not recognise any offer, sale, pledge, delivery, hypothecation or other transfer of the Offer Securities made other than in compliance with the above-stated restrictions;

J. the purchaser has received a copy of this Prospectus and has had access to such financial and other information concerning the Bank as it deems necessary in connection with making its own investment decision to purchase the Offer Securities. The purchaser acknowledges that none of the Bank, the Managers or any of their respective representatives has made any representation to it with respect to the Bank or the allocation, offering or sale of any Offer Securities other than as set forth in this Prospectus, which has been delivered to it and upon which it is solely relying in making its investment decision with respect to the Offer Securities. The purchaser has held and will hold any offering materials, including this Prospectus, it receives directly or indirectly from the Bank in confidence and understands that any such information received by it is solely for it and not to be redistributed or duplicated by it;

K. the purchaser also acknowledges that it has made its own assessment regarding the U.S. federal tax consequences of an investment in the Offer Securities; and

L. the purchaser understands that these representations and undertakings are required in connection with the securities laws of the United States and acknowledges that the Bank, the Managers and their respective affiliates will rely upon the truth and accuracy of the foregoing acknowledgments, representations and agreements. The purchaser undertakes promptly to notify the Bank and the Managers if, at any time prior to the purchase of the Offer Securities, any of the foregoing ceases to be true.

Notice to Investors Outside the United States

Each purchaser of the Offer Securities outside the United States will be deemed to have represented and agreed that it has received a copy of this Prospectus and such other information as it deems necessary to make an informed investment decision and as follows:

A. the purchaser is authorised to consummate the purchase of the Offer Securities in compliance with all applicable laws and regulations;

B. the purchaser understands and acknowledges that the Offer Securities have not been, and will not be, registered under the U.S. Securities Act or with any securities regulatory authority of any state of the United States and are being offered in the United States only in transactions not involving any public offering in the United States within the meaning of the U.S. Securities Act or which are exempt from the registration requirements of the U.S. Securities Act;

C. the purchaser (and the person, if any, for whose account or benefit the purchaser is acquiring the Offer Securities) was located outside the United States at the time the buy order for the Offer Securities was originated and continues to be located outside the United States and has not purchased the Offer Securities for the account or benefit of any person in the United States or entered into any arrangement for the transfer of the Offer Securities or any economic interest therein to any person in the United States;

D. the purchaser is not an affiliate of the Bank or a person acting on behalf of such affiliate;

E. the Offer Securities have not been offered to it by means of any "directed selling efforts" as defined in Regulation S;

F. the purchaser is aware of the restrictions on the offer and sale of the Offer Securities pursuant to Regulation S described in this Prospectus;

G. the purchaser has (i) conducted its own investigation with respect to the Bank and the Offer Securities, (ii) received all information that it believes is necessary or appropriate in connection with an investment in the Offer Securities and (iii) made its own assessment and has satisfied itself concerning the relevant tax, legal and other economic considerations relevant to an investment in the Offer Securities;

H. the Bank will not recognise any offer, sale, pledge, delivery, hypothecation or other transfer of the Offer Securities made other than in compliance with the above-stated restrictions;

I. if it is acquiring any of the Offer Securities as a fiduciary or agent for one or more accounts, the purchaser represents that it has sole investment discretion with respect to each such account and that it has full power to make the foregoing acknowledgments, representations and agreements on behalf of such account;

J. the purchaser has received a copy of this Prospectus and has had access to such financial and other information concerning the Bank as it deems necessary in connection with making its own investment decision to purchase the Offer Securities. The purchaser acknowledges that none of the Bank, the Managers or any of their respective representatives has made any representation to it with respect to the Bank or the allocation, offering or sale of any Offer Securities other than as set forth in this Prospectus, which has been delivered to it and upon which it is solely relying in making its investment decision with respect to the Offer Securities. The purchaser has held and will hold any offering materials, including this Prospectus, it receives directly or indirectly from the Bank in confidence and understands that any such information received by it is solely for it and not to be redistributed or duplicated by it; and

K. the purchaser acknowledges that the Bank, the Managers and their respective affiliates will rely upon the truth and accuracy of the foregoing acknowledgments, representations and agreements and undertakes promptly to notify the Bank and the Managers if, at any time prior to the purchase of the Offer Securities, any of the foregoing ceases to be true.

European Economic Area

In relation to each Relevant Member State, no Offer Securities have been offered or will be offered pursuant to the offer to the public in such Relevant Member State prior to the publication of a prospectus in relation to the Offer Securities which has been approved by the competent authority in such Relevant Member State or, where appropriate, approved in another Relevant Member State, all in accordance with the Prospectus Directive, except that offers of the Offer Securities may be made to the public in such Relevant Member State at any time under the following exemptions under the Prospectus Directive, if they are implemented in such Relevant Member State:

- to any legal entity that is a Qualified Investor within the meaning of the Prospectus Directive;
- to fewer than 100, or if the Relevant Member State has implemented the relevant provision of the 2010 PD Amending Directive, 150 natural or legal persons in a Relevant Member State (other than Qualified Investors within the meaning of the Prospectus Directive) subject to obtaining the prior consent of the Joint Global Coordinators; or
- in any other circumstances which do not require the publication by the Company of a prospectus pursuant to Article 3(2) of the Prospectus Directive;

provided that no such offer of the Offer Securities will result in a requirement for the publication of a prospectus pursuant to Article 3 of the Prospectus Directive or of a supplement to a prospectus pursuant to Article 16 of the Prospectus Directive.

For the purposes of this provision, (a) the expression an "**offer to the public**" in relation to any Offer Securities in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the Offering and the Offer Securities so as to enable an investor to decide to purchase the Offer Securities, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Directive in such Relevant Member State, (b) the expression "**Prospectus Directive**" means Directive 2003/71/EC (with amendments thereto, including the 2010 PD Amending Directive) and includes any relevant implementing measure in each Relevant Member State and (c) the expression "**2010 PD Amending Directive**" means Directive 2010/73/EU.

United Kingdom

In the United Kingdom, this Prospectus is being distributed only to, and directed only at, Qualified Investors within the meaning of the Prospectus Directive (a) who have professional experience in matters relating to investments who fall within the definition of "investment professionals" in Article 19(5) of the Order, (b) who are high net worth entities as described in Article 49(2)(a) to (d) of the Order or (c) other persons to whom it may lawfully be communicated (all such persons being referred to in (a), (b) and (c) are collectively Relevant Persons). In the United Kingdom, any investment or investment activity to which this Prospectus relates is only available to, and will only be engaged in with, Relevant Persons. Any other persons who receive this Prospectus should not rely on or act upon it.

If any Offer Securities are offered to a financial intermediary as such term is used in Article 3(2) of the Prospectus Directive, such financial intermediary will be deemed to have represented, acknowledged and agreed that the Offer Securities acquired by it in the Offering have not been acquired on a non-discretionary basis on behalf of, nor have they been acquired with a view to their offer or resale to, persons in circumstances which may give rise to an offer of any Offer Securities to the public other than their offer or resale in a Relevant Member State to a Qualified Investor within the meaning of the Prospectus Directive as so defined or in circumstances in which the prior consent of the Joint Global Coordinators has been obtained to each such proposed offer or resale. The Bank, the Selling Shareholders, the Managers and their affiliates, and other persons will rely upon the truth and accuracy of the foregoing representation, acknowledgement and agreement.

Canada

The Offer Securities may be sold in Canada only to purchasers purchasing, or deemed to be purchasing, as principal that are accredited investors, as defined in National Instrument 45-106 *Prospectus Exemptions* or subsection 73.3(1) of the *Securities Act* (Ontario), and are permitted clients, as defined in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*. Any resale of the Offer Securities must be made in accordance with an exemption from, or in a transaction not subject to, the prospectus requirements of applicable securities laws.

Securities legislation in certain provinces or territories of Canada may provide a purchaser with remedies for rescission or damages if this Prospectus (including any amendment thereto) contains a misrepresentation, provided that the remedies for rescission or damages are exercised by the purchaser within the time limit prescribed by the securities legislation of the purchaser's province or territory. The purchaser should refer to any applicable provisions of the securities legislation of the purchaser's province or territory for particulars of these rights or consult with a legal advisor.

Pursuant to section 3A.3 of National Instrument 33-105 *Underwriting Conflicts* ("**NI 33-105**"), the Managers are not required to comply with the disclosure requirements of NI 33-105 regarding underwriter conflicts of interest in connection with this offering.

Transfer Restrictions for SDRs

Each purchaser of SDRs, by its acceptance of delivery of this Prospectus and the SDRs, will be deemed to have represented, agreed and acknowledged as follows:

A. The purchaser is aware that the SDRs are "restricted securities" as defined in Rule 144(a)(3) under the U.S. Securities Act.

B. In the future, if the purchaser decides to offer, resell, pledge or otherwise transfer the SDRs, such SDRs may be offered, sold, pledged or otherwise transferred only (i) pursuant to an effective registration statement under the U.S. Securities Act, (ii) to a person whom the seller and any person acting on its behalf reasonably believe is a QIB purchasing for its own account or for the account of a QIB in a transaction meeting the requirements of Rule 144A, (iii) outside the United States, in an "offshore transaction" in compliance with Regulation S (and not in a pre-arranged transaction resulting in the resale of such SDRs into the United States) or (iv) in accordance with Rule 144 under the U.S. Securities Act, and, in each case, in accordance with all applicable securities laws of the United States, any state or territory thereof and any other relevant jurisdiction. The purchaser will, and each subsequent holder is required to, notify any subsequent purchaser from it of the SDRs of the resale restrictions referred to in (ii) and (iii) above.

C. The Bank, Kaupskil, the Managers and their affiliates and others will rely upon the truth and accuracy of the foregoing acknowledgements, representations and agreements.

DEFINITIONS AND GLOSSARY

2010 PD Amending Directive	Directive 2010/73/EU
ABMIIF	Arion Mortgages Institutional Investor Fund, an institutional investment fund, the business of which is to acquire loans and their related security pursuant to the terms of mortgage sale agreements to guarantee Arion Bank's covered bonds
ACC	Arion Credit Committee
AFL	AFL-sparisjódur, a savings bank in which the Bank acquired a 100% shareholding in September 2015 and which was subsequently merged into the Bank in October 2015
Agricultural Bank of Iceland	Bunadarbanki Islands hf.
ALCO	Asset and Liability Committee, which is responsible for managing any asset liability mismatches, liquidity risk, market risk, interest rate risk and capital management
Alternate Directors	Alternate directors to the Board of Directors who attend a meeting of the Board of Directors if a regular member resigns or is unable to attend
AML Act	Act No. 64/2006 on Measures to Combat Money Laundering and the Financing of Terrorist Activities
Annual Accounts Act	Act No. 3/2006 on Annual Accounts, as amended
Annual Financial Statements	Audited consolidated financial statements prepared in accordance with IFRS and additional requirements in the Annual Accounts Act, the Financial Undertakings Act and rules No. 532/2003
Annual General Meeting	Annual general meeting of Arion Bank's shareholders
Arion Bank, Bank or Group	Arion Banki hf., a public limited company established under the laws of the Republic of Iceland, and its consolidated subsidiaries, unless the context otherwise requires
Articles of Association	The articles of association of Arion Bank
ASF	Amount of available stable funding calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness
ATMs	Automated teller machines
Bakkavor	Bakkavor Group Limited
Bank, Arion Bank or Group	Arion Banki hf., a public limited company established under the laws of the Republic of Iceland, and its consolidated subsidiaries, unless the context otherwise requires
Bank Levy	Annual levy imposed by the Parliament of Iceland in December 2010, currently calculated at 0.376% of the Bank's total debt, excluding liabilities in excess of ISK 50.0 billion
BCC	Board Credit Committee, which decides on all major credit risk exposures
BIN	Bank identification number, which uniquely identifies the institution issuing the credit card
Board or **Board of Directors**	Board of directors of Arion Bank
BRRD	Bank Recovery and Resolution Directive, a European-wide framework not yet implemented in Iceland for the recovery and resolution of credit institutions

and investment firms which sets out a set of tools available to competent authorities to intervene sufficiently early and quickly in unsound or failing banks so as to ensure the continuity of such banks' critical financial and economic functions while minimising the impact of such banks' failure on the economy and financial system

CAGR	Compound annual growth rate
Capital Controls	Capital controls introduced by the Parliament of Iceland in November 2008 with the view of stabilising the foreign exchange rate of Icelandic Krona and currently set out in the Foreign Exchange Act, which were largely lifted as of March 2017
CCC	Corporate Credit Committee
Central Bank or **Icelandic Central Bank**	Central Bank of Iceland (*Sedlabanki Íslands*)
CEO	Chief executive officer of Arion Bank
Code	U.S. Internal Revenue Code of 1986, as amended
Co-Lead Managers	Svenska Handelsbanken AB (publ), Fossar Markadir hf., Íslandsbanki hf. and Landsbankinn hf.
Competition Act	Competition Act No. 44/2005, as amended
Cornerstone Investors . . .	Miton Asset Management Limited and Lansdowne Partners (UK) LLP
Cornerstones	Arion Bank's core values introduced in 2012
Corporate Governance Guidelines	Fifth edition of the Icelandic Guidelines on Corporate Governance issued by the Iceland Chamber of Commerce, SA—Business Iceland and NASDAQ Iceland
CPI	Consumer Price Index, a measure which examines the weighted average of prices of a basket of consumer goods and services in order to track inflation
CRA Regulation	Regulation (EC) No. 1060/2009 (as amended), under which Standard & Poor's is established in the European Union as a credit rating agency
CRD IV	Capital Requirements Directive IV, an legislative package in the European Union covering prudential rules for banks, building societies and investment firms which implements the Basel III agreement and strengthens bank capital requirements
CRD IV Directive	Directive (2013/36/EU) which implements CRD IV
CRR	Regulation (EU) No. 575/2013
CSDR	Central Securities Depositories Regulation (909/2014) on improving securities settlement in the European Union and on central securities depositories
CSMAD	Directive (2014/57/EU) on criminal sanctions for insider dealing and market manipulation
customer loan portfolio . .	Arion Bank's customer loans
Deloitte	Deloitte ehf., auditors of the Bank for the financial years ended 31 December 2016 and 2015
Deposit Guarantees Act . .	Act No. 98/1999 on Deposit Guarantees and Investor-Compensation Scheme, as amended
EBA	European Banking Authority
EEA	European Economic Area
EEA Agreement	Agreement on the European Economic Area, which entered into force on 1 January 1994

EFTA	European Free Trade Association, a regional trade organisation and free trade area consisting of Iceland, Liechtenstein, Norway and Switzerland
EFTA Court	Court of Justice of the EEA EFTA states
Eignabjarg	Eignabjarg ehf, a wholly owned subsidiary of Arion Bank which was liquidated in 2015 and was responsible for managing and selling shareholdings in companies which Arion Bank acquired through debt restructurings or other enforcement procedures
Eik	Eik Fasteignafelag hf., the company to which Arion Bank sold Landfestar in exchange for shares in the company which were later sold upon Eik's listing on NASDAQ Iceland
Eimskip	Eimskip hf., Icelandic transportation company
EIOPA	European Insurance and Occupational Pensions Authority
Electronic Money Directive	Directive (2009/110/EC) on the taking up, pursuit and prudential supervision of the business of electronic money institutions
Electronic Registration of Title to Securities Act	Act No. 131/1997 on Electronic Registration of Title to Securities governing electronic registration of securities
EMIR	European Markets Infrastructure Regulation (648/2012) on over-the-counter derivatives, central counterparties and trade repositories
EMTN Bond	Each of senior unsecured notes issued from time to time by the Bank under the EMTN Programme, which may have either fixed or floating rate, be denominated in any currency and be either rated or unrated
EMTN Programme	Group's multicurrency euro medium-term note programme
ESA	European Surveillance Authority, an EFTA body which monitors compliance with EEA rules in Iceland, Liechtenstein and Norway, enabling them to participate in the European internal market
ESRB	European Systemic Risk Board
European Supervisory Authorities	European supervisory authorities composed of ESMA, the European Banking Authority and the European Insurance and Occupational Pensions Authority
ESMA	European Securities and Markets Authority
Euroclear Sweden	Euroclear Sweden AB, at Box 191, 101 23 Stockholm, Sweden
EWS	Early Warning System, which is a forward-looking classification system for loans and borrowers which attempts to anticipate a deterioration in a customer's credit quality
Executive Committee	Executive committee of Arion Bank, comprising its senior management
Existing Offer Shares	Issued and outstanding Shares of Arion Bank that are offered and sold in the Offering
FATCA	U.S. Foreign Account Tax Compliance Act, consisting of Sections 1471 through 1474 of the U.S. Internal Revenue Code of 1986, as amended
FATCA Withholding	Any withholding under FATCA or an IGA
FFI	Foreign financial institutions, as defined by FATCA
Financial Activities Supervision Act	Act No. 87/1998 on the Official Supervision of Financial Operations, as amended, by which the activities of the FME are primarily governed
Financial Activity Tax	A tax, pursuant to Act No. 165/2011 on Financial Activities Tax, on certain types of financial institutions, including the Bank, requiring payment of a special additional 5.5% tax levied on all remuneration paid to employees

Financial Undertakings Act	Act No. 161/2002 on Financial Undertakings, as amended
First Banking Consolidation Directive	Directive (2000/12/EC) relating to the taking up and pursuit of the business of credit institutions implemented into Icelandic national law through the enactment of the Financial Undertakings Act
First Trading Date	On or about 15 June 2018, the date on which Shares are expected to commence trading, conditional on admission, on NASDAQ Iceland and NASDAQ Stockholm
FME	The Financial Supervisory Authority, Iceland (*Fjármálaeftirlitid*)
Foreign Exchange Act	Act No. 87/1992 on Foreign Exchange, as amended
foreign financial institution	Certain payments to any non-U.S. financial institution
FSA	Financial Supervisory Authority of Sweden (*Finansinspektionen*)
FTEs	Full-time equivalent employees
GDP	Gross domestic product
GDPR	The European General Data Protection Regulation
Glitnir	Glitnir Bank hf., the assets of which were transferred to Íslandsbanki following the financial crisis in 2008
Group, Arion Bank or Bank	Arion Banki hf., a public limited company established under the laws of the Republic of Iceland, and its consolidated subsidiaries, unless the context otherwise requires
HB Grandi	HB Grandi hf., a fishing company
ICA	Icelandic Competition Authority (*Samkeppniseftirlitid*)
ICAAP	The internal capital adequacy assessment process, an ongoing process which Arion Bank carries out with the aim of ensuring that Arion Bank has in place sufficient risk management processes and systems to identify, manage and measure Arion Bank's total risk exposure
Iceland	Republic of Iceland
Icelandic Krona or ISK	Icelandic krona, the lawful currency of Iceland
IFRS	International Financial Reporting Standards, a single set of accounting standards as adopted by the European Union
IGA	Intergovernmental agreements entered into by the U.S. and a number of potential partner countries, including Iceland, to facilitate the implementation of FATCA and ensure that FFIs in the signatory country generally are treated as "Reporting FIs" and therefore not subject to FATCA withholding on payments they receive
ILAAP	Internal liquidity adequacy assessment process, the process for the identification, measurement, management and monitoring of liquidity implemented by an institution pursuant to Article 86 of CRD IV
IMF	International Monetary Fund
Income Tax Act	Income Tax Act No. 90/2003, as amended
Insurance Activities Act	Act No. 100/2016 on Insurance Activities, as amended
Interest Act	Act No. 38/2001 on Interest and Price Indexation, as amended
interest funds	Special funds that consist solely of Swedish receivables
IRS	Internal Revenue Service of the United States
ISFI	Icelandic State Financial Investments
Íslandsbanki	Íslandsbanki hf., a successor to Glitnir

IT	Arion Bank's information technology systems, including Valitor's international payments platform
Joint Bookrunners	Arion banki hf., Carnegie Investment Bank AB (publ), Citigroup Global Markets Limited, Deutsche Bank AG, London Branch, Goldman Sachs International and Morgan Stanley & Co. International plc
Joint Global Coordinators	Arion banki hf., Carnegie Investment Bank AB (publ), Citigroup Global Markets Limited and Morgan Stanley & Co. International plc
Kaupskil	Kaupskil ehf., the largest shareholder of Arion Bank
Kaupthing	Kaupthing ehf. (formerly named Kaupthing Bank hf.), the shareholder of Kaupskil
Kolufell	Kolufell ehf.
Kortathjonustan	Kortathjonustan hf., the claimant in legal proceedings against Arion Bank and others which are currently on hold regarding damages of ISK 1.2 billion plus interest as a result of losses allegedly caused by violations of the Competition Act
Krona Asset Act	Act No. 37/2016 on the Treatment of Krona-denominated Assets Subject to Special Restrictions
Landey	Eignarhaldsfélagid Landey ehf., a wholly owned subsidiary of Arion Bank and property development company
Landfestar	Bank's subsidiary Landfestar ehf., which was sold to Eik in 2014
Landsbanki	Landsbanki Islands hf. (later renamed LBI hf.), the assets of which were transferred to Landsbankinn following the financial crisis in 2008
Landsbankinn	Landsbankinn hf., a successor to Landsbanki
LCR	Liquidity coverage ratio, a classification established by the Icelandic Central Bank which represents the balance between highly liquid assets and the expected net cash outflow of the Group in the following 30-day period under stressed conditions
LCR Rules	Rules no. 266/2017 on liquidity coverage ratios issued by the Icelandic Central Bank
Lugano Convention	A convention in force between the European Union and Iceland on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters which forms the basis on which international jurisdictions of the courts is determined
M&A	Merger and acquisition transactions
Managers	The Co-Lead Managers together with the Joint Bookrunners
manual trades	Securities traded off NASDAQ Iceland or NASDAQ Stockholm (*i.e.*, outside INET) during and outside the official trading hours
MAR	Market Abuse Regulation (596/2014)
Market Abuse Act	Swedish Market Abuse Penal Act of 2016 (Sw. *lagen (2016:1307) om straff för marknadsmissbruk vid handel med finansiella instrument)*
Market Abuse Directive . .	Securities Transactions Act, implementing in part Directive (2003/6/EC)
Market Abuse Regulation .	Regulation (EU) 596/2014
MCR	Mortgage Credit Directive (2014/17/EU) on credit agreements for consumers relating to residential immovable property
MiFID	Directive (2004/39/EC) on markets in financial instruments
MiFID 2	Directive (2014/65/EC) on markets in financial instruments which, along with MiFIR, is designed to improve the functioning of financial markets, making

	them more efficient resilient and transparent and which empowers ESMA to develop technical standards
MiFIR	Regulation (600/2014) on markets in financial instruments which along with MiFID 2, is designed to improve the functioning of financial markets, making them more efficient resilient and transparent and which empowers ESMA to develop technical standards
Nasdaq CSD Iceland	Nasdaq CSD Iceland hf., at Laugavegur 182, 105 Reykjavík, Iceland
NASDAQ Iceland	NASDAQ Iceland, the stock exchange in Iceland
NASDAQ Iceland Rules	NASDAQ Iceland Rules for Issuers of Financial Instruments
NASDAQ Stockholm	NASDAQ Stockholm, the stock exchange in Sweden
Non-IFRS Information	Certain financial measures that are not defined or recognised under IFRS, including adjusted return on equity, adjusted net interest margin on interest-earning assets, adjusted net interest margin on total assets, adjusted cost-to-income ratio, adjusted cost of risk, return on equity excluding Valitor, return on equity excluding the effects of the Bank Levy and additional income taxes, cost-to-income ratio excluding Valitor, loan-to-deposit ratio excluding covered bonds and the adjusted income statement information and metrics derived therefrom, representing events which the Directors consider to be non-recurring items
Nordic Judgements Convention	Convention on the recognition and enforcement of judgements and a convention on the recognition and enforcement of judgements in civil matters, both of which Iceland, Denmark Finland, Norway and Sweden are a party to
Norwegian Krone or NOK	Norwegian krone
Notice	Notice issued by the IRS in 1989, which set down requirements for non-U.S. banks who seek to avoid being classified as a PFIC
notional rule	Alternative method for determining the tax basis for listed shares under Swedish tax regulations
NSFR	Net stable funding ratio which measures the amount of ASF at the Group against the RSF as defined by Icelandic Central Bank's rules No. 1032
Offer Price	Price at which the Offer Securities will be sold
Offer Price Range	Price range of the Offer Securities
Offer Securities	The Existing Offer Shares and the SDRs, together with, unless the context indicates otherwise, the Over Allotment Securities
offer to the public	Communication in any form and by any means of sufficient information on the terms of the Offering and the Offer Securities so as to enable an investor to decide to purchase the Offer Securities
Offering	Offering of the Offer Securities, consisting of (i) a public offering in Iceland and Sweden to institutional and retail investors and (ii) a private placement to certain institutional investors in various other jurisdictions
Okkar Life Insurance	Okkar líftryggingar hf., which, prior to its merger with Vördur, was a wholly owned subsidiary of Arion Bank and the second largest life insurance company in Iceland based on insurance premiums
Omnibus II Directive	Directive (2014/51/EU) which amends the Prospectus Directive and the Solvency II Directive
Order	Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended

Over-Allotment Option	Option granted to the Managers by the Selling Shareholders pursuant to which the Managers may require the Selling Shareholders to sell at the Offer Price the Over-Allotment Shares
Over-Allotment Shares	Up to 108,600,000 additional shares (either in the form of Existing Offer Shares or SDRs), comprising up to 15% of the total number of Existing Offer Shares and SDRs sold in the Offering
Payment Services Act	Act No. 120/2011 on Payment Services, as amended
Payment Services Directive	Directive (2007/64/EC) on payment services in the internal market
PFIC	Passive foreign investment company, defined by the IRS tax code as a foreign-based corporation which has at least 75% of its gross income as passive (derived from investments rather than regular business operations) and at least 50% of the company's assets are investments that produce income in the form of earned interest, dividends or capital gains
Placing Agreement	Placing agreement expected to be entered into by Arion Bank, the Selling Shareholders and the Managers with respect to the Offering
Proposed Regulations	Proposed Treasury Regulations issued by the U.S. Department of Treasury subsequent to the issuance of the Notice which are not yet in effect but would markedly modify the Notice
Prospectus	Offering document pursuant to which the Shares are offered and sold in the Offering
Prospectus Directive	Directive 2003/71/EC of the European Parliament and the European Council, and amendments thereto (including those resulting from Directive 2010/73/EU) including any relevant implementing measure in each Relevant Member State
Public Limited Companies Act	Act No. 2/1995 respecting Public Limited Companies, as amended, under which Arion Bank was established as a public limited company
QIBs	Qualified Institutional Buyers as defined in, and in reliance on, Rule 144A under the U.S. Securities Act
Qualified Investors	Qualified investors within the meaning of article 2(1)(e) of the Prospectus Directive
RB	Reiknistofa Bankanna, a centralised cash settlement system in Iceland
RBC	Retail Branch Credit Committee
Regulation S	Regulation S under the U.S. Securities Act
Reitir	Reitir fasteignafelag hf., the largest commercial real estate company in Iceland
Relevant Member State	Each member state of the EEA that has implemented the Prospectus Directive
Relevant Persons	Qualified Investors within the meaning of the Prospectus Directive (a) who have professional experience in matters relating to investments who fall within the definition of "investment professionals" in the Order (b) who are high net worth entities as described in Article 49(2)(a) to (d) of the Order or (c) other persons to whom the Prospectus may lawfully be communicated
Resettable Notes	Resettable Notes due in 2023 issued by Arion Bank on 11 January 2016 in the amount of USD 747,481,000 under the EMTN Programme, which were repaid in full as of 30 June 2017
risk-weighted assets	Risk-weighted assets are calculated in accordance with CRD IV and weighted according to risk to determine the minimum capital requirements
RSF	Required stable funding, determined by applying different weight to different asset classes depending on the level of liquidity
Rule 144A	Rule 144A under the U.S. Securities Act

Rules of Procedure	Rules of procedure for the Board of Directors which were established with reference to Article 54 (4) of the Financial Undertakings Act, Article 70 (5) of the Public Limited Companies Act and the FME Guidelines No. 1/2010
SDRs	Swedish depository receipts, each representing one ordinary share of Arion Bank
Securities Transactions Act	Act No. 108/2007 on Securities Transactions, as amended
Selling Shareholders	Kaupskil ehf., at Borgartún 26, 105 Reykjavík, Iceland and Trinity Investments Designated Activity Company (an investment entity managed by Attestor Capital LLP), 3 George's Dock, IFSC, Dublin 1, Ireland
Settlement	Payment for, and issue and delivery of, the Offer Securities
Settlement Date	On or about 19 June 2018
SFTs	Securities financing transactions
Shares	Ordinary shares of Arion Bank, each with a par value of ISK 1.00 (including, for the avoidance of doubt, issued ordinary shares held in treasury by Arion Bank)
Síminn	Síminn hf., the largest telecommunications company in Iceland
SMEs	Small- to medium-sized enterprises, defined as corporates which are customers of the Retail Banking division with loans up to ISK 2.0 billion
Solvency II Directive	Directive (2009/138/EC) on the taking-up and pursuit of the business of insurance and reinsurance
Special Financial Activity Tax	A tax, pursuant to Income Tax Act No. 90/2003, as amended, of 6.0% on financial institutions such as the Bank in respect of taxable profit exceeding ISK 1.0 billion irrespective of joint taxation or carry-forward losses
SPRON	Reykjavík Savings Bank, the largest of the savings banks, which was taken over by the FME in March 2009 following its collapse
SREP	Supervisory review and evaluation process by the FME which summarises their findings and tells Arion Bank where it stands in terms of capital requirements and the way it deals with risks
SSR	Short Selling Regulation (236/2012) on short selling and certain aspects of credit default swaps
Stabilising Manager	Citigroup Global Markets Limited, who may over-allot Shares and/or SDRs or effect other transactions with a view to supporting the market price of the Shares and SDRs at a higher level than that which might otherwise prevail in the open market
Standard & Poor's	Standard & Poor's Credit Market Services Europe Limited, a credit rating agency
Statutory Covered Bonds	Covered bonds issued by the Bank under its statutory covered bond programme to finance its residential mortgage lending
Stefnir	Stefnir hf., an independently operating financial company owned by Arion Bank and the largest fund management company in Iceland
Stock Exchanges Act	Act No. 110/2007 on Stock Exchanges, as amended
Structured Covered Bonds	Covered bonds issued by Kaupthing from 2006 to 2008 to finance its mortgage loans under the covered bond programme established by Kaupthing on 30 March 2006 which were guaranteed by the Fund
Surveillance and Court Agreement	Agreement which established the EFTA Surveillance authority and the EFTA Court
Swedish Central Bank	Sveriges Riksbank

Swedish Krona or SEK	Swedish krona, the lawful currency of Sweden
Swedish Securities Market Act	Securities Market Act of 2007 of Sweden (Sw. *lagen (2007:528) om värdepappersmarknaden*)
Takeover Act	Swedish Act on Public Takeovers on the Securities Market (Sw. *lagen (2006:451) om offentliga uppköpserbjudanden på aktiemarknaden)*
Takeover Rules	Takeover rules adopted by NASDAQ Stockholm
Trading Act	Swedish Financial Trading Act (1991:980) (Sw. *lagen (1991:980) om handel med finansiella instrument*)
Trading Surveillance	NASDAQ Stockholm's market supervision unit that monitors trading on a "real time" basis
Transparency Directive	Directive (2004/109/EC) on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market
Treasury Regulations	Treasury regulations issued under the Code
Underwriters	Arion banki hf., Carnegie Investment Bank AB (publ), Citigroup Global Markets Limited, Deutsche Bank AG, London Branch, Goldman Sachs International and Morgan Stanley & Co. International plc, Svenska Handelsbanken AB (publ), Íslandsbanki hf. and Landsbankinn hf.
U.S. or United States	United States of America
U.S. GAAP	Generally accepted accounting principles in the United States
U.S. Holder	A beneficial owner of the Offer Securities that is, for U.S. federal income tax purposes, (i) an individual who is a citizen or resident of the United States, (ii) a corporation or any entity taxable as a corporation created or organised in or under the laws of the United States, any state thereof or the District of Columbia, (iii) any estate the income of which is subject to U.S. federal income taxation regardless of its source or (iv) any trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or if a valid election is in place to treat the trust as a U.S. person
U.S. Securities Act	U.S. Securities Act of 1933, as amended
U.S.-Iceland Treaty	Convention and Protocol Between the United States of America and Iceland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income
U.S.-Sweden Treaty	Convention Between the Government of Sweden and the Government of the United States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income
UCITS	Undertakings for the collective investment in transferable securities, which are investment funds regulated at the European Union level
UIC	Underwriting and Investment Committee, which decides on underwriting and principal investments
United Silicon	Sameinad Sílikon hf., a borrower and subsidiary of the Bank
Valitor	Valitor Holding hf. and its subsidiaries
VAT	Value added tax
Visa Europe	Visa Europe Ltd.
Vördur	Vördur tryggingar hf., the fourth largest universal insurance company in Iceland based on insurance premiums

CONSOLIDATED FINANCIAL STATEMENTS

Condensed Consolidated Interim
Financial Statements

1 January - 31 March 2018

Arion Bank

Endorsement and statement
by the Board of Directors and the CEO

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period from 1 January to 31 March 2018 include the Condensed Consolidated Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Outlook

Following a period of exceptional growth the Icelandic economy is slowing down and approaching equilibrium as the output gap closes. GDP grew by 3.6% in 2017, fueled by soaring private consumption, and to a lesser extent, continued investment growth and tourism. In 2017 investment reached a turning point when growth in business investment was dwarfed by housing and public investment. Despite this, investment growth has been slowing down, as has export growth. It appears that tourism has passed its peak growth, at least for the time being, with more moderate growth on the horizon. Inflation is still low in a historical context but passed the Central Bank of Iceland's inflation target in March for the first time in four years. Inflationary pressures seem to picking up, with the exchange rate effects ebbing out and tough wage bargaining on the horizon. The Icelandic króna has remained strong and remarkably stable for the past couple of months, even though nearly all capital controls have been removed and domestic investors are free to invest abroad. Arion Research predicts that there is moderate GDP growth ahead coupled with a narrowing of the output gap, low unemployment and possibly rising inflation in the coming months.

Operations during the period

Net earnings amounted to ISK 1,949 million for the period ended 31 March 2018 and the total equity amounted to ISK 204,245 million at the end of the period. Return on equity was 3.6% for the period. The capital ratio of the Bank, according to the Financial Undertakings Act No. 161/2002, was 23.6% and the corresponding CET 1 ratio was 23.6%. This comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also strong at period-end and well above the regulatory minimum.

The main changes on the Balance Sheet from year-end 2017 are due to the purchase of own shares in February and a dividend payment in March, a total of ISK 24.3 billion, an increase in loans to customers of ISK 17.0 billion, or 2.2%, and increased borrowings of ISK 15.9 billion or 4.1%, following a net increase in issued bonds on international markets. New lending is mainly in the form of mortgages to individuals and corporate loans to wholesale and retail trade.

The Bank's liquidity position is strong, with a liquidity coverage ratio of 210%, see Note 40, well above the regulatory minimum of 100%. In March 2018 the Bank issued five-year senior unsecured bonds in the amount of EUR 300 million (ISK 36 billion). The bonds were sold at rates corresponding to a 0.65 % margin over interbank rates and bear a fixed 1.00% coupon.

In February 2018 an agreement was reached between the administrator of the bankruptcy estate of United Silicon and Arion Bank, whereby the Bank foreclosed on its collateral and acquired all the company's main assets. The assets of the silicon plant are managed by the Bank's newly established subsidiary Eignabjarg ehf. The Bank's objective is to sell the plant. This transaction had a minor effect on the Statement of Comprehensive Income of the Group.

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

Employees

The Group had 1,299 full-time equivalent positions at the end of the period, compared with 1,284 at the end of 2017; 832 of these positions were at Arion Bank, compared with 844 at the end of 2017. The increase in FTE's from year-end is mainly due to the growth strategy of Valitor on international markets but is partly off-set by decrease at the Bank due to outsourcing of the cash center.

Group ownership

Kaupthing ehf. has a controlling share in Arion Bank hf. through its subsidiary Kaupskil ehf. At the end of the period Kaupskil held 55.57% of share capital. Kaupskil ehf. also controls the 9.99% shareholding of Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. and 6.58% shareholding of Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group. Other shareholders are Attestor Capital LLP through Trinity Investment Designated Activity Company, which holds 12.44%, and Goldman Sachs International through ELQ Investors II Ltd, which holds 3.37%.

In February 2018 Arion Bank hf. agreed to a buyback of 9.5% of issued share capital in Arion Bank from Kaupskil ehf., a subsidiary of Kaupthing ehf. The decision to buy back these shares was in accordance with a decision made at a shareholders' meeting of Arion Bank on 12 February 2018. The shares are held in Treasury and are for the most part expected to be cancelled in due course. A small proportion could potentially be retained in connection with the Bank's incentive scheme.

Endorsement and statement
by the Board of Directors and the CEO

The Board of Directors has seven members, three women and four men. Furthermore, three Alternate Directors (two men and one woman) are elected and they attend meetings of the Board of Directors in the event that a Director resigns or is unable to attend. The ratio of men to women is therefore in compliance with the law which states that companies with more than 50 employees should ensure that the ratio of either gender on the Board of Directors should not be less than 40%. Six Directors are nominated by Kaupskil ehf. and one by Attestor Capital LLP. Six Directors and two Alternates are independent of Arion Bank and its day-to-day managers as well as of Arion Bank's significant shareholders.

At Arion Bank's annual general meeting on 15 March 2018 Herdís Dröfn Fjeldsted was elected as a new Director and replaced Thóra Hallgrímsdóttir. Kirstín Th. Flygenring did not seek re-election as a Director at the annual general meeting and the number of Directors thereby decreased by one.

Endorsement of the Board of Directors and the Chief Executive Officer

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 31 March 2018 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

It is our opinion that the Condensed Consolidated Interim Financial Statements give a true and fair view of the financial performance of the Group for the period ended 31 March 2018 and its financial position as at 31 March 2018.

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

The Board of Directors and the CEO have today discussed the Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 31 March 2018 and confirm them by means of their signatures.

Reykjavík, 2 May 2018

Board of Directors

Eva Cederbalk
Chairman

Brynjólfur Bjarnason

Herdís Dröfn Fjeldsted

Jakob Már Ásmundsson

John P. Madden

Måns Höglund

Steinunn K. Thórdardóttir

Chief Executive Officer

Höskuldur H. Ólafsson

Review Report
on the Condensed Consolidated Interim Financial Statements

To the Board of Directors and shareholders of Arion Bank.

We have reviewed the accompanying Condensed Consolidated Interim Statement of Financial Position of Arion Bank hf. (the "Group") as of 31 March 2018 and the related Condensed Consolidated Interim Statement of Comprehensive Income, Condensed Consolidated Interim Statement of Changes in Equity and Condensed Consolidated Interim Statement of Cash Flows for the three months then ended and a summary of significant accounting policies and other explanatory notes.

The Board of Directors and Management's Responsibility for the Consolidated Financial Statements

The Board of Directors and management are responsible for the preparation and fair presentation of this Interim Consolidated Financial Statements in accordance with International Financial Reporting Standards for Interim Financial Reporting, IAS 34, as adopted by the EU.

Auditor's Responsibility

Our responsibility is to express a conclusion on this Interim Consolidated Financial Statements based on our review.

Scope of Review

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

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying Condensed Consolidated Interim Financial Statements do not give a true and fair view of the financial position of the Group as at 31 March 2018, and of its financial performance and its cash flows for the three month period then ended in accordance with International Financial Reporting Standards for Interim Financial Reporting, IAS 34, as adopted by the EU and additional requirements in the Icelandic Act on Annual Accounts.

Confirmation of Endorsement and Statement by the Board of Directors and the CEO

Pursuant to the requirement of Paragraph 2 Article 104 of the Icelandic Act on Annual Accounts No. 3/2006, we confirm to the best of our knowledge that the accompanying Endorsement and Statement by the Board of Directors and the CEO includes all information required by the Icelandic Act on Annual Accounts that is not disclosed elsewhere in the Interim Consolidated Financial Statements.

Kópavogur, 2 May 2018

Deloitte ehf.

Páll Grétar Steingrímsson
State Authorized Public Accountant

Gunnar Thorvardarson
State Authorized Public Accountant

Condensed Consolidated Interim Statement of Comprehensive Income
for the period from 1 January to 31 March 2018

Income Statement

	Notes	2018 1.1.-31.3.	2017 1.1.-31.3.*
Interest income		14,162	13,723
Interest expense		(7,254)	(6,563)
Net interest income	5	6,908	7,160
Fee and commission income		8,197	6,091
Fee and commission expense		(4,655)	(2,761)
Net fee and commission income	6	3,542	3,330
Net financial income	7	1,340	1,230
Net insurance income	8	143	447
Share of profit of associates and net impairment	24	(18)	(34)
Other operating income	9	269	564
Operating income		12,184	12,697
Salaries and related expense	10	(4,636)	(4,222)
Other operating expense	11	(3,996)	(3,834)
Bank levy	12	(804)	(797)
Net impairment	13	(99)	880
Earnings before tax		2,649	4,724
Income tax expense	14	(818)	(1,371)
Net earnings from continuing operations		1,831	3,353
Discontinued operations, net of tax	15	118	-
Net earnings		1,949	3,353
Attributable to			
Shareholders of Arion Bank		1,949	3,352
Non-controlling interest	24	-	1
Net earnings		1,949	3,353
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	16	0.95	1.68

Other Comprehensive Income

	Notes	2018 1.1.-31.3.	2017 1.1.-31.3.*
Net earnings		1,949	3,353
Net gain on financial assets carried at fair value through OCI, net of tax		30	-
Realized net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement**		(97)	-
Changes to reserve for financial instruments at fair value through OCI	32	1,882	3,353
Exchange difference on translating foreign subsidiaries	32	(59)	44
Total comprehensive income		1,823	3,397
Attributable to			
Shareholders of Arion Bank		1,823	3,396
Non-controlling interest		-	1
Total comprehensive income		1,823	3,397

Comparative figures have been changed, see Note 1.

*The Condensed Consolidated Interim statements of comprehensive Income for the period ended 31 March 2017 have not been reviewed by the Bank's auditors.

**Fair value gain of ISK 38 million would have been recognized in the Income Statement during the period if the financial assets had not been reclassified as Financial assets carried at FVOCI, net of tax, in accortance with IFRS 9.

The Notes on pages 14 to 74 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Condensed Consolidated Interim Statement of Financial Position
as at 31 March 2018

Assets	Notes	31.3.2018	31.12.2017
Cash and balances with Central Bank	17	97,934	139,819
Loans to credit institutions	18	94,961	86,609
Loans to customers	19	782,255	765,101
Financial instruments	20-22	106,415	109,450
Investment property	22	6,749	6,613
Investments in associates	24	743	760
Intangible assets	25	13,498	13,848
Tax assets	26	611	450
Non-current assets and disposal groups held for sale	27	8,496	8,138
Other assets	28	20,107	16,966
Total Assets		1,131,769	1,147,754
Liabilities			
Due to credit institutions and Central Bank	21	7,880	7,370
Deposits	21	453,059	462,161
Financial liabilities at fair value	21	3,130	3,601
Tax liabilities	26	6,885	6,828
Other liabilities	29	55,715	57,062
Borrowings	21, 30	400,855	384,998
Total Liabilities		927,524	922,020
Equity			
Share capital and share premium	32	58,722	75,861
Other reserves	32	14,880	16,774
Retained earnings		130,515	132,971
Total Shareholders' Equity		204,117	225,606
Non-controlling interest		128	128
Total Equity		204,245	225,734
Total Liabilities and Equity		1,131,769	1,147,754

The Notes on pages 14 to 74 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Condensed Consolidated Interim Statement of Changes in Equity
for the period from 1 January to 31 March 2018

	Share capital and share premium	Other reserves	Retained earnings	**Total share-holders' equity**	Non-controlling interest	**Total equity**
Equity 31 December 2017	75,861	16,774	132,971	225,606	128	225,734
Impact of adopting IFRS 9	-	3	939	942	-	942
Restated opening balance under IFRS 9	75,861	16,777	133,910	226,548	128	226,676
Net earnings	-	-	1,949	1,949	-	1,949
Realized net gain on financial assets carried at fair value through OCI, net of tax	-	30	-	30	-	30
Realized net gain through the Income Statement on financial assets through OCI, net of tax	-	(97)	-	(97)	-	(97)
Translation difference	-	(59)	-	(59)	-	(59)
Total comprehensive income	-	(126)	1,949	1,823	-	1,823
Dividend paid	-	-	(7,115)	(7,115)	-	(7,115)
Purchase of treasury stock	(17,139)	-	-	(17,139)	-	(17,139)
Reserve for investments in subsidiaries	-	(1,434)	1,434	-	-	-
Reserve for investments in associates	-	(19)	19	-	-	-
Reserve for investments in securities	-	(426)	318	(108)	-	(108)
Reserve for financial instruments at FVOCI	-	108	-	108	-	108
Equity 31 March 2018	58,722	14,880	130,515	204,117	128	204,245
Equity 1 January 2017	75,861	19,761	115,590	211,212	172	211,384
Net earnings	-	-	3,352	3,352	1	3,353
Translation difference	-	44	-	44	-	44
Total comprehensive income	-	44	3,352	3,396	1	3,397
Reserve for investments in subsidiaries	-	859	(859)	-	-	-
Reserve for investments in associates	-	1	(1)	-	-	-
Reserve for investments in securities	-	(467)	467	-	-	-
Equity 31 March 2017*	75,861	20,197	118,549	214,607	173	214,780

*The Condensed Consolidated Interim Statement of Changes in Equity for the period ended 31 March 2017 have not been reviewed by the Bank's auditors.

The Notes on pages 14 to 74 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Condensed Consolidated Interim Statement of Cash flows
for the period from 1 January to 31 March 2018

	2018	2017
Operating activities	1.1.-31.3.	1.1.-31.3.*
Net earnings	1,949	3,353
Non-cash items included in net earnings and other adjustments	(5,987)	(6,592)
Changes in operating assets and liabilities	(12,894)	91,676
Interest received	13,113	10,467
Interest paid	(4,776)	(3,896)
Dividend received	95	84
Income tax paid	(1,158)	(515)
Net cash (to) from operating activities	(9,658)	94,577
Investing activities		
Acquisition of associates	-	(54)
Dividend received from associates	-	41
Acquisition of intangible assets	(436)	(324)
Acquisition of property and equipment	(187)	(262)
Proceeds from sale of property and equipment	-	67
Net cash to investing activities	(623)	(532)
Financing activities		
Dividend paid to shareholders of Arion Bank and purchase of treasury stock	(24,254)	-
Net cash used in financing activities	(24,254)	-
Net increase (decrease) in cash and cash equivalents	(34,535)	94,045
Cash and cash equivalents at beginning of the year	181,898	123,933
Effect of exchange rate changes on cash and cash equivalents	(1,047)	439
Cash and cash equivalents	146,316	218,417
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	319	286
Settlement of loans through foreclosure on collateral from customers with view to resale	(319)	(286)

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

*The Condensed Consolidated Interim Statement of Cash flows for the period ended 31 March 2017 have not been reviewed by the Bank's auditors.

The Notes on pages 14 to 74 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Statement of Cash flows
for the period from 1 January to 31 March 2018

Non-cash items included in net earnings	2018 1.1.-31.3.	2017 1.1.-31.3.*
Net interest income	(6,908)	(7,160)
Net impairment	99	(880)
Income tax expense	818	1,371
Bank levy	804	797
Net foreign exchange gain	208	32
Net gain on financial instruments	(1,332)	(1,178)
Depreciation and amortization	560	508
Share of profit of associates and net impairment	18	34
Investment property, fair value change	(136)	(93)
Discontinued operations, net of tax	(118)	-
Other changes	-	(23)
Non-cash items included in net earnings	(5,987)	(6,592)

Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	(170)	366
Loans to credit institutions, excluding bank accounts	(3,187)	15,156
Loans to customers	(19,780)	(2,837)
Financial instruments and financial liabilities at fair value	3,307	8,268
Investment property	-	(460)
Other assets	(1,203)	46
Due to credit institutions and Central Bank	517	1,621
Deposits	(9,007)	60,792
Borrowings	19,625	13,163
Other liabilities	(2,996)	(4,439)
Changes in operating assets and liabilities	(12,894)	91,676

Cash and cash equivalents		
Cash and balances with Central Bank	97,934	178,593
Bank accounts	57,776	48,790
Mandatory reserve deposit with Central Bank	(9,394)	(8,966)
Cash and cash equivalents	146,316	218,417

*The notes to the Condensed Consolidated Interim Statement of Cash flows for the period ended 31 March 2017 have not been reviewed by the Bank's auditors.

The Notes on pages 14 to 74 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Reconciliation of Consolidated Statement of Financial Position
transition from IAS 39 to IFRS 9 as at 1 January 2018

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

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

Amounts are in ISK millions

Financial assets and financial liabilites classification
transition from IAS 39 to IFRS 9

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

Financial assets	Measurement category under IAS 39	Measurement category under IFRS 9	Carrying amount under IAS 39	Reclassi-fication	Remeasure-ment	Carrying amount under IFRS 9
Cash and balances with Central Bank	Loans	Amortized cost	139,819	-	(7)	139,812
Loans to credit institutions	Loans	Amortized cost	86,609	-	(3)	86,606
Loans to customers			765,101	486	930	766,517
Overdrafts	*Loans*	*Amortized cost*	*30,942*	-	*(50)*	*30,892*
Credit cards	*Loans*	*Amortized cost*	*12,040*	-	*(11)*	*12,029*
Mortgage loans	*Loans*	*Amortized cost*	*329,735*	-	*276*	*330,011*
Other loans	*Loans*	*Amortized cost*	*386,606*	-	*715*	*387,321*
Other loans	*Loans*	*FVTPL (mandatory)*	*5,778*	*486*	-	*6,264*
Financial instruments			109,450	-	-	109,450
Bonds and debt instruments	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*11,347*	-	-	*11,347*
Bonds and debt instruments	*FVTPL (designated)*	*FVOCI**	*40,408*	-	-	*40,408*
Shares and equity instruments	*FVTPL (designated)*	*FVTPL (mandatory)*	*36,190*	-	-	*36,190*
Derivatives	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*7,624*	-	-	*7,624*
Securites used for hedging	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*13,881*	-	-	*13,881*
Other financial assets	*Amortized cost*	*Amortized cost*	*8,948*	-	-	*8,948*
Total financial assets			1,109,927	486	920	1,111,333
Financial liabilities						
Due to credit institutions and Central Bank	Amortized cost	Amortized cost	7,370	-	-	7,370
Deposits	Amortized cost	Amortized cost	462,161	-	-	462,161
Financial liabilities at fair value	FVTPL (held for trading)	FVTPL (mandatory)	3,601	-	-	3,601
Other liabilities			34,705	-	229	34,934
Accounts payable	*Amortized cost*	*Amortized cost*	*26,394*	-	-	*26,394*
Unsettled securities trading	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*527*	-	-	*527*
Depositors and investors guarentee fund	*Amortized cost*	*Amortized cost*	*218*	-	-	*218*
Withholding tax	*Amortized cost*	*Amortized cost*	*1,414*	-	-	*1,414*
Sundry financial liabilities	*Amortized cost*	*Amortized cost*	*6,152*	-	*229*	*6,381*
Borrowings	Amortized cost	Amortized cost	384,998	-	-	384,998
Total financial liabilities			892,835	-	229	893,064
Other liabilities						
Tax liabilities	*Amortized cost*	*Amortized cost*	*6,828*	*97*	*138*	7,063

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

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

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Notes to the Condensed Consolidated Interim Financial Statements

General information

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Condensed Consolidated Interim Financial Statements for the period ended 31 March 2018 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Condensed Consolidated Interim Financial Statements have been prepared in accordance with International Financial Reporting Standard, IAS 34 Interim Financial Reporting, as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and rules on Accounting for Credit Institutions. The Condensed Consolidated Interim Financial Statements do not include all the information and disclosures required in the Annual Financial Statements, and should be read in conjunction with Arion Bank's Annual Financial Statements for the year ended 31 December 2017. The Annual Financial Statements are available at Arion Bank's website www.arionbanki.is.

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

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

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

Basis of measurement

New classification and measurement categories for IFRS 9 have replaced the ones used under IAS 39. For further details on the accounting policy under IAS 39 see the Annual Financial Statements 2017. For further details on the accounting policy under IFRS 9, see Note 42. To view the effects of the changes on individual portfolios see Financial assets and Finacial liabilites classification transition from IAS 39 to IFRS 9.

Functional and presentation currency

The Condensed Consolidated Interim Financial Statements are presented in Icelandic krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the period the exchange rate of the ISK against USD was 98.41 and 121.50 for EUR (31.12.2017: USD 103.70 and EUR 124.52).

Comparative figures

In the Condensed Consolidated Interim Statement of Comprehensive Income for the period ended 31 March 2018 net income from non-current assets held for sale are presented among other operating income. Prior to the fourth quarter of 2017 net income from non-current assets held for sale were classified as discontinued operations, net of tax. Comparative figures have been changed accordingly by reducing discontinued operations, net of tax, by ISK 147 million, increasing other operating income by ISK 184 million and increasing income tax by ISK 37 million. The effects on the Statement of Cash flow was shift between Non-cash items included in net earnings and other adjustments and Changes in operating assets and liabilities of ISK 147 million.

2. Significant accounting estimates and judgements in applying accounting policies

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

3. The Group

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

			Equity interest	
	Operating activity	Currency	31.3.2018	31.12.2017
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland	Retail banking	ISK	100.0%	100.0%
BG12 slhf., Katrínartún 2, Reykjavík, Iceland	Holding company	ISK	62.0%	62.0%
Bjarnathing ehf., Ögurhvarf 4a, Kópavogur, Iceland	Real estate	ISK	100.0%	-
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Eignarhaldsfélagid Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland	Real estate	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjördur, Iceland	Payment solutions	ISK	100.0%	100.0%
VISA Ísland ehf., Dalshraun 3, Hafnarfjördur, Iceland	Holding company	ISK	100.0%	-
Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland	Insurance	ISK	100.0%	100.0%

In addition the Bank holds the subsidiary Eignabjarg ehf. which is classified as Non-current assets and disposal groups held for sale, see Note 27.

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

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

Amounts are in ISK millions

3. The Group, continued

In 2017 the Bank's subsidiary Valitor Holding hf. acquired two companies; IPS - International Payment Services Ltd. and Chip and Pin Solutions Ltd. The purpose of the acquisition is to strengthen Valitor's direct channel market position in the UK as the focus has been on partnership in that market until now. Further information on intangible assets related to those two companies are in Note 25. The transactions are as follows:

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

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

Amounts are in ISK millions

Operating segment reporting

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. In presenting the geographic information, segment revenue has been based on the geographic location of customers or assets.

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

Operating segments

The Group comprises the following operating segments:

Asset Management comprises Institutional Asset Management, Private Banking, Investment Services and Pension Fund Administration. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Asset Management also administers pension funds. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

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

Investment Banking is divided into Corporate Finance, Capital Markets and Research. Corporate Finance arranges the buying and selling of companies and advises on all other major financial decisions undertaken by companies and investors such as financial restructuring, IPO's and listing of securities. Capital Markets buys and sells securities and FX on behalf of Arion Bank's clients and provide services regarding risk management products. Capital Markets also manages securities offerings for companies, often in co-operation with Corporate Finance. Research is an independent research team covering the Icelandic economy and financial markets.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of services in it's 24 branches all around Iceland and also through leading digital solutions featured in both an app and internet bank. This includes deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into five regions clusters, with the smaller branches capitalizing on the strength of larger units within each region. Retail Banking's brances have a total of more than 100,000 customers.

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

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

In addition to the above operating segments, the Group presents information for the corporate **Headquarters** carrying out support functions such as Overhead, Risk Management, Finance (excluding Treasury and Market Making), Legal and IT. The Headquarters information presented does not represent an operating segment. Significant part of expenses from support functions is allocated to operating segments in separate line in the operating segment overview, see Note 4.

4. Operating segments

1.1.-31.3.2018	Asset Manage-ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Subsidi-aries and Other divisions	Head-quarters and Elimination	Total
Net interest income	148	1,314	38	4,333	979	128	(32)	6,908
Net fee and commission income	866	236	465	1,092	(82)	1,043	(78)	3,542
Net financial income	15	(161)	2	-	268	537	679	1,340
Net insurance income	-	-	-	-	-	211	(68)	143
Share of profit of associates and net impairment	-	-	-	-	-	2	(20)	(18)
Other operating income	3	-	-	81	-	165	20	269
Operating income (loss)	1,032	1,389	505	5,506	1,165	2,086	501	12,184
Operating expense	(382)	(126)	(210)	(1,791)	(51)	(2,384)	(3,688)	(8,632)
Allocated expense	(219)	(762)	(182)	(1,660)	(278)	(6)	3,107	-
Bank levy	(46)	(170)	(10)	(278)	(300)	-	-	(804)
Net impairment	-	(376)	-	268	(29)	36	2	(99)
Earnings before tax	385	(45)	103	2,045	507	(268)	(78)	2,649
Net seg. rev. from ext. customers	304	3,768	366	8,690	(3,993)	2,246	803	12,184
Net seg. rev. from other segments	728	(2,379)	139	(3,184)	5,158	(160)	(302)	-
Operating income (loss)	1,032	1,389	505	5,506	1,165	2,086	501	12,184
Depreciation and amortization	-	1	-	92	-	282	185	560
Total assets	62,603	269,324	22,435	545,300	484,548	89,961	(342,402)	1,131,769
Total liabilities	57,069	212,716	21,609	477,386	450,058	55,149	(346,463)	927,524
Allocated equity	5,534	56,608	826	67,914	34,490	34,812	4,061	204,245
1.1.-31.3.2017								
Net interest income	146	1,656	69	3,974	1,096	324	(105)	7,160
Net fee and commission income	838	176	333	996	(78)	962	103	3,330
Net financial income	41	176	(31)	51	(270)	857	406	1,230
Net insurance income	-	-	-	-	-	455	(8)	447
Share of profit of associates and net impairment	-	-	-	-	-	97	(131)	(34)
Other operating income	7	60	-	128	(1)	164	206	564
Operating income	1,032	2,068	371	5,149	747	2,859	471	12,697
Operating expense	(405)	(188)	(194)	(1,681)	(47)	(2,230)	(3,311)	(8,056)
Allocated expense	(259)	(595)	(168)	(1,475)	(212)	(2)	2,711	-
Bank levy	(48)	(167)	(12)	(271)	(299)	-	-	(797)
Net impairment	-	819	14	20	55	(27)	(1)	880
Earnings (loss) before tax	320	1,937	11	1,742	244	600	(130)	4,724
Net seg. rev. from ext. customers	552	3,636	241	7,436	(2,743)	3,032	543	12,697
Net seg. rev. from other segments	480	(1,568)	130	(2,287)	3,490	(173)	(72)	-
Operating income	1,032	2,068	371	5,149	747	2,859	471	12,697
Depreciation and amortization	-	-	-	87	-	217	204	508
Total assets	88,551	254,939	18,946	513,622	492,909	75,906	(325,225)	1,119,648
Total liabilities	82,442	198,498	15,233	442,761	451,687	46,961	(332,714)	904,868
Allocated equity	6,109	56,441	3,713	70,861	41,222	28,945	7,489	214,780

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

Amounts are in ISK millions

4. Operating segments, continued

Subsidiaries and other divisions	2018 1.1.-31.3.			2017 1.1.-31.3.		
1.1.-31.3.2018	Valitor	Other	Total	Valitor	Other	Total
Net interest income	84	44	128	294	30	324
Net fee and commission income	1,151	(108)	1,043	1,004	(42)	962
Net financial income	35	502	537	312	545	857
Net insurance income	-	211	211	-	455	455
Share of profit of associates and net impairment	-	2	2	-	97	97
Other operating income	1	164	165	71	93	164
Operating income	1,271	815	2,086	1,681	1,178	2,859
Operating expense	(1,872)	(512)	(2,384)	(1,578)	(652)	(2,230)
Allocated expense	-	(6)	(6)	-	(2)	(2)
Net impairment	36	-	36	(27)	-	(27)
Earnings before tax	(565)	297	(268)	76	524	600
Net seg. rev. from ext. customers	1,450	796	2,246	1,832	1,200	3,032
Net seg. rev. from other segments	(179)	19	(160)	(151)	(22)	(173)
Operating income	1,271	815	2,086	1,681	1,178	2,859
Depreciation and amortization	250	33	283	182	35	217
Total assets	39,483	50,478	89,961	34,294	41,612	75,906
Total liabilities	23,573	31,576	55,149	18,899	28,062	46,961
Allocated equity	15,910	18,902	34,812	15,395	13,550	28,945

Geographic information

1.1.-31.3.2018	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	7,768	17	74	(967)	3	13	6,908
Net fee and commission income	2,881	158	309	191	2	1	3,542
Net financial income	1,306	(7)	221	(84)	(89)	(7)	1,340
Net insurance income	143	-	-	-	-	-	143
Share of profit of associates and net impairment	(18)	-	-	-	-	-	(18)
Other operating income	269	-	-	-	-	-	269
Operating income (loss)	12,349	168	604	(860)	(84)	7	12,184

1.1.-31.3.2017	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	7,938	95	77	(1,084)	122	12	7,160
Net fee and commission income	2,717	46	29	542	(5)	1	3,330
Net financial income	1,353	(5)	(241)	(4)	127	-	1,230
Net insurance income	447	-	-	-	-	-	447
Share of profit of associates and net impairment	(34)	-	-	-	-	-	(34)
Other operating income	564	-	-	-	-	-	564
Operating income (loss)	12,985	136	(135)	(546)	244	13	12,697

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Statement of Comprehensive Income

5. Net interest income

	2018				2017
	1.1.-31.3.				1.1.-31.3.
Interest income	Amortizised cost	Fair value thr. P/L	Fair value thr. OCI	Total	
Cash and balances with Central Bank	1,275	-	-	1,275	1,382
Loans	12,499	71	-	12,570	11,435
Securities	-	95	138	233	682
Other	84	-	-	84	224
Interest income	13,858	166	138	14,162	13,723
Interest expense					
Deposits	(3,236)	-	-	(3,236)	(3,123)
Borrowings	(3,987)	-	-	(3,987)	(3,413)
Other	(31)	-	-	(31)	(27)
Interest expense	(7,254)	-	-	(7,254)	(6,563)
Net interest income	6,604	166	138	6,908	7,160
Net interest income from financial assets and liabilities at fair value	-	166	138	304	682
Interest income from financial assets not at amortized cost	13,858	-	-	13,858	13,041
Interest expense from financial liabilities at amortized cost	(7,254)	-	-	(7,254)	(6,563)
Net interest income	6,604	166	138	6,908	7,160

	2018	2017
	1.1.-31.3.	1.1.-31.3.
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	2.6%	2.8%

6. Net fee and commission income

	2018			2017		
	1.1.-31.3.			1.1.-31.3.		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	1,012	(123)	889	991	(113)	878
Cards and payment solution	5,870	(4,315)	1,555	3,848	(2,488)	1,360
Collection and payment services	361	(26)	335	339	(27)	312
Investment banking	216	(10)	206	218	(13)	205
Lending and financial guarantees	462	-	462	409	-	409
Other	276	(181)	95	286	(120)	166
Net fee and commission income	8,197	(4,655)	3,542	6,091	(2,761)	3,330

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

Amounts are in ISK millions

7. Net financial income

	2018 1.1.-31.3.	2017 1.1.-31.3.
Dividend income	95	84
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	1,106	-
Net gain on fair value hedge of interest rate swap	226	59
Realized gain on financial assets carried at fair value through OCI*	121	-
Net gain on financial assets and financial liabilities classified as held for trading (IAS 39)	-	12
Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)	-	1,107
Net foreign exchange gain (loss)	(208)	(32)
Net financial income	1,340	1,230
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss		
Equity instruments mandatorily measured at fair value	1,083	-
Debt instruments mandatorily measured at fair value	76	-
Derivatives	(57)	-
Loans	4	-
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	1,106	-
Net gain on fair value hedge of interest rate swap		
Fair value change of interest rate swaps designated as hedging instruments	253	(256)
Fair value change on bonds issued by the Group attributable to interest rate risk	(27)	315
Net gain on fair value hedge of interest rate swap	226	59
Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)		
Equity instruments designated at fair value	-	752
Interest rate instruments designated at fair value	-	355
Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)	-	1,107

*Realized gain on financial assets carried at fair value through OCI comprises gain previously recognized in the Income Statement under IAS 39. With the adoption of IFRS 9, 1 January 2018 the total amount of unrealized gain on financial assets carried at fair value through OCI, net of tax was transferred to reserve for financial instruments carried at fair value, net of tax, see Note 32. Upon disposal realized gain on financials assets carried at fair value through OCI transferred to the Income Statement in accordance with IFRS 9, as the Bank elected not to restate comparative figures.

8. Net insurance income

	2018 1.1.-31.3.	2017 1.1.-31.3.
Earned premiums, net of reinsurers' share		
Premiums written	3,587	3,641
Premiums written, reinsurers' shares	(89)	(102)
Change in provision for unearned premiums	(1,056)	(1,400)
Change in provision for unearned premiums, reinsurers' share	-	(3)
Earned premiums, net of reinsurers' share	2,442	2,136
Claims incurred, net of reinsurers' share		
Claims paid	(1,851)	(1,470)
Claims paid, reinsurers' share	30	17
Change in provision for claims	(468)	(253)
Changes in provision for claims, reinsurers' share	(10)	17
Claims incurred, net of reinsurers' share	(2,299)	(1,689)
Net insurance income	143	447

Amounts are in ISK millions

9. Other operating income

	2018 1.1.-31.3.	2017 1.1.-31.3.
Fair value changes on investment property	136	93
Net gain on non-current assets held for sale	75	184
Other income	58	287
Other operating income	**269**	**564**

Net gain on non-current assets held for sale		
Income from real estates and other assets	149	266
Expense related to real estates and other assets	(74)	(82)
Net gain on non-current assets held for sale	**75**	**184**

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

10. Personnel and salaries

Number of employees	2018 1.1.-31.3.	2017 1.1.-31.3.
Average number of full-time equivalent positions during the period	1,290	1,209
Full-time equivalent positions at the end of the period	1,299	1,204
Number of employees at Arion Bank		
Average number of full-time equivalent positions during the period	832	833
Full-time equivalent positions at the end of the period	832	827
Salaries and related expense		
Salaries	3,735	3,391
Defined contribution pension plans	536	487
Salary-related expense	496	430
Capitalization of salaries, due to internally developed software	(131)	(86)
Salaries and related expense	**4,636**	**4,222**
Salaries and related expense for Arion Bank		
Salaries	2,450	2,397
Defined contribution pension plans	353	343
Salary-related expense	363	364
Salaries and related expense	**3,166**	**3,104**

During the period the Group made a provision of ISK 123 million (Q1 2017: ISK 146 million) for performance plan payments, including salary-related expense, of which the Bank made a provision of ISK 106 million (Q1 2017: ISK 128 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for Financial Undertakings. At the end of the period the Group's accrual for performance plan payments amounted to ISK 833 million (31.12.2017: ISK 942 million), of which the Bank's accrual amounts to ISK 686 million (31.12.2017: ISK 762 million).

Amounts are in ISK millions

11. Other operating expense

	2018 1.1.-31.3.	2017 1.1.-31.3.
Administration expense	3,202	3,101
Depositors' and Investors' Guarantee Fund	214	205
Depreciation of property and equipment	205	211
Amortization of intangible assets	355	297
Other expense	20	20
Other operating expense	3,996	3,834

12. Bank levy

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

13. Net impairment

	2018 1.1.-31.3.
Net change in impairment of cash and balances with Central Bank	(9)
Net change in impairment of loans to credit institutions	(20)
Net change in impairment of loans to corporates	(491)
Net change in impairment of loans to individuals	371
Net change in impairment of financial instruments carried at fair value through OCI, net of tax	(21)
Net change in impairment of loan commitments, guarantees and unused credit facilities	(314)
Net impairment on financial instruments	(484)
Increase in book value of loans to corporates	17
Increase in book value of loans to individuals	368
Other value changes on loans	385
Net impairment	(99)

Net impairment under IAS 39	2017 1.1.-31.3.
Net change in impairment of loans to corporates	671
Net change in impairment of loans to individuals	(35)
Net change in collective impairment on loans	(429)
Provision for losses	207
Increase in book value of loans to corporates	288
Increase in book value of loans to individuals	385
Net impairment	880

Amounts are in ISK millions

14. Income tax expense

	2018 1.1.-31.3.	2017 1.1.-31.3.
Current tax expense	898	1,524
Deferred tax expense	(80)	(153)
Income tax expense	**818**	**1,371**

Reconciliation of effective tax rate	2018 1.1.-31.3.		2017 1.1.-31.3.	
Earnings before tax		2,649		4,724
Income tax using the Icelandic corporate tax rate	20.0%	530	20.0%	945
Additional 6% tax on Financial Undertakings	6.2%	165	4.9%	410
Non-deductible expenses	0.0%	1	0.0%	(8)
Tax exempt revenue	(10.5%)	(278)	(4.4%)	(257)
Non-deductible taxes	6.1%	161	2.0%	159
Tax incentives not recognized in the Statement of Comprehensive Income	9.7%	258	0.0%	(17)
Other changes	(0.7%)	(19)	0.8%	139
Effective tax rate	**30.9%**	**818**	**29.0%**	**1,371**

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

Tax exempt revenues consist mainly of profit from equity positions.

15. Discontinued operations, net of tax

	2018 1.1.-31.3.	2017 1.1.-31.3.
Income from discontinued operations	148	-
Income tax expense	(30)	-
Discontinued operations, net of tax	**118**	**-**

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

16. Earnings per share

	Continued operations		Discontinued operations		Continued and discontinued operations	
	2018 1.1.-31.3.	2017 1.1.-31.3.	2018 1.1.-31.3.	2017 1.1.-31.3.	2018 1.1.-31.3.	2017 1.1.-31.3.
Net earnings attributable to the shareholders of Arion Bank	1,831	3,353	118	-	1,949	3,353
Weighted average number of outstanding shares for the period, million	1,930	2,000	1,930	2,000	1,930	2,000
Basic earnings per share	0.95	1.68	0.06	-	1.01	1.68

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

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Statement of Financial Position

17. Cash and balances with Central Bank

	31.3.2018	31.12.2017
Cash on hand	7,038	9,954
Cash with Central Bank	81,502	120,641
Mandatory reserve deposit with Central Bank	9,394	9,224
Cash and balances with Central Bank	97,934	139,819

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

18. Loans to credit institutions

Bank accounts	57,776	51,303
Money market loans	32,270	32,309
Other loans	4,915	2,997
Loans to credit institutions	94,961	86,609

19. Loans to customers

	Individuals		Corporates		Total	
31.3.2018	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	14,821	13,723	20,909	19,772	35,730	33,495
Credit cards	10,164	9,960	1,178	1,152	11,342	11,112
Loans to customers at fair value	-	-	6,339	6,339	6,339	6,339
Mortgage loans	320,681	319,811	20,448	20,391	341,129	340,202
Other loans	33,274	30,958	366,917	360,149	400,191	391,107
Loans to customers	378,940	374,452	415,791	407,803	794,731	782,255
31.12.2017						
Overdrafts	14,469	13,438	18,778	17,504	33,247	30,942
Credit cards	11,133	10,931	1,123	1,109	12,256	12,040
Mortgage loans	311,507	310,318	19,632	19,417	331,139	329,735
Other loans	33,629	30,600	368,312	361,784	401,941	392,384
Loans to customers	370,738	365,287	407,845	399,814	778,583	765,101

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

Further analysis of loans is provided in Risk Management Disclosures.

20. Financial instruments

	31.3.2018	31.12.2017
Bonds and debt instruments	56,698	51,755
Shares and equity instruments with variable income	24,220	36,190
Derivatives	7,650	7,624
Securities used for economic hedging	17,847	13,881
Financial instruments	106,415	109,450

Amounts are in ISK millions

21. Financial assets and financial liabilities

IFRS 9 measurement categories for the Group's financial assets and financial liabilities as at 31 March 2018.

31.3.2018 *Loans*	Amortized cost	Fair value through OCI	Manda-torily at fair value trough P/L	Total
Cash and balances with Central Bank	97,934	-	-	97,934
Loans to credit institutions	94,961	-	-	94,961
Loans to customers	775,916	-	6,339	782,255
Loans	968,811	-	6,339	975,150
Bonds and debt instruments				
Listed	-	39,760	14,191	53,951
Unlisted	-	2,382	365	2,747
Bonds and debt instruments	-	42,142	14,556	56,698
Shares and equity instruments with variable income				
Listed	-	-	8,085	8,085
Unlisted	-	-	12,248	12,248
Bond funds with variable income, unlisted*	-	-	3,887	3,887
Shares and equity instruments with variable income	-	-	24,220	24,220
Derivatives				
OTC derivatives	-	-	7,650	7,650
Derivatives used for hedge accounting	-	-	304	304
Derivatives	-	-	7,954	7,954
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	6,966	6,966
Bonds and debt instruments, unlisted	-	-	184	184
Shares and equity instruments with variable income, listed	-	-	10,685	10,685
Shares and equity instruments with variable income, unlisted	-	-	12	12
Securities used for economic hedging	-	-	17,847	17,847
Accounts receivable	8,472	-	-	8,472
Other financial assets	3,303	-	-	3,303
Financial assets	972,114	42,142	70,916	1,085,172
Financial liabilities				
Due to credit institutions and Central Bank	7,880	-	-	7,880
Deposits	453,059	-	-	453,059
Borrowings	400,855	-	-	400,855
Short position in bonds	-	-	877	877
Short position in equity	-	-	-	-
Derivatives	-	-	2,253	2,253
Derivatives used for hedge accounting	-	-	250	250
Other financial liabilities	30,480	-	-	30,480
Financial liabilities	892,274	-	3,380	895,654

*Including share certificates in funds with underlying high rated bonds, as part of the Bank's liquidity.

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

Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

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

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

**Including share certificates in funds with underlying high rated bonds, as part of the Bank's liquidity.

Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

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

31.3.2018	FVOCI	Mandatorily FVPL	Total
Financial and insurance activities	2,756	4,380	7,136
Public sector	33,459	9,477	42,936
Corporates	5,927	699	6,626
Bonds and debt instruments at fair value	42,142	14,556	56,698

31.12.2017*	Trading	Designated at fair value	Total
Financial and insurance activities	1,575	4,415	7,136
Public sector	823	38,389	42,936
Corporates	77	6,476	6,626
Bonds and debt instruments designated at fair value	2,475	49,280	56,698

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

The total amount of pledged bonds was ISK 10.7 billion at the end of the period (31.12.2017: ISK 13.4 billion). Pledged bonds comprised Icelandic and foreign Government bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

22. Fair value hierarchy

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

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

For assets and liabilities that are recognized at fair value on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorization (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting period. On 1 January 2018 the Group implemented IFRS 9 and as a result of the implementation assets previously measured at amortized cost were reclassified to mandatorily measured at fair value through profit and loss. The reclassified assets are measured as Level 2 assets.

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

31.3.2018

Assets at fair value	Level 1	Level 2	Level 3	Total
Loans to customers	-	6,148	-	6,148
Bonds and debt instruments	39,818	16,842	38	56,698
Shares and equity instruments with variable income	5,213	17,872	1,135	24,220
Derivatives	-	7,346	-	7,346
Derivatives used for hedge accounting	-	304	-	304
Securities used for economic hedging	17,496	351	-	17,847
Investment property	-	-	6,749	6,749
Assets at fair value	62,527	42,715	7,922	113,164
Liabilities at fair value				
Short position in bonds	877	-	-	877
Derivatives	-	2,003	-	2,003
Derivatives used for hedge accounting	-	250	-	250
Liabilities at fair value	877	2,253	-	3,130

Amounts are in ISK millions

22. Fair value hierarchy, continued

31.12.2017

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

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

There was no transfer between Level 1 and Level 2 during the period (2017: No transfers).

Fair value of assets and liabilities

The fair value of asset and liabilities is the amount at which the asset and liability could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Group to measure assets and liabilities. If quoted prices for an asset fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

Methods for establishing fair value

The best evidence of the fair value of an asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of an asset in Note 21 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

Level 1: Fair value established from quoted market prices
For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from quoted market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

Level 2: Fair value established using valuation techniques with observable market information
For assets and liabilities, for which the market is not active, the Group applies valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent market transactions between knowledgeable and willing parties, if available, reference to current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

For assets and liabilities for which quoted prices on active markets are not available, the fair value is derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

In most cases the valuation is based on theoretical financial models, such as the Black Scholes model or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

Amounts are in ISK millions

22. Fair value hierarchy, continued

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

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

In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of assets with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organizations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

The Group applies management valuation for determining fair value of investment properties. Management valuation is either based on recent transactions and offers for similar assets or present value calculations which involve estimation of future cash flow and the assessment of appropriate discount rate.

Movements in Level 3 assets measured at fair value

	Investment	Financial assets		
31.3.2018	property	Bonds	Shares	Total
Balance at the beginning of the year	6,613	39	1,130	7,782
Net fair value changes	136	(1)	(4)	131
Additions	-	-	9	9
Balance at the end of the period	**6,749**	**38**	**1,135**	**7,922**

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

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

Amounts are in ISK millions

22. Fair value hierarchy, continued

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

1.1.-31.3.2018	Investment property	Financial assets Bonds	Financial assets Shares	Total
Net interest income	-	-	-	-
Net financial income	-	(1)	(5)	(6)
Other operating income	136	-	-	136
Effects recognized in the Statement of Comprehensive Income	136	(1)	(5)	130

1.1.-31.3.2017	Investment property	Financial assets Bonds	Financial assets Shares	Total
Net interest income	-	16	-	16
Net financial income	-	(46)	-	(46)
Other operating income	93	-	-	93
Effects recognized in the Statement of Comprehensive Income	93	(30)	-	63

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

31.3.2018	Carrying value	Fair value	Unrealized gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	97,934	97,934	-
Loans to credit institutions	94,961	94,961	-
Loans to customers	782,255	789,007	6,752
Other financial assets	11,775	11,775	-
Financial assets not carried at fair value	986,925	993,677	6,752
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,880	7,880	-
Deposits	453,059	453,059	-
Borrowings	400,855	414,343	(13,488)
Other financial liabilities	30,480	30,480	-
Financial liabilities not carried at fair value	892,274	905,762	(13,488)

Amounts are in ISK millions

22. Fair value hierarchy, continued

31.12.2017 *Financial assets not carried at fair value*	Carrying value	Fair value	Unrealized gain (loss)
Cash and balances with Central Bank	139,819	139,819	-
Loans to credit institutions	86,609	86,609	-
Loans to customers	765,101	772,185	7,084
Other financial assets	8,948	8,948	-
Financial assets not carried at fair value	1,000,477	1,007,561	7,084
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,370	7,370	-
Deposits	462,161	462,161	-
Borrowings	384,998	402,355	(17,357)
Other financial liabilities	34,705	34,705	-
Financial liabilities not carried at fair value	889,234	906,591	(17,357)

Loans to customers are largely with variable interest rate. Those loans, including corporate loans, are presented at book value as they have generally short duration and very limited interest rate risk. Loans with fixed interest rate, mainly long term retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account loan to value. Defaulted loans are presented at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value.

The fair value for deposits with stated maturities is calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Statement of Financial Position.

Derivatives	Notional	Fair value	
31.3.2018	value	Assets	Liabilities
Forward exchange rate agreements	60,925	585	584
Fair value hedge of interest rate swap	133,650	358	44
Interest rate and exchange rate agreements	143,252	6,042	1,304
Bond swap agreements	4,924	3	24
Share swap agreements	10,433	660	283
Options - purchased agreements	449	2	14
Derivatives	353,633	7,650	2,253
31.12.2017			
Forward exchange rate agreements	52,914	563	251
Fair value hedge of interest rate swap	99,613	80	345
Interest rate and exchange rate agreements	199,723	6,265	1,392
Bond swap agreements	1,818	1	15
Share swap agreements	8,270	701	64
Options - purchased agreements	1,219	14	-
Derivatives	363,557	7,624	2,067

The Group applies fair value hedge accounting only with respect to interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate bonds, see Note 30, arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. On 1 January 2018 the Group implemented IFRS 9, but has elected to continue to apply the hedge accounting principles under IAS 39. For further information about the Group's hedge, accounting policy, see Note 54 in the Annual Financial Statement 2017.

Amounts are in ISK millions

23. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

	Assets subject to netting arrangements			Netting potential not recognized in the Balance Sheet				
31.3.2018	Gross assets before Balance Sheet nettings	Balance sheet nettings with gross liabilities	Assets recognized on balance sheet, net	Financial liabilities	Collateral received	Assets after consideration of netting potential	Assets not subject to enforceable netting arr-angements	Total assets recognized on balance sheet
Reverse repurchase agreements	15,197	-	15,197	(82)	-	15,115	-	15,197
Derivatives	6,400	-	6,400	(926)	-	5,474	1,250	7,650
Total assets	21,597	-	21,597	(1,008)	-	20,589	1,250	22,847
31.12.2017								
Reverse repurchase agreements	15,197	-	15,197	(82)	-	15,115	-	15,197
Derivatives	6,350	-	6,350	(1,210)	-	5,140	1,274	7,624
Total assets	21,547	-	21,547	(1,292)	-	20,255	1,274	22,821

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the Balance Sheet				
31.3.2018	Gross liabilities before Balance Sheet nettings	Balance sheet nettings with gross assets	Liabilities recognized on Balance Sheet, net	Financial assets	Collateral pledged	Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arr-angements	Total liabilities recognized on balance sheet
Repurchase agreements	82	-	82	(82)	-	-	-	82
Derivatives	1,087	-	1,087	(926)	-	161	1,166	2,253
Total liabilities	1,169	-	1,169	(1,008)	-	161	1,166	2,335
31.12.2017								
Repurchase agreements	82	-	82	(82)	-	-	-	82
Derivatives	1,299	-	1,299	(1,210)	-	89	768	2,067
Total liabilities	1,381	-	1,381	(1,292)	-	89	768	2,149

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

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

24. Investments in associates

The Group's interest in its principal associates	31.3.2018	31.12.2017
Audkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	25.4%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	35.8%	35.8%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	23.0%	23.0%
220 Fjördur ehf., Fjardargötu 13-15, Hafnarfjördur, Iceland	37.4%	37.4%

Investments in associates		
Carrying amount at the beginning of the year	760	839
Acquisitions	-	961
Dividend received	-	(41)
Disposals	-	(74)
Share of profit of associates and net impairment	(18)	(925)
Investment in associates	743	760

Arion Bank holds 38.4% of share capital in Farice ehf., but holds 35.8% of voting rights, based on different classes of share capital of Farice ehf.

25. Intangible assets

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

Infrastructure, which is capitalized as an intangible asset, is related to the asset management operation, payment solution and credit card operation and branding of the insurance operation. The business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as described below.

Customer relationships and related agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries and agreements bought. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationship related to individual customers through Retail Banking. The customer relationships is tested for impairment and related agreements are amortized over a period of five years with one year remaining. When deciding on the lifetime of those agreements it was based on experience of the Bank and the industry. As a result, those agreements are assessed as having an identified useful lifetime.

Acquired software and internally developed software is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

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

Amounts are in ISK millions

25. Intangible assets, continued

31.3.2018	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	4,315	3,705	1,492	4,336	13,848
Additions and transfers	-	-	-	305	305
Additions, internally developed	-	-	-	131	131
Exchange difference	(75)	-	(24)	(38)	(137)
Transfers and recalculation	(414)	-	106	14	(294)
Amortization	-	-	(73)	(282)	(355)
Intangible assets	3,826	3,705	1,501	4,466	13,498

31.12.2017	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,202	3,705	1,608	3,542	11,057
Acquisition through business combination	1,773	-	297	107	2,177
Additions and transfers	174	-	(125)	1,310	1,359
Additions, internally developed	-	-	-	347	347
Exchange difference	166	-	20	41	227
Impairment	-	-	(3)	-	(3)
Amortization	-	-	(305)	(1,011)	(1,316)
Intangible assets	4,315	3,705	1,492	4,336	13,848

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

26. Tax assets and tax liabilities

	31.3.2018		31.12.2017	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	6,307	-	6,329
Deferred tax	611	578	450	499
Tax assets and tax liabilities	611	6,885	450	6,828

Amounts are in ISK millions

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

	31.3.2018	31.12.2017
Disposal groups held for sale	5,860	5,219
Real estate	2,577	2,879
Other assets	59	40
Non-current assets and disposal groups held for sale	8,496	8,138

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

Eignabjarg ehf.

At 31 December 2016, the Bank held a loan of ISK 6,277 million against United Silicon, collateralized with shares in the company and other assets. The Bank also had a 6% equity interest in United Silicon and an unsecured bond. In 2017, Arion Bank further invested in United Silicon, obtaining an interest ownership of 16.3%, with voting rights of 23.9% and thus United Silicon became an associate of Arion Bank, accounted for according to the equity method, less impairment. The purpose of the investment was to support the company in operating difficulties, but due to those operating difficulties the Bank fully provisioned for the equity holdings in United Silicon in 2017.

In September 2017 the Bank foreclosed on collateral and took possession of the shares in United Silicon and became the largest shareholder of the company, with an interest ownership of 66.58% and voting rights of 66.68%. With this transaction the Bank acquired the control of United Silicon and thus the company became a subsidiary of the Bank. The fair value calculation of the underlying assets resulted in a provision on loans of ISK 2,962 million recognized in Net impairment as well as fair value loss of unsecured bond of ISK 708 million recognized in Net financial income of the Statement of Comprehensive Income. As of 31 December 2017, the book value of assets of United Silicon held by the Group was ISK 5,219 million. Late 2017 United Silicon was granted moratorium that did not turn out successfully and thus the board of directors of United Silicon declared the company bankrupt on 22 January 2018.

As United Silicon's primary lender, the Bank asserted a first lien position against all the operational assets of the company. In its capacity as such, the Bank also demanded the transfer of these assets and accompanying rights to a subsidiary of the Bank, Eignabjarg, an entity established for this purpose. This transfer occurred in March 2018. Eignabjarg thus holds assets acquired exclusively with a view to resale, and is classified as an asset held for sale and as discontinued operations as of 31 March 2018 in accordance with IFRS 5.

28. Other assets

	31.3.2018	31.12.2017
Property and equipment	6,543	6,561
Accounts receivable	8,472	6,531
Unsettled securities trading	1,604	481
Investment for life assurance policyholders where risk is held by policyholder	836	869
Sundry assets	2,652	2,524
Other assets	20,107	16,966

Amounts are in ISK millions

29. Other liabilities

	31.3.2018	31.12.2017
Accounts payable	18,260	26,394
Unsettled securities trading	620	527
Depositors' and Investors' Guarantee Fund	218	218
Technical provision	13,652	12,129
Technical provision for life assurance policyholders were investment risk is held by policyholder	836	869
Withholding tax	1,930	1,414
Bank levy	3,976	3,172
Sundry liabilities	16,223	12,339
Other liabilities	55,715	57,062

Technical provision	Technical provision	Reinsurers' share	Total 31.3.2018	Technical provision	Reinsurers' share	Total 31.12.2017
Claims reported and loss adjustment expenses	6,055	(121)	5,934	5,587	(121)	5,466
Claims incurred but not reported	1,664	(99)	1,565	1,664	(99)	1,565
Claims outstanding	7,719	(220)	7,499	7,251	(220)	7,031
Provision for unearned premiums	5,933	(19)	5,914	4,878	(19)	4,859
Own technical provision	13,652	(239)	13,413	12,129	(239)	11,890

Insurance claim consists of claims outstanding and provision for unearned premiums. Claims outstanding present unsettled claims incurred. Claims outstanding is the total of claims reported and actuarial estimation of claims incurred but not reported. Provision for unearned premiums presents the current insurance risk that will be conditional on future fiscal years.

Amounts are in ISK millions

30. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	31.3.2018	31.12.2017
ARION CBI 19, ISK 4,500 million	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,596	4,586
ARION CB 19, ISK 2,740 million	2016	2019	At maturity	Fixed, 5.50%	1,813	1,789
ARION CBI 21, ISK 10,220 million	2014	2021	At maturity	Fixed, CPI linked, 3.50%	9,839	9,729
ARION CB 22, ISK 23,660 million	2015	2022	At maturity	Fixed, 6.50%	25,176	23,339
ARION CBI 25, ISK 23,080 million	2017	2025	At maturity	Fixed, CPI linked, 3.00%	24,369	22,875
ARION CBI 29, ISK 25,220 million	2014	2029	At maturity	Fixed, CPI linked, 3.50%	26,658	26,243
ARION CBI 34, ISK 2,500 million	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	-	2,152
ARION CBI 48 ISK 3,500 million	2018	2048	Amortizing	Fixed, CPI linked, 2.50%	2,453	-
Statutory covered bonds					94,904	90,713
ARION CB 2, ISK 51,125 million	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	78,538	78,267
Structured Covered bonds					78,538	78,267
Total Covered bonds					173,442	168,980
EUR 21 million	2009	2018	Amortizing	Floating, EURIBOR +1.00%	346	348
ISK 3,835 million	2010	2018	Amortizing	Floating, REIBOR +1.00%	544	531
EUR 300 million	2015	2018	At maturity	Fixed, 3.125%	-	25,461
SEK 500 million	2016	2018	At maturity	Floating, 3 month STIBOR +1.09%	5,921	6,348
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	37,270	37,957
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	920	966
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	3,252	3,485
SEK 100 million	2017	2019	At maturity	Fixed, 0.29%	1,184	1,268
NOK 800 million	2015	2020	At maturity	Floating, NIBOR +2.95%	10,153	10,236
NOK 320 million	2016	2020	At maturity	Floating, NIBOR +1.95%	4,052	4,087
EUR 300 million*	2017	2020	At maturity	Fixed, 0.75%	36,529	37,356
SEK 300 million	2017	2020	At maturity	Floating, 3 month STIBOR +1.35%	3,556	3,811
SEK 250 million	2017	2020	At maturity	Floating, 3 month STIBOR +0.75%	2,960	3,173
EUR 500 million*	2016	2021	At maturity	Fixed, 1.625%	60,052	61,341
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,230	3,231
EUR 300 million	2018	2023	At maturity	Fixed, 1.0%	36,242	-
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,241	3,240
Senior unsecured bonds					209,452	202,839
Bills issued					16,248	10,794
Other					1,713	2,385
Other loans/bills					17,961	13,179
Borrowings					400,855	384,998

*The Group applies fair value hedge accounting to these bond issuances and uses certain foreign currency denominated interest rate swaps as hedging instruments, see Note 22. The interest rate swaps are hedging the exposure of the Group's changes in the fair value of these fixed-rate foreign currency denominated bonds arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. The total carrying amount of the bond issuances is ISK 96,581 million and included in the amount are negative fair value changes amounting to ISK 27 million, see Note 7.

The book value of listed bonds was ISK 382 billion at the end of the period (31.12.2017: ISK 371 billion). The market value of those bonds was ISK 395 billion (31.12.2017: ISK 388 billion). The Group repurchased own debts during the period for the amount of ISK 1 billion (2017: ISK 20 billion) with minor effects on the Statement of Comprehensive Income.

Amounts are in ISK millions

31. Pledged assets

Pledged assets against liabilities	31.3.2018	31.12.2017
Assets, pledged as collateral against borrowings	205,118	202,381
Assets, pledged as collateral against loans from credit institutions and short positions	10,734	13,364
Pledged assets against liabilities	215,852	215,745

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 205 billion at the end of the period (31.12.2017: ISK 202 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 173 billion at the end of the period (31.12.2017: ISK 169 billion).

The Group has pledged bonds against short term lending from the Central Bank of Iceland and against short positions, related to swap agreements, to hedge market risk of those assets.

32. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	31.3.2018	Number (million)	31.12.2017
Issued share capital	2,000	75,861	2,000	75,861
Purchase of treasury stock	(190)	(17,139)	-	-
Shares outstanding	1,810	58,722	2,000	75,861
Own shares	160	17,139	-	-

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

Other reserves	31.3.2018	31.12.2017
Statutory reserve	1,637	1,637
Reserve for investments in subsidiaries	12,577	14,011
Reserve for investments in associates	20	39
Reserve for investments in securities	475	901
Reserve for financial instruments carried at fair value through OCI, net of tax	44	-
Foreign currency translation reserve	127	186
Other reserves	14,880	16,774

Other information

33. Legal matters

The Group has in place formal controls and policies for managing legal claims. Once professional advice has been obtained and the likelihood and amount of loss reasonably estimated, the Group makes adjustments, if appropriate, to account for any adverse effects the claims may have on its financial standing. Should the Group conclude that it is to the detriment of the Group's case to disclose such potential amounts, relating to the legal claims raised, it elects not to do so. At the end of the year, the Group had several unresolved legal claims.

Contingent liabilities

Legal proceedings regarding damages

With a writ issued in June 2013, Kortathjónustan hf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and the Bank's subsidiary Valitor hf. in the amount of ISK 1.2 billion plus interest, as a result of damage Kortathjónustan hf. contended the five parties caused the company due to violations of the Competition Act. In June 2017 the Supreme Court dismissed the case on procedural grounds. Kortathjónustan hf. issued a new writ in September 2017 regarding the same matter of dispute, this time with a claim for damages in the amount of ISK 922 million plus interest from the same defendants. The District Court of Reykjavík dismissed the case in March 2018. Kortathjónustan hf. has appealed the judgement to the Court of Appeal. Should the defendants be ordered to pay damages, they would be jointly responsible. Therefore the Bank has not made any provision.

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., has filed two cases against the Bank with a claim for damages in the amount of more than ISK 4 billion, plus interest. The plaintiffs maintain that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagid Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. In April 2018 the District Court of Reykjavík dismissed the case ex officio. It is unclear whether the plaintiffs will appeal the judgment. The Bank believes that it will be acquitted of the plaintiffs' claims in both cases and has therefore not made any provision.

In January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed a suit against Valitor hf. for compensatory damages amounting to approximately ISK 8.1 billion relating to Valitor hf.'s termination of Datacell's vendor agreement. The Icelandic Supreme Court ruled on 24 April 2013 in case no. 612/2012 that Valitor hf. did not have the authority to terminate the agreement. The plaintiffs had court-appointed appraisers evaluate the plaintiffs' alleged losses and they returned their report in March 2016. Valitor hf. disagreed with the assessment stated in the report and filed a motion to appoint three court appraisers to re-evaluate the plaintiffs' alleged losses. The district court agreed to Valitor hf.'s demand. The reassessment has been completed but it was not filed with the court. Valitor hf. had requested a new assessment, which would examine particular aspects which have not yet been assessed butthe district court has rejected the request. It is unclear whether Valitor hf. will appeal the decision. Recently Datacell and Sunshine Press Production claimed an attachment of Valitor’s property on the basis of the aforementioned claim of compensatory damages but the district magistrate declined the claim. The plaintiffs subsequently filed a complaint with the District Court to re-evaluate the decision by the Magistrate to decline the attachment. A hearing has been scheduled in the District Court of Reykjavik on 16 May 2018 where Valitor will continue to defend itself. When Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014-2015, the Bank signed agreements with the sellers (Landsbankinn and two savings banks) concerning losses which Valitor may potentially sustain in relation to the compensatory damages described above. Thus the Group may lodge a claim against the sellers for their share in the potential loss should Valitor lose the case. The Group has not made any provision in this case.

33. Legal matters, continued

Other legal matters

Mortgage documents

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

United Silicon

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

Penalty interest during extension of payments

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

Off balance sheet information

34. Commitments

	31.3.2018	31.12.2017
Financial guarantees, unused credit facilities and undrawn loan commitments the Group has granted its customers		
Financial guarantees	12,892	13,224
Unused overdrafts	44,923	45,897
Unused loan commitments	93,388	87,942
Financial guarantees, unused credit facilities and undrawn loan commitments the Group has granted its customers	**151,203**	**147,063**

Depositors' and Investors' Guarantee Fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without reaching a conclusion on the matter.

35. Assets under management and under custody

	31.3.2018	31.12.2017
Assets under management	954,795	984,653
Assets under custody	1,705,432	1,620,355

Assets under management represent the total market value of the financial assets which the Group manages on behalf of its customers.

The Group, acting as custodian, is responsible for safeguarding a firm's or individual's financial assets, hold in safekeeping securities such as stocks, bonds and securities funds, arrange the settlement of trades and movements of securities, process corporate actions such as income on bonds and dividends on shares; and pricing on securities.

Amounts are in ISK millions

Related party

36. Related party

The Group has a related party relationship with Kaupskil ehf., which is the ultimate controlling party with a 55.57% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., which is the parent company of Kaupskil ehf. Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. holds 9.99% shareholding in Arion Bank and Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group manages 6.58% shareholding in Arion Bank, but the shareholding is managed by Kaupskil ehf. Taconic Capital Advisors UK LLP, TCA New Sidecar III S.A.R.L., Sculptor Investments S.A.R.L. and Och-Ziff Capital Management Group are thus defined as related party with control over the Group.

Attestor Capital LLP through Trinity Investment Designated Activity Company manages 12.44% shareholding in Arion Bank and Goldman Sachs International through ELQ Investors II Ltd. manages 3.37% shareholding in Arion Bank. All above-mentioned parties are defined as related party with influence over the Group.

In February 2018 Kaupskil ehf. acquired 13% shareholding held by the Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance). Íslandsbanki hf. and Landsbankinn hf. are wholly owned by ISFI. While the ISFI was defined as related party the Group applied the partial exemption for government-related entities as described in IAS 24, paragraphs 25-27.

In February 2018 Arion Bank hf. agreed to a buyback of 9.5% of issued share capital in Arion Bank from Kaupskil ehf. The decision to buy back these shares was in accordance with a decision made at a shareholders' meeting of Arion Bank on 12 February 2018.

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

Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

31.3.2018 *Balances with related parties*	Assets	Liabilities	Net balance
Shareholders with control over the Group	62	(2,367)	(2,305)
Shareholders with influence over the Group	1,501	(410)	1,091
Board of Directors and key Management personnel	207	(1,212)	(1,005)
Associates and other related parties	-	(39)	(39)
Balances with related parties	1,770	(4,028)	(2,258)

31.12.2017			
Shareholders with control over the Group	57	(4,785)	(4,728)
Shareholders with influence over the Group	423	(151)	272
Board of Directors and key Management personnel	183	(101)	82
Associates and other related parties	-	(83)	(83)
Balances with related parties	663	(5,120)	(4,457)

Amounts are in ISK millions

Risk management disclosures

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

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

37. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off balance sheet items such as commitments and guarantees.

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

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

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

37. Credit risk, continued

Exposure to credit risk

The table below shows the maximum exposure to credit risk for the components of the Interim Statement of Financial Position before the effect of mitigation due to collateral agreements or other credit enhancements. The table also shows related collateral and credit enhancements. The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- Retail loans to individuals: Mortgages on residential properties.
- Corporate loans: Real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

The value of collateral is based on estimated market value. The valuation of real estate is built on market price, official valuation of the Icelandic Property Registry, or the opinion of internal or external specialists. The valuation of fishing vessels takes into account related fishing quotas.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses. Collateral value are capped by the exposure amount. Comparative figures have not been updated.

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

		Collateral				
31.3.2018	Maximum exposure	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	97,934	-	-	-	-	-
Loans to credit institutions	94,961	-	-	-	-	-
Loans to customers	782,255	15,126	543,442	52,848	61,964	673,380
Individuals	*374,452*	*129*	*339,232*	*2*	*8,495*	*347,858*
Corporates	*407,803*	*14,997*	*204,210*	*52,846*	*53,469*	*325,522*
Real estate activities and construction	*128,346*	*297*	*114,652*	*-*	*1,619*	*116,568*
Fishing industry	*78,502*	*27*	*9,110*	*52,048*	*10,174*	*71,359*
Information and communication technology	*20,925*	*564*	*1,070*	*-*	*5,104*	*6,738*
Wholesale and retail trade	*62,505*	*269*	*34,226*	*18*	*19,154*	*53,667*
Financial and insurance activities	*31,255*	*13,380*	*7,045*	*684*	*6,588*	*27,697*
Industry, energy and manufacturing	*29,655*	*427*	*19,693*	*-*	*5,432*	*25,552*
Transportation	*16,957*	*2*	*1,069*	*8*	*1,961*	*3,040*
Services	*17,390*	*26*	*7,406*	*88*	*2,953*	*10,473*
Public sector	*9,080*	*5*	*3,800*	*-*	*193*	*3,998*
Agriculture and forestry	*6,848*	*-*	*6,139*	*-*	*291*	*6,430*
Other assets with credit risk	11,775	8,709	-	-	-	8,709
Financial guarantees	12,892	1,234	3,608	1,736	2,685	9,263
Undrawn loan commitments and unused overdrafts	138,311	-	-	-	-	-
Fair value through OCI	42,142	-	-	-	-	-
Government bonds	*33,459*	*-*	*-*	*-*	*-*	*-*
Corporate bonds	*8,683*	*-*	*-*	*-*	*-*	*-*
Balance at the end of the period	987,375	25,069	547,050	54,584	64,649	691,352

Amounts are in ISK millions

37. Credit risk, continued

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

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

LTV ratio for residential mortgage lending

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

31.3.2018	Gross carrying amount	Thereof credit impaired
Less than 50%	121,477	1,349
50-70%	120,610	2,351
70-90%	62,541	1,705
90-100%	15,576	603
100%-110%	7,825	516
More than 110%	13,071	1,043
Not classified	29	-
Balance at the end of the period	341,129	7,567

At the end of the period the gross carrying amount of assets in stage 3 are ISK 24,882 million with ISK 12,686 million in collateral, there of ISK 11,517 million in real estate.

Collateral repossessed

During the period the Group took possession of assets due to foreclosures. The total amounts of real estates the Group took possession of during the period and still holds at the end of the year amount to ISK 297 million (31.12.2017: ISK 833 million) and other assets ISK 22 million (31.12.2017: ISK 2 million). The assets are held for sale, see Note 28.

Amounts are in ISK millions

37. Credit risk, continued

Credit quality

The Bank uses internal credit rating models and external credit ratings if available to monitor credit risk. The internal credit rating models rates customers with one of four statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgement for large corporate exposures. Two models rate individuals' exposures – one for prime mortgages and another for other exposures. The models are updated at least annually and recalibrated with current data with the aim of improving their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement. External ratings are used for marketable securities, cash and balances, and loans to credit institutstions. For futher information on the rating scales used see Note 42.

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

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

Credit quality profile by rating class
31.3.2018

Assets carrying stage 1 ECL	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI
Investment grade	97,950	94,617	42,166
Non-investment grade	-	367	-
Gross carrying amount	97,950	94,984	42,166
Loss allowance	(16)	(23)	(24)
Book value	97,934	94,961	42,142

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 1 - (Grades A+ to BBB-)	336,263	83	-	-	336,346
Risk class 2 - (Grades BB+ to BB-)	243,618	19,137	-	-	262,755
Risk class 3 - (Grades B+ to B-)	111,791	12,564	-	50	124,405
Risk class 4 - (Grades CCC+ to CCC-)	18,901	11,784	-	2	30,687
Risk class 5 - (DD)	-	-	24,532	1,453	25,985
Unrated	7,537	326	350	-	8,213
Gross carrying amount	718,110	43,894	24,882	1,505	788,391
Loss allowance	(1,489)	(706)	(9,991)	(289)	(12,475)
Book value	716,621	43,188	14,891	1,216	775,916

Loans to customers - mortgage loans					
Risk class 1 - (Grades A+ to BBB-)	185,843	-	-	-	185,843
Risk class 2 - (Grades BB+ to BB-)	95,300	3,200	-	-	98,500
Risk class 3 - (Grades B+ to B-)	31,434	2,659	-	40	34,133
Risk class 4 - (Grades CCC+ to CCC-)	8,970	6,114	-	2	15,086
Risk class 5 - (DD)	-	-	6,524	1,043	7,567
Unrated	-	-	-	-	-
Gross carrying amount	321,547	11,973	6,524	1,085	341,129
Loss allowance	(170)	(68)	(585)	(104)	(927)
Book value	321,377	11,905	5,939	981	340,202

Amounts are in ISK millions

37. Credit risk, continued

Loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Risk class 1 - (Grades A+ to BBB-)	97,043	3	-	97,046
Risk class 2 to 4 - (Grades BB+ to CCC-)	45,644	3,012	208	48,864
Unrated	4,937	356	-	5,293
Gross carrying amount	147,624	3,371	208	151,203
Loss Allowance	(171)	(63)	(366)	(600)
Book value	147,453	3,308	(158)	150,603

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

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

Neither past due nor impaired loans

	Risk classification						
31.12.2017	1	2	3	4	5	Unrated	Total
Individuals	176,980	116,296	36,507	9,953	2,238	2,855	344,829
Real estate activities and construction	28,508	51,363	40,327	3,013	83	479	123,773
Fishing industry	37,742	28,908	9,129	1,498	653	-	77,930
Information and communication technology	17,691	1,162	2,958	21	-	3	21,835
Wholesale and retail trade	19,996	20,822	9,368	2,117	563	141	53,007
Financial and insurance activities	14,638	3,708	15,103	105	-	10	33,564
Industry, energy and manufacturing	17,236	6,394	4,233	794	187	-	28,844
Transportation	10,644	3,713	2,201	48	-	65	16,671
Services	2,392	6,227	5,224	432	2,443	3	16,721
Public sector	1,730	4,938	862	108	47	-	7,685
Agriculture and forestry	863	1,740	1,816	585	163	-	5,167
Neither past due nor impaired loans	328,420	245,271	127,728	18,674	6,377	3,556	730,026

Amounts are in ISK millions

37. Credit risk, continued

Past due but not impaired loans by class of loans 31.12.2017	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	4,361	4,221	1,774	1,339	1,960	13,655
Loans to individuals	3,065	8,149	4,387	350	2,978	18,929
Past due but not impaired loans	7,426	12,370	6,161	1,689	4,938	32,584

Loans past due up to three days are mainly overdrafts that were not renewed in time. The majority of the past due but not impaired loans are considered fully secured with collateral or have been acquired at discount. Loans acquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

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

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

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

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

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

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

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

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

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

Amounts are in ISK millions

37. Credit risk, continued

31.3.2018

Impairment loss allowance total	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	3,195	-	10,346	-	13,541
Net remeasurement	(1,309)	621	(363)	363	(688)
Opening balance at 1.1.2018	1,886	621	9,983	363	12,853
Transfers of financial assets:					
Transfers to Stage 1 - (12-month ECL)	326	(167)	(159)	-	-
Transfers to Stage 2 - (lifetime ECL)	(63)	80	(17)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(29)	(68)	97	-	-
Net remeasurement of loss allowance	(521)	325	1,442	11	1,257
New financial assets, originated or purchased	240	11	36	-	287
Derecognitions and maturities	(103)	(24)	(236)	(17)	(380)
Write-offs	(6)	(6)	(668)	(68)	(748)
Foreign exchange difference	(7)	(3)	(121)	-	(131)
Impairment loss allowance	1,723	769	10,357	289	13,138

Impairment loss allowance for assets only carrying 12-month ECL	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI	Total
ECL balance at 31.12.2017	-	-	-	-
Net remeasurement	7	3	3	13
Opening balance at 1.1.2018	7	3	3	13
Net remeasurement of loss allowance	9	20	8	37
Net effects of trading	-	-	13	13
Impairment loss allowance for assets only carrying 12-month ECL	16	23	24	63

Impairment loss allowance for loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	3,195	-	10,288	-	13,483
Net remeasurement	(1,502)	572	(363)	363	(930)
Opening balance at 1.1.2018	1,693	572	9,925	363	12,553
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	285	(154)	(131)	-	-
Transfers to Stage 2 - (lifetime ECL)	(61)	78	(17)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(29)	(67)	96	-	-
Net remeasurement of loss allowance	(492)	299	1,107	11	925
New financial assets, originated or purchased	172	9	36	-	217
Derecognitions and maturities	(66)	(22)	(236)	(17)	(341)
Write-offs	(6)	(6)	(668)	(68)	(748)
Foreign exchange	(7)	(3)	(121)	-	(131)
Impairment loss allowance for loans to customers	1,489	706	9,991	289	12,475

Amounts are in ISK millions

37. Credit risk, continued

Impairment loss allowance for loans to customers - mortgage loans	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	538	-	797	-	1,335
Net remeasurement	(345)	70	(128)	127	(276)
Opening balance at 1.1.2018	193	70	669	127	1,059
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	89	(13)	(76)	-	-
Transfers to Stage 2 - (lifetime ECL)	(7)	16	(9)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	-	(11)	11	-	-
Net remeasurement of loss allowance	(126)	4	(7)	(20)	(149)
New financial assets, originated or purchased	24	2	-	-	26
Write-offs	(3)	-	(3)	(3)	(9)
Impairment loss allowance for loans to customers - mortgage loans	170	68	585	104	927

Impairment loss allowance for loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
ECL balance at 31.12.2017	-	-	58	58
Net remeasurement	180	49	-	229
Opening balance at 1.1.2018	180	49	58	287
Transfers of financial assets				
Transfers to 12-month ECL	41	(13)	(28)	-
Transfers to lifetime ECL	(2)	2	-	-
Transfers to credit impaired financial assets	-	(1)	1	-
Net remeasurement of loss allowance	(66)	26	335	295
New financial assets, originated or purchased	55	2	-	57
Derecognitions and maturities	(37)	(2)	-	(39)
Impairment loss allowance for loan commitments, guarantees and unused credit facilities	171	63	366	600

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

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

*At the end of September 2017 Arion Bank became majority owner of United Silicon, see Note 27. Arion Bank had made provision for losses on loans to United Silicon which was eliminated on Group level when United Silicon became a subsidiary of Arion Bank.

Large exposure

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

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

Amounts are in ISK millions

38. Market risk

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

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

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

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

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

Interest rate risk

Interest rate risk arises from the possibility that changes in market rates adversely affect net interest income and fair value of interest-bearing instruments on the Group's balance sheet. The Group's operations are subject to interest rate risk due to mismatches in the fixing of interest rates between assets and liabilities, resulting in a repricing risk for the Group. The Group also faces interest basis risk between interest-bearing assets and interest-bearing liabilities due to different types of floating-rate indices in different currencies.

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

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

38. Market risk, continued

Interest rate risk in the banking book

The following table shows the Group's interest-bearing assets and liabilities by interest fixing periods. The figures for loans to customers and borrowings are shown on a fair value basis, see Note 22, and are therefore different from the amounts shown in these Condensed Consolidated Interim Financial Statements. The fair value reflects the likelihood of prepayment. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category.

31.3.2018	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	90,896	-	-	-	-	90,896
Loans to credit institutions	94,961	-	-	-	-	94,961
Loans to customers	469,207	71,275	137,308	7,011	104,206	789,007
Financial instruments	20,963	6,622	12,638	-	1,938	42,161
Assets	676,027	77,897	149,946	7,011	106,144	1,017,025
Liabilities						
Due to credit institutions and Central Bank	7,880	-	-	-	-	7,880
Deposits	392,727	44,665	13,434	1,343	890	453,059
Borrowings	37,261	11,938	221,546	31,957	111,641	414,343
Liabilities	437,868	56,603	234,980	33,300	112,531	875,282
Derivatives and other off-balance sheet items (net position)	(98,616)	931	100,902	1,520	-	4,737
Net interest gap	139,543	22,225	15,868	(24,769)	(6,387)	146,480

31.12.2017	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	129,864	-	-	-	-	129,864
Loans to credit institutions	86,609	-	-	-	-	86,609
Loans to customers	440,161	77,099	141,944	5,867	107,114	772,185
Financial instruments	27,342	3,033	8,186	-	1,866	40,427
Assets	683,976	80,132	150,130	5,867	108,980	1,029,085
Liabilities						
Due to credit institutions and Central Bank	7,370	-	-	-	-	7,370
Deposits	427,393	19,453	13,083	1,343	889	462,161
Borrowings	64,533	6,637	187,998	31,293	111,946	402,407
Liabilities	499,296	26,090	201,081	32,636	112,835	871,938
Derivatives and other off-balance sheet items (net position)	(99,372)	114	102,038	1,548	-	4,328
Net interest gap	85,308	54,156	51,087	(25,221)	(3,855)	161,475

Amounts are in ISK millions

38. Market risk, continued

Sensitivity analysis of interest rate risk in the banking book

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

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

	31.3.2018		31.12.2017	
NPV change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(2,161)	2,311	(1,465)	2,411
ISK, Non index-linked	103	1,103	(76)	742
Foreign currencies	55	(91)	88	(113)

	31.3.2018		31.12.2017	
NII change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(829)	829	(693)	693
ISK, Non index-linked	(98)	98	(429)	429
Foreign currencies	155	(155)	353	(353)

Sensitivity analysis of interest rate risk in the trading book

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

	31.3.2018		31.12.2017	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	149	(135)	99	(95)
ISK, Non index-linked	63	(52)	19	(14)
Foreign currencies	28	(27)	27	(27)

Amounts are in ISK millions

38. Market risk, continued

Indexation risk

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

Book value and maturity profile of indexed assets and liabilities

31.3.2018 *Assets, CPI index-linked*	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans to customers	22,393	94,570	235,041	352,004
Financial instruments	8,012	-	-	8,012
Off-balance sheet position	3,620	517	-	4,137
Assets, CPI index-linked	34,025	95,087	235,041	364,153
Liabilities, CPI index-linked				
Deposits	70,874	12,988	2,231	86,093
Borrowings	1,471	20,903	124,275	146,649
Other	894	204	1,364	2,462
Off-balance sheet position	-	548	-	548
Liabilities, CPI index-linked	73,239	34,643	127,870	235,752
Net on-balance sheet position	(42,834)	60,475	107,171	124,812
Net off-balance sheet position	3,620	(31)	-	3,589
CPI Balance	(39,214)	60,444	107,171	128,401

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

Amounts are in ISK millions

38. Market risk, continued

Currency risk

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

Breakdown of assets and liabilities by currency

31.3.2018

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank .	96,270	650	196	147	205	84	382	97,934
Loans to credit institutions	14,843	25,469	27,829	5,268	2,569	12,023	6,960	94,961
Loans to customers	640,484	96,713	30,069	3,718	6,587	759	3,925	782,255
Financial instruments	65,379	25,879	13,472	117	9	1,544	15	106,415
Other financial assets	8,760	1,179	530	1,123	136	23	24	11,775
Assets	825,736	149,890	72,096	10,373	9,506	14,433	11,306	1,093,340
Liabilities								
Due to credit inst. and Central Bank ..	7,349	388	58	3	-	1	81	7,880
Deposits	404,532	20,645	20,814	3,462	1,507	898	1,201	453,059
Financial liabilities at fair value	1,951	721	290	28	-	106	34	3,130
Other financial liabilities	21,385	2,881	4,100	1,260	495	195	164	30,480
Borrowings	191,334	170,455	1,504	12	-	20,676	16,874	400,855
Liabilities	626,551	195,090	26,766	4,765	2,002	21,876	18,354	895,404
Net on-balance sheet position	199,185	(45,200)	45,330	5,608	7,504	(7,443)	(7,048)	
Net off-balance sheet position	(2,034)	42,481	(45,459)	(2,235)	(7,742)	7,491	7,498	
Net position	197,151	(2,719)	(129)	3,373	(238)	48	450	

Addition, for management reporting

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Investment property	6,749	-	-	-	-	-	-	6,749
Investments in associates	735	8	-	-	-	-	-	743
Intangible assets	8,647	-	-	1,933	2,918	-	-	13,498
Tax assets	611	-	-	-	-	-	-	611
Non-current assets and disposal groups held for sale	8,496	-	-	-	-	-	-	8,496
Other non financial assets	7,991	68	17	203	17	9	27	8,332
Assets	33,229	76	17	2,136	2,935	9	27	38,429
Liabilities and equity								
Tax liabilities	6,885	-	-	-	-	-	-	6,885
Other non-financial liabilities	24,638	96	374	123	2	-	2	25,235
Shareholders' equity	204,117	-	-	-	-	-	-	204,117
Non-controlling interest	128	-	-	-	-	-	-	128
Liabilities and equity	235,768	96	374	123	2	-	2	236,365
Management reporting of currency risk*	(5,388)	(2,739)	(486)	5,386	2,695	57	475	

Amounts are in ISK millions

38. Market risk, continued

31.12.2017

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

Addition, for management reporting

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

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

Amounts are in ISK millions

38. Market risk, continued

Sensitivity analysis on currency risk

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

	31.3.2018		31.12.2017	
Currency	-10%	+10%	-10%	+10%
EUR	274	(274)	239	(239)
USD	49	(49)	(75)	75
GBP	(539)	539	(277)	277
DKK	(270)	270	232	(232)
NOK	(6)	6	(36)	36
Other	(48)	48	(101)	101

Equity risk

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. For information on assets seized and held for sale and equity exposures, see Notes 28 and 21 respectively.

Sensitivity analysis of equity risk

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

	31.3.2018		31.12.2017	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(366)	366	(166)	166
Banking book - listed	(443)	443	(540)	540
Banking book - unlisted	(1,225)	1,225	(1,170)	1,170

Derivatives

Derivatives are a part of the Group's customer product offering. The types of derivatives currently offered are forward contracts, swaps and options. Eligible underlying market factors are interest rates, foreign exchange rates, equities and commodities. Exposure limits, hedging requirements and collateral requirements are determined in accordance with the Group's risk appetite and monitored by Risk Management on a daily basis. The Group also uses derivatives to reduce market risk on its balance sheet. Note 22 shows a breakdown of the Group's derivative positions by type.

Amounts are in ISK millions

39. Liquidity and Funding risk

Liquidity risk is defined as the risk that the Group, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

The Group's primary source of funding is deposits from individuals, businesses and financial undertakings. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 69% is on-demand.

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

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

Maturity analysis of assets and liabilities

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

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

Contractual cash flow of assets and liabilities

31.3.2018 *Assets*	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Cash and balances with CB	12,418	76,151	9,535	-	-	-	98,104	97,934
Loans to credit institutions	62,079	31,993	-	916	-	-	94,988	94,961
Loans to customers	9,734	114,733	90,654	323,636	592,011	-	1,130,768	782,255
Financial instruments	12,893	12,252	15,151	28,925	6,519	34,917	110,657	106,415
Derivatives - assets leg	*4,800*	*34,461*	*4,495*	*62,072*	*1,319*	-	*107,147*	97,637
Derivatives - liabilities leg	*(4,711)*	*(32,423)*	*(4,956)*	*(54,127)*	*(938)*	-	*(97,155)*	(89,985)
Other financial assets	1,644	6,770	3,297	64	-	-	11,775	11,775
Assets	98,768	241,899	118,637	353,541	598,530	34,917	1,446,292	1,093,340

Amounts are in ISK millions

39. Liquidity and Funding risk, continued

Liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Due to credit inst. and Central Bank ...	8,236	-	-	-	-	-	8,236	7,880
Deposits	314,642	83,287	40,017	13,599	3,512	-	455,057	453,059
Financial liabilities at fair value	-	1,520	1,335	3,407	59	-	6,321	3,130
Derivatives - assets leg	-	*(35,925)*	*(17,035)*	*(22,978)*	*(985)*	-	*(76,923)*	(74,643)
Derivatives - liabilities leg	-	*36,568*	*18,370*	*26,385*	*1,044*	-	*82,367*	76,896
Short position bonds and derivatives	-	-	-	-	-	-	-	-
Short position securities used for economic hedging	-	*877*	-	-	-	-	*877*	877
Other financial liabilities	17,465	13,319	1,241	2,445	928	-	35,398	35,404
Borrowings	-	13,607	30,084	270,268	178,165	-	492,124	400,855
Liabilities	340,343	111,733	72,677	289,719	182,664	-	997,136	900,328
Net position for assets and liabilities	(241,575)	130,166	45,960	63,822	415,866	34,917	449,156	193,012
Off-balance sheet items								
Financial guarantees	2,978	1,308	2,964	3,226	2,416	-	12,892	12,892
Unused overdraft	-	44,923	-	-	-	-	44,923	44,923
Undrawn loan commitments	-	52,350	22,863	10,917	7,258	-	93,388	93,388
Off-balance sheet items	2,978	98,581	25,827	14,143	9,674	-	151,203	151,203
Net contractual cash flow	(244,553)	31,585	20,133	49,679	406,192	34,917	297,953	41,809

31.12.2017 *Assets*	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Cash and balances with CB	31,281	99,340	9,362	-	-	-	139,983	139,819
Loans to credit institutions	52,320	34,294	-	-	-	-	86,614	86,609
Loans to customers	2,908	107,790	90,076	336,545	568,833	-	1,106,152	765,101
Financial instruments	8,512	15,082	14,641	20,028	5,926	44,047	108,236	109,450
Derivatives - assets leg	*1,436*	*38,718*	*18,153*	*71,627*	*678*	-	*130,612*	*126,111*
Derivatives - liabilities leg	*(1,423)*	*(37,084)*	*(18,084)*	*(68,879)*	*(585)*	-	*(126,055)*	*(118,487)*
Other financial assets	1,535	5,103	2,224	86	-	-	8,948	8,948
Assets	96,556	261,609	116,303	356,659	574,759	44,047	1,449,933	1,109,927
Liabilities								
Due to credit inst. and Central Bank ...	7,658	-	26	-	-	-	7,684	7,370
Deposits	331,796	86,524	30,244	13,071	2,246	-	463,881	462,161
Financial liabilities at fair value	-	2,182	(102)	593	(273)	-	2,400	3,601
Derivatives - assets leg	-	*(20,039)*	*(11,449)*	*(14,407)*	*(1,557)*	-	*(47,452)*	*(40,930)*
Derivatives - liabilities leg	-	*20,688*	*11,347*	*15,000*	*1,284*	-	*48,319*	*42,998*
Short position bonds and derivatives	-	*410*	-	-	-	-	*410*	*410*
Short position securities used for economic hedging	-	*1,124*	-	-	-	-	*1,124*	*1,124*
Other financial liabilities	25,538	7,296	28	1,843	-	-	34,705	34,705
Borrowings	-	37,110	23,066	239,210	175,845	-	475,231	384,998
Liabilities	364,992	133,112	53,262	254,717	177,818	-	983,901	892,835
Net position for assets and liabilities	(268,436)	128,497	63,041	101,942	396,941	44,047	466,032	217,092
Off-balance sheet items								
Financial guarantees	2,918	2,852	3,164	2,827	1,463	-	13,224	13,224
Unused overdraft	-	45,897	-	-	-	-	45,897	45,897
Undrawn loan commitments	2,966	45,788	17,751	9,559	11,878	-	87,942	87,942
Off-balance sheet items	5,884	94,537	20,915	12,386	13,341	-	147,063	147,063
Net contractual cash flow	(274,320)	33,960	42,126	89,556	383,600	44,047	318,969	70,029

Amounts are in ISK millions

39. Liquidity and Funding risk, continued

Net Stable Funding Ratio

The net stable funding ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per the definition of the Central Bank of Iceland rules No. 1032/2014. In general, RSF is determined by applying different weights to different asset classes depending on the level of liquidity. ASF however is calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness. The NSFR for foreign currency shall exceed 100%.

Calculations of the NSFR are based on consolidated figures for the Bank and Arion Bank Mortgages Institutional Investor Fund. When calculating the ratio for foreign currencies, a negative foreign currency balance is subtracted from the numerator and a positive balance is subtracted from the denominator. The foreign currency balance used is different from that of this Consolidated Financial Statement due to the sub-consolidation applied.

31.3.2018	ISK	Foreign currency	Total
Available stable funding	652,619	229,355	881,974
Required stable funding	583,006	109,418	692,424
Foreign currency balance		12	
Net stable funding ratio	112%	210%	127%

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

Amounts are in ISK millions

39. Liquidity and Funding risk, continued

Liquidity coverage ratio

The Liquidity Coverage Ratio (LCR) is part of the standards introduced in the Basel III Accord. The LCR is the result of a stress test that is designed to ensure that banks have the necessary assets on hand to withstand short-term liquidity disruptions. More accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, assets must be non-pledged, liquid and easily priced on the market, repo-able at the Central Bank and not issued by the Group or related entities.

On 31 March 2017, new liquidity rules No. 266/2017 took effect. The rules are issued by the Central Bank of Iceland and effectively adopt the liquidity rules of the EU Capital Requirements Regulation (CRR), replacing the previous LCR rules No. 1031/2014. The Bank is required to maintain a 100% minimum LCR ratio for both foreign currencies and all currencies.

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

31.3.2018	ISK	Foreign currency	Total
Liquid assets level 1 *	89,456	32,893	122,349
Liquid assets level 2**	-	-	-
Liquid Assets	89,456	32,893	122,349
Deposits	95,166	30,063	125,229
Borrowing	3,772	1,006	4,778
Other cash outflows	6,441	10,702	17,143
Cash outflows	105,379	41,771	147,150
Short-term deposits with other banks ***	1,878	69,756	71,634
Other cash inflows	13,062	4,157	17,219
Cash inflows	14,940	73,913	88,853
Liquidity coverage ratio (LCR) ****	99%	315%	210%

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

* Level 1 assets include the Group's cash and balances with the Central Bank, domestic bonds eligible as collateral at the Central Bank and foreign government bonds which receive 100% weight. Under Rules No. 266/2017 the Group's covered bonds also classify as Level 1 assets and receive 93% weight.

** Level 2 assets include the Group's covered bonds with a minimum rating of AA- and receive a 85% weight in LCR calculations.

*** Short-term deposits in other banks are defined as cash inflows in LCR calculations.

**** LCR is defined as: LCR = Weighted liquid assets / (weighted cash outflows - weighted cash inflows) where weighted cash inflows are capped at 75% of weighted cash outflows.

Amounts are in ISK millions

39. Liquidity and Funding risk, continued

Composition of liquid assets

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

31.3.2018	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	96,270	196	650	818	97,934
Short-term deposits in other banks	1,878	21,788	22,172	25,796	71,634
Domestic bonds eligible as collateral at the Central Bank	4,802	-	-	-	4,802
Foreign government bonds	-	10,472	17,757	-	28,229
Covered bonds with a minimum rating of AA-	-	-	1,230	1,524	2,754
Liquidity reserve	102,950	32,456	41,809	28,138	205,353
31.12.2017					
Cash and balances with Central Bank	137,399	293	943	1,184	139,819
Short-term deposits in other banks	1,048	24,796	15,334	19,398	60,576
Domestic bonds eligible as collateral at the Central Bank	3,022	-	-	-	3,022
Foreign government bonds	-	6,401	16,291	-	22,692
Covered bonds with a minimum rating of AA-	-	-	1,262	1,538	2,800
Liquidity reserve	141,469	31,490	33,830	22,120	228,909

LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. The table contains deposits at the Bank and at banking subsidiaries. Thus, amounts due to Central Bank and amounts due to credit institutions at non-banking subsidiaries are excluded.

LCR categorization - amounts and LCR outflow weights	Deposits maturing within 30 days					
31.3.2018	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Retail	160,107	11%	49,367	5%	70,044	279,518
Corporations	42,074	40%	737	20%	6,608	49,419
Sovereigns, central banks and PSE	15,377	40%	-	-	5,317	20,694
Pension funds	51,126	100%	-	-	17,806	68,932
Domestic financial entities	18,550	100%	-	-	17,000	35,550
Foreign financial entities	3,039	100%	-	-	3,787	6,826
Total	290,273		50,104		120,562	460,939
31.12.2017						
Retail	163,542	11%	52,401	5%	68,741	284,684
Corporations	51,968	40%	811	20%	5,757	58,536
Sovereigns, central banks and PSE	14,583	40%	-	-	1,383	15,966
Pension funds	53,116	100%	-	-	15,391	68,507
Domestic financial entities	23,175	100%	-	-	15,949	39,124
Foreign financial entities	2,714	100%	-	-	-	2,714
Total	309,098		53,212		107,221	469,531

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

Amounts are in ISK millions

40. Capital management

Capital adequacy

The focus of capital management at the Group is to normalize the capital structure in the medium term and consequently maintain the Group's capitalization comfortably above the regulatory requirement, including capital buffers and Pillar 2 requirements.

The Group's capital ratios are calculated in accordance with Act No. 161/2002 on Financial Undertakings and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR), but has temporarily excluded Article 501 on capital requirements relief for small and medium enterprises. The Group uses the standardized approach to calculate capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

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

Own funds	31.3.2018	31.12.2017
Total equity	204,245	225,734
Deductions related to the consolidated situation	(7,870)	(8,635)
Non-controlling interest not eligible for inclusion in CET 1 capital	(128)	(128)
Common Equity Tier 1 capital before regulatory adjustments	196,247	216,971
Intangible assets	(10,834)	(11,125)
Tax assets	(425)	(357)
Cash flow hedges	(314)	265
Foreseeable dividend*	(975)	(25,000)
Additional value adjustments	(116)	(119)
Common equity Tier 1 capital	183,583	180,635
Non-controlling interest not eligible for inclusion in CET 1 capital	128	128
Tier 1 capital	183,711	180,763
General credit risk adjustments**	-	3,195
Tier 2 capital	-	3,195
Total own funds	183,711	183,958
Risk-weighted assets		
Credit risk, loans	610,623	605,058
Credit risk, securities and other	52,976	56,979
Counterparty credit risk	6,009	5,844
Market risk due to currency imbalance	8,695	4,895
Market risk other	11,522	5,473
Credit valuation adjustment	3,148	2,506
Operational risk	86,013	86,013
Total risk-weighted assets	778,986	766,768
Capital ratios		
CET 1 ratio	23.6%	23.6%
Tier 1 ratio	23.6%	23.6%
Capital adequacy ratio	23.6%	24.0%

* At 31 March 2018, the foreseeable dividend is 50% of the accumulated net earnings in 2018 which reflects the Bank's dividend policy. At 31 December 2017 the amount is the equity reduction executed in the first quarter of 2018 through purchase of own shares and dividend distribution.

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

Amounts are in ISK millions

40. Capital management, continued

The following table outlines the implementation of the capital buffer requirements in accordance with the Financial Undertakings Act, as prescribed by the Financial Stability Council and approved by the FME.

Capital buffer requirement, % of RWA	1.3.2017	1.11.2017	(1.5.2019)*
Capital conservation buffer	2.50%	2.50%	2.50%
Capital buffer for systematically important institutions	2.00%	2.00%	2.00%
Systemic risk buffer **	3.00%	3.00%	3.00%
Countercyclical capital buffer **	1.00%	1.25%	1.75%
Combined capital buffer requirement	8.50%	8.75%	9.25%

The Bank carries out an ongoing process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Group has in place sufficient risk management processes and systems to identify, manage and measure the Group's total risk exposure. The ICAAP is aimed at identifying and measuring the Group's risk across all risk types and ensure that the Group has sufficient capital in accordance with its risk profile. The FME supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole following the Supervisory Review and Evaluation Process (SREP). The Group's own funds exceeds the FME's SREP requirements.

The Bank's Pillar 2R capital add-on, which is the result of the ICAAP/SREP, may comprise 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. With the current capital structure, the Pillar 2R requirement is solely met with CET 1 capital.

31.3.2018

Capital requirement, % of RWA, current	CET 1	Tier 1	Total
Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement ***	1.9%	2.6%	3.4%
Combined buffer requirement **	8.4%	8.4%	8.4%
Regulatory capital requirement	14.8%	17.0%	19.8%
Available capital	23.6%	23.6%	23.6%

* On 13 April 2018, the Financial Stability Council gave recommendation to the FME for a 0.5% increase to the countercyclical capital buffer for Icelandic exposures. The FME had not confirmed the increase as of the release of the Comprehensive Financial Statement.

**The effective capital buffers for systemic risk and countercyclical effects are determined by calculating the weighted average of the corresponding buffer levels of each country (if recognized by the FME), the weights being the total risk weighted exposures for credit risk against counterparties residing in those countries.

*** The SREP result based on the Group's financial statement at 31.12.2016. The Pillar 2 requirement is 3.7% of risk-weighted assets based on accounting consolidation. Based on the Group's consolidated situation under CRR, which excludes Vörður tryggingar hf., the requirement is 3.4%.

Leverage ratio

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

	31.3.2018	31.12.2017
On-balance sheet exposures	1,081,484	1,074,207
Derivative exposures	10,931	10,957
Securities financing transaction exposures	8,542	8,925
Off-balance sheet exposures	88,456	83,058
Total exposure	1,189,413	1,177,147
Tier 1 capital	183,711	180,763
Leverage ratio	15.4%	15.4%

Solvency II

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vördur Group was 3,503 million at 31 December 2017 and calculated solvency of Vördur Group was ISK 4,949 million. The solvency ratio, which is the ratio of calculated solvency to the solvency requirements was 141% at 31 December 2017.

Amounts are in ISK millions

Significant accounting policies

The accounting policies adopted in the preparation of these Condensed Consolidated Interim Financial Statements are consistent with those followed in the preparation of the Annual Financial Statements for the year ended 31 December 2017 except for changes due to implementation of new accounting standards. The Group adopted IFRS 9 Financial Instruments. As a result of the implementation, the Group changed the accounting policies in the areas outlined below regarding classification of financial assets and impairment calculations. The Group has elected to continue to apply the hedge accounting prinsiples under IAS 39 instead of those under IFRS 9. The new policies were applicable from January 1, 2017. As permitted by the transition provisions of IFRS 9, the Group elected not to restate comparative figures; Accordingly, all comparative periods are presented in accordance with IAS 39. For further detail on the accounting policy under IAS 39 see the Groups Annual Financial statements 2017. Adjustments to carrying amounts of financial assets and liabilities at the date of initial application were recognized in Retained earnings and Other reserves within Equity. New or amended interim disclosures have been provided for the period, where applicable, and comparative period disclosures are consistent with those made in prior year. For further information, see Financial assets and Finacial liabilites classification transition from IAS 39 to IFRS 9.

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

41. Going concern assumption

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

42. Financial assets and financial liabilities - Classification and Measurement

Recognition and initial measurement

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

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

Debt instruments

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

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

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

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

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

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

All other debt instruments are carried at FVTPL.

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

Business model assessment

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

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

Cash flow characteristics assessment

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

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

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

Debt instruments measured at amortized cost

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

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

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

Debt instruments measured at FVOCI

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

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

Debt instruments measured at FVTPL

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

Equity instruments

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

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

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

Financial assets and liabilities designated at FVTPL

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

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

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

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

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

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

Purchased loans

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

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

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

Expected credit losses

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

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

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

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

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

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

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

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

Definition of default

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

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

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

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

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

Probability of default and credit risk rating

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

The Group's rating scale is shown below.

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

Amounts are in ISK millions

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

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

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

PD term structures

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

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

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

Significant increase in credit risk

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

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

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

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

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

Exposures in default

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

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

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

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

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

Expected credit loss measurement

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

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

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

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

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

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

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

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

Forward looking scenarios

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

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

Write-off of loans

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

Modifications

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

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

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

Consolidated
Financial Statements

For the year 2017

Arion Bank

Endorsement and statement
by the Board of Directors and the CEO

The Consolidated Financial Statements of Arion Bank for the period from 1 January to 31 December 2017 include the Consolidated Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Outlook

Icelandic economy is doing well and GDP grew by 4.3% in the first nine months of 2017, fueled by soaring private consumption, and to a lesser extent, continued investment growth. In recent months signs have been emerging suggesting that the economy is reaching an equilibrium following a period of exceptional growth. A turning point was reached last year as housing investment took up the baton from business investment as the main driving force behind investment growth, while public investment also picked up steam. However, there was a substantial slow-down in both investment and export growth. It appears that tourism has passed its peak growth, at least for the time being, with more moderate growth on the horizon. Inflation remains below the Central Bank's inflation target, although inflationary pressure is picking up. Despite a slight depreciation last summer following the removal of nearly all capital controls, the króna has remained strong and fluctuations have somewhat decreased. The economic outlook is favorable and Arion Research predicts continued GDP growth, low unemployment but rising inflation as the year goes by, albeit still remaining within the Central Bank’s tolerance level.

About Arion Bank

Arion Bank is a leading, well balanced universal relationship bank operating on the Icelandic financial market. The Bank has a moderate risk profile and enjoys a strong position in all its business segments: Retail Banking, Corporate Banking, Asset Management and Investment Banking. The Bank's subsidiaries further supplement its service offering. The largest subsidiaries are Valitor, Stefnir and Vördur tryggingar. Valitor is a market leader in Iceland in acquiring services and payment solutions and also has operations in Scandinavia and the United Kingdom. Stefnir is Iceland's largest fund management company and Vördur tryggingar is the fourth largest insurance company in Iceland and provides both non-life and life insurance services.

Arion Bank places great importance on innovation and efficiency in its operations. A key area of focus for many years has been developing online banking, and in recent years mobile banking has been a priority. The Bank has also set itself the goal of being the leading digital bank in Iceland and has become a market leader in digital solutions. Over the last two years the Bank has launched 15 digital solutions, particularly targeted at retail customers. These solutions have had a profound impact on the Bank's market position, for example in the mortgage market, where the Bank is in fierce competition with the pension funds which enjoy a far more beneficial regulatory and taxation environment. Arion Bank has been able to maintain and even increase its market share by competing on services and dealing swiftly with customer requests. New digital solutions have therefore already had, and will continue to have, a lasting impact on how the Bank meets the needs of its customers. The new solutions will furthermore reduce operating expenses across the Bank in the long term. The number of branches has been substantially reduced in recent years and the Bank will continue to seek ways to bring greater efficiency to the branch network.

Arion Bank will keep on offering its customers quality services in the areas which are important to them, whether in Retail Banking, Corporate Banking, Asset Management or Investment Banking. The Bank is financially robust which enables it to grow alongside its customers and to pay competitive dividends to its owners.

Operations during the year

Net earnings amounted to ISK 14,419 million for 2017, and the total equity amounted to ISK 225,734 million at the end of the year. Return on equity was 6.6% for the year. The capital ratio of the Bank, according to the Financial Undertakings Act No. 161/2002, was 24.0% and the corresponding CET 1 ratio was 23.6%, when taking into account the foreseeable dividend payment and purchase of own shares in the coming weeks. This comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also strong at year-end and well above the regulatory minimum.

The main changes on the Balance Sheet from year-end 2016 relate to Cash and balance with the Central Bank, which have increased by ISK 52,185 million, or 59.5%, during the year. Loans to customers increased by ISK 52,679 million or 7.4%, deposits increased by ISK 50,097 million or 12.2% and borrowings grew by ISK 45,522 million or 13.4% during the year. The main reasons for the increase in cash are higher deposits in Retail Banking in 2017 and new borrowings, as well as the fact that no dividend has been paid for two years. New lending is mainly in the form of mortgages to retail customers and loans to corporates in the real estate and transportation sectors.

In 2017 the Bank's subsidiary Valitor Holding hf. acquired two companies: IPS - International Payment Services Ltd. and Chip and Pin Solutions Ltd. The purpose of the acquisition is to strengthen Valitor's direct channel market position in United Kingdom.

The Group had 1,284 full-time equivalent positions at the end of the year, compared with 1,239 at the end of 2016; 844 of these positions were at Arion Bank, compared with 869 at the end of 2016. The increase between years is mainly due to the acquisition of active companies within the Valitor group and the company's increased activities internationally. The decrease at the parent company can be attributed to the outsourcing of IT systems and streamlining measures taken in implementing the Bank's digital strategy.

The tax environment did not change for Arion Bank during the year even though taxes paid by the main Icelandic banks are much higher than those paid by other companies. Most significant in this respect are the special 6% tax on earnings exceeding ISK 1 billion and the bank levy of 0.376% on liabilities exceeding ISK 50 billion.

In October Standard & Poor's upgraded Arion Bank's credit rating from BBB with a positive outlook to BBB+ with a stable outlook. The upgrade reflects Arion Bank's improved capital position, and the expectation that the Bank will maintain a very strong risk-adjusted capital ratio. It also reflects an improved view of the economic risks in the Icelandic banking sector, as the economic environment remains supportive following the release of capital controls earlier this year.

United Silicon

Sameinad sílikon hf. (United Silicon), a borrower of the Bank, was granted a moratorium on payments on 14 August 2017, the aim of which was enable an agreement to be reached with creditors over outstanding debts. The moratorium was granted owing to the operating difficulties experienced by the company following repeated shutdowns of production at the company's plant, which commenced operations in November 2016. A recent judgement on compensation from the company relating to a dispute over payments during the construction period to one of Iceland's largest contractors, ÍAV hf., exacerbated the problem.

United Silicon used the moratorium period to analyze the reasons for the operating difficulties at its plant and to negotiate deals with its creditors to defer payment or to convert debt. To analyze the operating difficulties at the plant, Icelandic and international specialists were hired to evaluate, as far as possible, whether and how much additional investment is needed to bring the plant up to full production capacity, both in terms of the quantity and quality of the products. Arion Bank monitored this analysis and in its assessment assumed that the plant would continue to operate, following additional investment. In light of this information, the Bank believed that the basis for running the plants operation was viable. However, in January 2018 it became clear that the Icelandic Environmental Agency did not agree with the remedial action proposed by the company following the aforesaid evaluation. The Agency found that further remedial action would need to be undertaken, some of which was likely to require an additional environmental impact study which, in turn, was likely to postpone the recommissioning of the plant by 18-20 months. Against this backdrop and without funds to sustain operations for this period, the board of directors of United Silicon declared the company bankrupt on 22 January 2018.

Arion Bank is United Silicon's primary lender and expects to enjoy a first lien position against all the operational assets of the company. As such the Bank will demand the transfer of these assets and accompanying rights to a newly established subsidiary of the Bank, Eignabjarg, established for this purpose. This transfer is expected to be effected in the first quarter of 2018. The Bank intends to either find buyers for this new subsidiary in its current form or proceed with the necessary remedial action and divest the plant thereafter. At year-end 2017, the Bank's holding in United Silicon was classified as a disposal group held for sale in accordance with IFRS, as reflected in Note 28.

In the Bank's view the work undertaken during United Silicon's moratorium dispelled some of the uncertainty regarding the operational status of its business and considerably simplified the recovery and divestment process ahead. On that basis, no further impairments against United Silicon's assets were made at the end of 2017. The book value of United Silicon's assets at year-end was ISK 5.4 billion and loan commitment and guarantees are an additional ISK 0.9 million.

Funding and liquidity

The Bank's liquidity position is strong, with a liquidity coverage ratio of 221%, see Note 42, well above the regulatory minimum of 100%. The strong liquidity position is partly due to pre-financing of upcoming maturities of bonds and planned dividend payments.

Deposits, which are the core of the Bank's funding, increased by ISK 50 billion or 12.2% during the year, mainly due to an increase in retail deposits. Long-standing economic growth and the increase in purchasing power of our customers is having a positive effect on deposit development.

At the beginning of 2017 Arion Bank tapped its outstanding five-year senior unsecured EUR 300 million (ISK 36 billion) bond originally issued in late 2016 for a further EUR 200 million (ISK 24 billion). The bonds were sold at rates corresponding to a 1.55% margin over interbank rates. In June 2017, Arion Bank issued new three-year senior unsecured bonds for a total of EUR 300 million (ISK 35 billion) in a transaction which was oversubscribed twofold. The bonds were sold at rates corresponding to a 0.88% margin over interbank rates.

The proceeds of these issues were partly used to repay the resettable EMTN held by Kaupthing and to tender outstanding notes due in March 2018 for EUR 100 million from EUR 300 million to EUR 200 million, thereby reducing refinancing risk for 2018.

During the year Arion Bank has issued EMTN private placements in NOK and SEK for an equivalent of ISK 19.6 billion, issued a total of ISK 29.9 billion of covered bonds and issued commercial paper amounting to ISK 20 billion.

Endorsement and statement
by the Board of Directors and the CEO

Capital and dividend

Arion Bank is financially robust, as reflected in its leverage ratio of 15.4%, see Note 43. Return on equity was 6.6% during the year. The capital ratio of the Bank, according to the Financial Undertakings Act No. 161/2002, was 24.0% and the corresponding Tier 1 ratio was 23.6%. The decrease from the previous year is due to the decision taken at a shareholders' meeting on 12 February on a proposed dividend of ISK 25 billion, based on profit generated prior to 2017, to be paid over the next few weeks. The reason the Bank's capital position is so strong is that Kaupthing, the majority shareholder, has, until now, not wished to be paid a divided because of its agreement with the government. The Bank aims to reduce its CET 1 ratio to 17% over the next few years through further dividend payments or buying its own shares. The Bank will remain financially robust, both in terms of the requirements of regulators and by international standards. The debt ratio is expected to be at least 10% after the above reduction of CET 1.

The Board of Directors proposes that net earnings be added to equity and that no dividend be paid in 2018 for the fiscal year 2017, for now. The Board of Directors has the authority to propose that the Bank pay dividends or other disbursement of equity and may convene a special shareholders' meeting, prior to Annual general meeting in 2019, to propose a payment.

Group ownership

Kaupthing ehf. has a controlling share in Arion Bank hf through its subsidiary Kaupskil ehf. At the end of 2017 Kaupskil held 57.41% of share capital. Kaupskil ehf. also controls the 9.99% shareholding of Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. and 6.58% shareholding of Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group. Other shareholders are Attestor Capital LLP through Trinity Investment Designated Activity Company, which holds 10.44%, and Goldman Sachs International through ELQ Investors II Ltd, which holds holds 2.57%. Icelandic State Financial Investments holds 13.00% on behalf of the Icelandic government. On 14 February 2018 changes among the shareholders of the Bank were announced, see further information in Note 38.

The Board of Directors has eight members, four women and four men. Furthermore, three Alternate Directors (two men and one woman) are elected and they attend meetings of the Board of Directors in the event that a Director resigns or is unable to attend. The ratio of men to women is therefore in compliance with the law which states that companies with more than 50 employees should ensure that the ratio of either gender on the Board of Directors should not be less than 40%. Six Directors are nominated by Kaupskil ehf., one by Attestor Capital LLP and one by Icelandic State Financial Investments. Seven Directors and two Alternates are independent of Arion Bank and its day-to-day managers as well as of Arion Bank's significant shareholders.

On 10 May 2017 Monica Caneman, Chairman of the Board of Directors, decided to step down from the Board of Directors of Arion Bank. On 23 June 2017 Eva Cederbalk was elected as a new Director to the Board of Arion Bank and was elected Chairman of the Board on 26 June 2017. Gudrún Johnsen, the Vice Chairman of the Board, served as interim Chairman of the Board from May 2017 until June 2017. On 30 November Steinunn K. Thórdardóttir was elected as a new Director to the Board of Arion Bank replacing Gudrún Johnsen, who stepped down from the Board of Directors.

Risk management

The Group faces various risks arising from its day-to-day operations as a financial institution. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as is the ability to ensure that the Group's exposure to risk remains within acceptable levels. The Group's risk management, its structure and main risk factors are described in the notes, starting at Note 40.

Corporate governance

The Board of Directors of Arion Bank is committed to good corporate governance and endeavours to promote responsible behavior and corporate culture within Arion Bank for the benefit of all stakeholders. Arion Bank has to this end devised a corporate governance statement which is designed to help foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. In December 2015 Arion Bank was recognized as a company which had achieved excellence in corporate governance. The recognition applies for three years unless significant changes are made to the Bank’s management or ownership.

The Board of Directors is the supreme authority in the affairs of the Bank between shareholders’ meetings. The Board tends to those operations of the Bank which are not considered part of the day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. The Board of Directors appoints a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The CEO hires the Executive Management. There are four Board subcommittees: the Board Audit Committee, the Board Risk Committee, the Board Credit Committee and the Board Remuneration Committee. The committee members are all Directors and there is one expert member on the Board Audit and Risk Committee.

Endorsement and statement
by the Board of Directors and the CEO

The main roles of the Board, as further specified in the rules of procedure of the Board, include approving the Bank's strategy, supervising financial affairs and accounting and ensuring that appropriate internal controls are in place. The Board ensures that the Bank has active Internal Audit, Compliance and Risk Management departments. The Internal Auditor is appointed by the Board of Directors and works independently of other departments of the Bank in accordance with a charter from the Board. The Internal Auditor provides independent and objective assurance and advice designed to add value and improve the Bank's operations. The Compliance Officer, who reports directly to the CEO, works independently within the Bank in accordance with a charter from the Board. The role of Compliance is to apply effective precautionary measures to ensure that Arion Bank complies at all times with the law, regulations and good business practices, and to foster an affirmative corporate culture in this respect.

Corporate governance at Arion Bank is described in more detail in the Bank's Corporate Governance Statement which is contained in the unaudited appendix to the Financial Statement and on the website www.arionbanki.is. The Corporate Governance Statement is based on legislation, regulations and recognized guidelines in force when the Bank's annual financial statements are adopted by Board of Directors. This statement is prepared in accordance with the Financial Undertakings Act No. 161/2002 and Guidelines on Corporate Governance, 5th edition, issued by the Icelandic Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland in May 2015. Corporate governance at Arion Bank complies with the guidelines with a few exceptions, which are explained in more detail in the Corporate Governance Statement.

Sustainability

Arion Bank takes an active role in our society and its development. Financial institutions are one of the pillars of society and our role is to help our customers, both individuals and companies, reach their goals. The employees are guided by the Bank's cornerstones: we make a difference, we say what we mean and we get things done. The Bank's code of ethics also serves as a key to responsible decision-making at Arion Bank. The code of ethics is approved by the Board of Directors.

Arion Bank has played an important role in the regeneration of the Icelandic economy, not least in the rebuilding of the Icelandic stock market. The Bank has played an active role in more than 60% of stock offerings in recent years, including all offerings since 2015. The Bank is dedicated to supporting the Icelandic business sector and with this aim in mind has actively supported innovation and it has helped to set up two business accelerators, Startup Reykjavík and Startup Energy Reykjavík, where entrepreneurs are given the opportunity to develop their business ideas. Startup Reykjavík is fully owned by Arion Bank, while Startup Energy Reykjavík is a joint project with several leading players on the Icelandic energy market. During the year Arion Bank invested in 9 startups which participated in the business accelerators and it has now invested in more than 80 such companies in the last few years. The Bank has also invested more than ISK 1 billion in the venture capital fund Eyrir Sprotar and supported innovation at primary and secondary level schools across Iceland.

Lean management has been introduced across the Bank with the aim of improving service and eliminating waste. Constant improvements are integral to the Bank's culture. Improvements are recorded, targets set and then followed up on. During the year an average of 7.5 improvements were made per employee. In keeping with lean management there has been a strong focus on increasing digital services and 10 new digital solutions for customers were introduced during the year. The principal objective of the Bank's digital solutions is to make things easier for the customer and to make banking more convenient. Digital solutions lessen the ecological footprint of the Bank and its customers by reducing the number of trips made by customers to branches and cutting back on the use of paper. The Bank also places great importance on being able to provide first-class advice at its branches and its employees also provide financial guidance to customers in order to help them gain a better understanding of their own finances.

Since the Bank was founded one its key objectives has been to run an efficient and profitable business and to safeguard the Bank's financial strength by meeting all capital and liquidity requirements. Internal control has been systematically reinforced and at the end of 2017 around 44 people worked in this area. Arion Bank has been recognized for good corporate governance. Arion Bank has been awarded Equal Pay Certification by the labour union VR and has implemented a quality system which aims to eliminate the gender pay gap.

In 2017 the Bank continued to implement its policy on sustainability, which was approved by the Board of Directors in late 2016 and presented to employees. Workshops were held during the year with employees to discuss the new sustainability policy and what employees could do in their day-to-day work to make the Bank an even more socially responsible business. The Bank also worked on devising a formal policy on responsible investments which will be implemented in the Bank's investment and lending processes. This work will continue in 2018. During the year the Bank became a signatory to the United Nations Principles on Responsible Investment.

In 2015 Arion Bank signed the City of Reykjavík and Festa's Declaration on Climate Change and in in 2016 in collaboration with an Icelandic innovation company, Klappir Green Solutions, the Bank assessed its ecological footprint and set itself a target on how to reduce it. The Bank continued to work on these issues in 2017 and the 2017 annual report will again contain a detailed report on social responsibility and sustainability at the Bank. The report takes into account non-financial information highlighted by Nasdaq Iceland, the UN's global objectives and the 10 principles in the UN Global Compact in which Arion Bank became a participant in 2016. Arion Bank's 2017 annual report will provide more in-depth coverage of environmental, social and HR issues at the Bank as stipulated in Article 66 d of the Annual Accounts Act, and the risk report will as usual deal with the main risks connected with the Bank's operations.

Endorsement and statement
by the Board of Directors and the CEO

Endorsement of the Board of Directors and the Chief Executive Officer

The Financial Statements of Arion Bank for the year ended 31 December 2017 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

It is our opinion that the Financial Statements give a true and fair view of the financial performance of the Group for the year 2017 and its financial position as at 31 December 2017.

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

The Board of Directors and the CEO have today discussed the Financial Statements of Arion Bank for the year 2017 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 14 February 2018

Board of Directors

Eva Cederbalk
Chairman

Brynjólfur Bjarnason

Jakob Már Ásmundsson

John P. Madden

Kirstín Th. Flygenring

Måns Höglund

Steinunn K. Thórdardóttir

Thóra Hallgrímsdóttir

Chief Executive Officer

Höskuldur H. Ólafsson

Independent Auditor's report

To the Board of Directors and Shareholders of Arion Bank hf.

Opinion

We have audited the Consolidated Financial Statements of Arion Bank hf. for the year ended December 31, 2017 which comprise the Consolidated Statement of Comprehensive Income, the Consolidated Statement of Financial Position, the Consolidated Statement of Changes in Equity, the Consolidated Statement of Cash Flows for the year then ended and the notes to the Consolidated Financial Statements, including a summary of significant accounting policies.

In our opinion, the accompanying Consolidated Financial Statements give a true and fair view of the consolidated financial position of Arion Bank hf. as at December 31, 2017, its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of Arion Bank hf. in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) and the Icelandic Institute of State Authorized Public Accountants (FLE), Code of Ethics and we have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the Consolidated Financial Statements of the current period. These matters were addressed in the context of our audit of the Consolidated Financial Statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key Audit Matters	***How the matter was addressed in the audit***
Loan valuation and loss provisioning	
Loans to customers is the largest class of asset on the Consolidated Statement of Financial Position. The management of the Bank exercise significant judgement when determining both when and how much to record as loan impairment provisions. Because of the significance of these judgements and the size of loans to customers, the audit of loan impairment provisions is a key audit matter. The basis of the provisions is summarized in the accounting policies in note 54 ans 56 to the Consolidated Financial Statements.	We have examined loan valuation policies, tested the relevant controls over the impairment process and assessed the technique management uses to estimate incurred but not reported losses. This includes testing of controls the Bank has in place for capturing loans that needs to be reviewed for impairment and their forbearance strategy. We selected a sample, of loans from the full population, both performing and non-performing loans. For selected sample we have challenged the appropriateness of management's key processes and assumptions used in the calculations of impairment for loans and advances and assessed whether the provisions are in accordance with IFRS. This included the impaired accounts and valuation of underlying collateral.
Revenue recognition	
Interest income and fee and commission income are key elements to the core business of the Bank. Those are the largest items of the Statement of Comprehensive Income. Both revenue sources are subject to contractual terms and highly reliant on IT controls and other controls within the Bank's control environment. Therefore, we consider the interest income and fee and commission income as key audit matter. The basis for revenue recognition and accounting policies are presented in note 49 to 50 the Consolidated Financial Statements.	We reviewed the policies, processes and controls surrounding the revenue recognition. We have tested relevant controls related to accounting for interest income and fee and commission income. We have tested the appropriateness of the interest calculation in accordance with IAS 39. We tested interest income by select sample of loans and compare the underlying data to the loans system. We also tested the interest income and fee income using analytical procedures. We selected sample of loans to ensure that interest is being accrued correctly.

Key Audit Matters	*How the matter was addressed in the audit*
IT controls	
Arion Bank is significantly dependent on their IT-systems to, serve customers, support their business processes, ensure complete and accurate processing of financial transactions and support the overall internal control framework. Many of the Bank's internal controls over financial reporting are depending upon automated application controls and completeness and integrity of reports generated by the IT-systems. Given the high dependency on technology, we consider this a key audit matter for our audit.	We have reviewed the policies and processes related to IT applications. We have tested relevant controls related to change management, access rights and IT operation of material IT systems related to financial reporting. A large majority of controls were operating effectively and did not require further action. For the remaining few, we performed additional testing in order to determine whether we could place reliance on the completeness and accuracy of system generated information.

Other information

The Board of Directors and CEO are responsible for the other information. The other information comprises the unaudited appendix to the Financial Statements, 5-year overview, key figures, unaudited quarterly statements in note number 5 and Endorsement and statements by the Board of Directors and the CEO.

Our opinion on the Consolidated Financial Statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon, except the confirmation regarding the Endorsement and statements by the Board of Directors and the CEO as stated below.

In connection with our audit of the Consolidated Financial Statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the Consolidated Financial Statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information; we are required to report that fact. We have nothing to report in this regard.

In accordance with Paragraph 2 article 104 of the Icelandic Financial Statement Act no. 3/2006, we confirm to the best of our knowledge that the accompanying the Endorsement and the statement by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statement Act that is not disclosed elsewhere in the Consolidated Financial Statements.

Responsibilities of the Board of Directors and the CEO for the Consolidated Financial Statements

The Board of Directors and the CEO are responsible for the preparation and fair presentation of the Consolidated Financial Statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act, and for such internal control as the Board of Directors and the CEO determines is necessary to enable the preparation of Consolidated Financial Statements that are free from material misstatement, whether due to fraud or error.

In preparing the Consolidated Financial Statements, the Board of Directors and the CEO are responsible for assessing Arion Bank hf.'s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the company or to cease operations, or has no realistic alternative but to do so.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the Consolidated Financial Statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Consolidated Financial Statements.

Independent Auditor's report

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the Consolidated Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Arion Banks hf.'s internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the Consolidated Financial Statements, including the disclosures, and whether the Consolidated Financial Statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the Consolidated and Separate Financial Statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with the Board of Directors and the Board Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the Board of Directors and the Board Audit Committee with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with the Board of Directors and the Board Audit committee, we determine those matters that were of most significance in the audit of the Consolidated Financial Statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Kópavogur, 14 February 2018

Deloitte ehf.

Páll Grétar Steingrimsson
State Authorized Public Accountant

Gunnar Thorvardarson
State Authorized Public Accountant

Consolidated Statement of Comprehensive Income
for the year 2017

Income Statement

	Notes	2017	2016
Interest income		57,089	61,655
Interest expense		(27,254)	(31,755)
Net interest income	6	29,835	29,900
Fee and commission income		29,777	23,887
Fee and commission expense		(14,420)	(9,909)
Net fee and commission income	7	15,357	13,978
Net financial income	8	4,091	5,162
Net insurance income	9	2,093	1,395
Share of profit of associates and net impairment	25	(925)	908
Other operating income	10	2,927	3,203
Operating income		53,378	54,546
Salaries and related expense	11	(17,189)	(16,659)
Other operating expense	12	(12,772)	(13,881)
Bank levy	13	(3,172)	(2,872)
Net impairment	14	186	7,236
Earnings before tax		20,431	28,370
Income tax expense	15	(5,806)	(6,631)
Net earnings from continuing operations		14,625	21,739
Discontinued operations, net of tax	16	(206)	-
Net earnings		14,419	21,739
Attributable to			
Shareholders of Arion Bank		14,400	21,147
Non-controlling interest	25	19	592
Net earnings		14,419	21,739
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	17	7.30	10.57

Other Comprehensive Income

	Notes	2017	2016
Net earnings		14,419	21,739
Net gain on AFS financial assets, net of tax		-	(2,903)
Exchange difference on translating foreign subsidiaries	33	(5)	182
Net other comprehensive income to be reclassified to profit or loss in subsequent periods		(5)	(2,721)
Total comprehensive income		14,414	19,018
Attributable to			
Shareholders of Arion Bank		14,395	18,426
Non-controlling interest		19	592
Total comprehensive income		14,414	19,018

Comparative figures have been changed, see Note 1.

The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2017 12 Amounts are in ISK millions

Consolidated Statement of Financial Position
as at 31 December 2017

Assets	Notes	2017	2016
Cash and balances with Central Bank	18	139,819	87,634
Loans to credit institutions	19	86,609	80,116
Loans to customers	20	765,101	712,422
Financial instruments	21-23	109,450	117,456
Investment property	23	6,613	5,358
Investments in associates	25	760	839
Intangible assets	26	13,848	11,057
Tax assets	27	450	288
Non-current assets and disposal groups held for sale	28	8,138	4,418
Other assets	29	16,966	16,436
Total Assets		1,147,754	1,036,024
Liabilities			
Due to credit institutions and Central Bank	22	7,370	7,987
Deposits	22	462,161	412,064
Financial liabilities at fair value	22	3,601	3,726
Tax liabilities	27	6,828	7,293
Other liabilities	30	57,062	54,094
Borrowings	22, 31	384,998	339,476
Total Liabilities		922,020	824,640
Equity			
Share capital and share premium	33	75,861	75,861
Other reserves	33	16,774	19,761
Retained earnings		132,971	115,590
Total Shareholders' Equity		225,606	211,212
Non-controlling interest		128	172
Total Equity		225,734	211,384
Total Liabilities and Equity		1,147,754	1,036,024

The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2017 13 Amounts are in ISK millions

Consolidated Statement of Changes in Equity
for the year 2017

	Share capital and share premium	Other reserves	Retained earnings	**Total share-holders' equity**	Non-controlling interest	**Total equity**
Equity 1 January 2017	75,861	19,761	115,590	211,212	172	211,384
Net earnings	-	-	14,400	14,400	19	14,419
Translation difference	-	(5)	-	(5)	-	(5)
Total comprehensive income	-	(5)	14,400	14,395	19	14,414
Reserve for investments in subsidiaries	-	(3,001)	3,001	-	-	-
Reserve for investments in associates	-	16	(16)	-	-	-
Reserve for investments in securities	-	4	(4)	-	-	-
Dividend to non-controlling interest	-	-	-	-	(63)	(63)
Equity 31 December 2017	75,861	16,774	132,971	225,606	128	225,734
Equity 1 January 2016	75,861	4,548	112,377	192,786	9,108	201,894
Net earnings	-	-	21,147	21,147	592	21,739
Net gain on AFS financial assets	-	(2,903)	-	(2,903)	-	(2,903)
Translation difference	-	182	-	182	-	182
Total comprehensive income	-	(2,721)	21,147	18,426	592	19,018
Reserve for investments in subsidiaries	-	17,012	(17,012)	-	-	-
Reserve for investments in associates	-	23	(23)	-	-	-
Reserve for investments in securities	-	899	(899)	-	-	-
Decrease due to sale of subsidiary	-	-	-	-	(141)	(141)
Disbursement of share capital and dividend to non-controlling interest	-	-	-	-	(9,387)	(9,387)
Equity 31 December 2016	75,861	19,761	115,590	211,212	172	211,384

In June 2016 the Icelandic Parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank, see Note 33.

The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2017 14 Amounts are in ISK millions

Consolidated Statement of Cash flows
for the year 2017

Operating activities	2017	2016
Net earnings	14,419	21,739
Non-cash items included in net earnings and other adjustments	(25,372)	(30,516)
Changes in operating assets and liabilities	47,923	(3,404)
Interest received	60,428	61,335
Interest paid*	(28,623)	(30,926)
Dividend received	320	2,280
Income tax paid	(6,432)	(3,032)
Net cash from operating activities	62,663	17,476
Investing activities		
Acquisition of associates	(961)	(76)
Acquisition of subsidiary	(2,123)	(5,300)
Cash and cash equivalents acquired through business combinations	127	1,068
Proceeds from sale of associates	41	27,291
Dividend received from associates	74	153
Disposal of subsidiary	-	293
Acquisition of intangible assets	(1,657)	(1,247)
Acquisition of property and equipment	(776)	(1,040)
Proceeds from sale of property and equipment	239	224
Net cash (to) from investing activities	(5,036)	21,366
Financing activities		
Payment of subordinated liabilities	-	(8,785)
Disbursement of share capital and dividend to non-controlling interest	(63)	(9,386)
Net cash used in financing activities	(63)	(18,171)
Net increase in cash and cash equivalents	57,564	20,671
Cash and cash equivalents at beginning of the year	123,933	110,000
Effect of exchange rate changes on cash and cash equivalents	401	(6,738)
Cash and cash equivalents	181,898	123,933
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	835	1,830
Settlement of loans through foreclosure on collateral from customers with view to resale	(835)	(1,830)
Non-cash changes due to acquisition of United Silicon		
Non-current assets and disposal groups held for sale	4,537	-
Borrowings	(4,537)	-
Non-cash changes due to funding agreement with Kaupthing		
Deposits	-	41,409
Borrowings	-	(41,409)

Financial effects due to the acquisition of Valitor Holding's subsidiaries, IPS and Chip and Pin, in 2017 and the acquisition of Vördur tryggingar hf. in 2016, see Note 3.

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

* Interest paid includes interest credited to deposit accounts at the end of the year.

The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2017 15 Amounts are in ISK millions

Notes to the Consolidated Statement of Cash flows
for the year 2017

Non-cash items included in net earnings	2017	2016
Net interest income	(29,837)	(29,900)
Net impairment	(186)	(7,236)
Income tax expense	5,806	6,631
Bank levy	3,172	2,872
Net foreign exchange gain (loss)	(122)	1,253
Net gain on financial instruments	(3,649)	(4,135)
Depreciation and amortization	2,132	1,842
Share of profit of associates and net impairment	925	(908)
Investment property, fair value change	(1,036)	(290)
Revised Depositors' and Investors' Guarantee Fund expense	(2,669)	-
Discontinued operations, net of tax	206	-
Other changes	(114)	(645)
Non-cash items included in net earnings	(25,372)	(30,516)

Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	108	3,303
Loans to credit institutions, excluding bank accounts	(2,879)	(22,769)
Loans to customers	(59,413)	(46,537)
Financial instruments and financial liabilities at fair value	15,512	11,854
Investment property	(204)	1,440
Other assets	993	481
Due to credit institutions and Central Bank	(702)	(3,151)
Deposits	50,653	(9,586)
Borrowings	42,071	68,016
Other liabilities	1,784	(6,455)
Changes in operating assets and liabilities	47,923	(3,404)

Cash and cash equivalents		
Cash and balances with Central Bank	139,819	87,634
Bank accounts	51,303	45,631
Mandatory reserve deposit with Central Bank	(9,224)	(9,332)
Cash and cash equivalents	181,898	123,933

The Notes on pages 17 to 94 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2017 16 Amounts are in ISK millions

Notes to the Consolidated Financial Statements
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Notes to the Consolidated Financial Statements

General information

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Consolidated Financial Statements for the year ended 31. December 2017 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and rules on Accounting for Credit Institutions.

The Consolidated Financial Statements were approved and authorized for issue by the Board of Directors of Arion Bank on 14 February 2018.

The same accounting policies, presentation and methods of computation are followed in these Consolidated Financial Statements as were applied in the presentation of the Group's Consolidated Financial Statements for the year ended 31 December 2016. Amendments to IFRS effective for 2017 did not have a material effect on the results for the year 2017.

Basis of measurement

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

- financial assets and financial liabilities held for trading are measured at fair value;
- financial assets and financial liabilities at fair value are measured at fair value;
- financial assets classified as available-for-sale are measured at fair value;
- investment properties are measured at fair value; and
- non-current assets and disposal groups held for sale are stated at the lower of their carrying amount and fair value, less costs to sell.

Functional and presentation currency

The Consolidated Financial Statements are presented in Icelandic krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the year the exchange rate of the ISK against USD was 103.70 and 124.52 for EUR (31.12.2016: USD 112.90 and EUR 119.18).

Comparative figures

In the Statement of Comprehensive Income for 2017 net income from non-current assets held for sale are presented among other operating income. Prior to 2017 net income from non-current assets held for sale was classified as discontinued operations, net of tax. Comparative figures have been changed accordingly by reducing discontinued operations, net of tax by ISK 886 million, increasing other operating income by ISK 1,107 million and increasing income tax by ISK 221 million.

The effects on the Statement of cash flow was shift between Non-cash items included in net earnings and other adjustments and Changes in operating assets and liabilities of ISK 1,107 million.

Methods used for calculation on Interest received and Interest paid in Statement of Cash flows were changed remotely and comparative figures were updated according. The effect were reclass beteween lines within the category Net cash from operating activities.

2. Significant accounting estimates and judgements in applying accounting policies

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

Judgements

The following are the critical judgements, apart from those involving estimations which are dealt with separately, that the directors have made in the process of applying the Group’s accounting policies and that have the most significant effect on the amounts recognized in Financial Statements.

2. Significant accounting estimates and judgements in applying accounting policies, continued

- Fair value measurement of financial instruments

  When the fair values of financial assets and financial liabilities recorded in the Statement of Financial Position cannot be measured based on quoted prices in active markets, their fair value is measured using valuation techniques including the discounted cash flow model. The inputs to these models are taken from observable markets where possible, but where this is not feasible, a degree of judgement is required in establishing fair values. Judgements include considerations of inputs such as liquidity risk, credit risk and volatility. Changes in assumptions relating to these factors could affect the reported fair value of financial instruments.

- Impairment losses on loans

  The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 53. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realizable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the Credit Risk function.

Estimates and assumptions

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are described below. The Group based its assumptions and estimates on parameters available when the Consolidated Financial Statements were prepared. Existing circumstances and assumptions about future developments, however, may change due to market changes or circumstances arising that are beyond the control of the Group. Such changes are reflected in the assumptions when they occur.

- Revaluation of investment properties

  The Group carries its investment properties at fair value, with changes in fair value being recognized in the statement of profit or loss. For investment properties, either a valuation methodology based on present value calculations, as there is a lack of comparable market data because of the nature of the properties, or the investment properties were valued by reference to transactions involving properties of a similar nature, location and condition.

- Impairment of intangible assets

  The carrying amounts of goodwill, infrastructure and customer relationship and related agreements are reviewed annually to determine whether there is indication of impairment. If any such indication exists the asset's recoverable amount is estimated. An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in profit or loss. The recoverable amount of an assets is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

- Non-current assets and disposal groups held for sale

  Legal entities acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less cost to sell. For most part, fair value at the date of classification of these legal entities was calculated using valuation models based on discontinued 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), could have impact on the value of these disposal groups.

  Real estates acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less costs to sell. Fair value at the date of classification is based on independent property values or management valuation. As the fair value measurement of real estates is based on valuation techniques there is uncertainty about the actual fair value of assets.

3. The Group

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

			Equity interest	
	Operating activity	Currency	2017	2016
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland	Retail banking	ISK	100.0%	100.0%
BG12 slhf., Katrínartún 2, Reykjavík, Iceland	Holding company	ISK	62.0%	62.0%
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Eignarhaldsfélagid Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland	Real estate	ISK	100.0%	100.0%
Okkar líftryggingar hf., Borgartún 25, Reykjavík, Iceland	Life insurance	ISK	-	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjördur, Iceland	Payment solutions	ISK	100.0%	100.0%
Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland	Insurance	ISK	100.0%	100.0%

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

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

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

On 1 January 2017 Vördur tryggingar hf. acquired the Bank's 100% shareholding in Okkar líftryggingar hf. Following the acquisition Vördur tryggingar merged its two life insurance subsidiaries under the name of Vördur líftryggingar hf. Combination of entities under common control, i.e. transactions in which all the combining entities are under the control of the Group both before and after the combination, and that control is not transitory, are outside the scope of the IFRS 3 Business combinations. Currently, there is no specific guidance for these transactions under IFRS, therefore, as permitted by IAS 8 Accounting policies, changes in accounting and errors, the Group has developed an accounting policy considering pronouncement of other standard-setting bodies. The assets and liabilities recognized as a result of transactions between entities under common control are recognized at the carrying value on the transferor's financial statements.

On 30 September 2016 Arion Bank acquired a 100% shareholding in the insurance company Vördur tryggingar hf. Vördur tryggingar hf. is classified as a subsidiary of Arion Bank from the day of acquisition. The transaction was as follows:

Purchase price, paid in cash	5,300
Fair value of asset and liabilities of Vördur tryggingar	
Loans to credit institutions (Bank accounts)	1,068
Financial instruments	8,773
Intangible assets, other than goodwill	2,045
Tax assets	147
Other assets	2,355
Tax liabilities	(409)
Other liabilities	(9,175)
Fair value of asset and liabilities of Vördur tryggingar	4,804
Calculated goodwill	496

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Operating segment reporting

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. In presenting the geographic information, segment revenue has been based on the geographic location of customers or assets.

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

Operating segments

The Group comprises the following operating segments:

Asset Management comprises Institutional Asset Management, Private Banking, Investment Services and Pension Fund Administration. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Asset Management also administers pension funds. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

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

Investment Banking is divided into Corporate Finance, Capital Markets and Research. Corporate Finance arranges the buying and selling of companies and advises on all other major financial decisions undertaken by companies and investors such as financial restructuring, IPO's and listing of securities. Capital Markets buys and sells securities and FX on behalf of Arion Bank's clients and provide services regarding risk management products. Capital Markets also manages securities offerings for companies, often in co-operation with Corporate Finance. Research is an independent research team covering the Icelandic economy and financial markets.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of services in it's 24 branches all around Iceland and also through leading digital solutions featured in both an app and internet bank. This includes deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into five regions clusters, with the smaller branches capitalizing on the strength of larger units within each region. Retail Banking's brances have a total of more than 100,000 customers.

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

Other divisions and subsidiaries include Market Making in domestic securities and currencies. The subsidiaries are Valitor Holding hf., Vördur tryggingar hf., Okkar líftryggingar hf. (in 2016), Eignarhaldsfélagid Landey ehf., EAB 1 ehf., BG12 slhf. and other smaller entities of the Group.

In addition to the above operating segments, the Group presents information for the corporate **Headquarters** carrying out support functions such as Overhead, Risk Management, Finance (excluding Treasury and Market Making), Legal and IT. The Headquarters information presented does not represent an operating segment.

4. Operating segments

2017	Asset Manage-ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub-sidiaries	Head-quarters and Elimination	Total
Net interest income	502	6,002	240	15,502	6,536	1,269	(216)	29,835
Net fee and commission income	4,011	1,171	1,298	4,703	(312)	4,213	273	15,357
Net financial income	145	224	(71)	19	(13)	4,052	(265)	4,091
Net insurance income	-	-	-	-	-	2,224	(131)	2,093
Share of profit of associates and net impairment	-	-	-	-	-	15	(940)	(925)
Other operating income	19	1,146	-	927	5	478	352	2,927
Operating income (loss)	4,677	8,543	1,467	21,151	6,216	12,251	(927)	53,378
Operating expense	(1,138)	(357)	(780)	(5,134)	161	(9,317)	(13,396)	(29,961)
Allocated expense	(1,019)	(2,424)	(652)	(5,905)	(887)	(15)	10,902	-
Bank levy	(182)	(671)	(39)	(1,097)	(1,183)	-	-	(3,172)
Net impairment	-	(1,794)	(53)	2,489	70	(527)	1	186
Earnings (loss) before tax	2,338	3,297	(57)	11,504	4,377	2,392	(3,420)	20,431
Net seg. rev. from ext. customers	2,638	15,689	1,003	30,765	(9,044)	12,948	(621)	53,378
Net seg. rev. from other segments	2,039	(7,146)	464	(9,614)	15,260	(697)	(306)	-
Operating income (loss)	4,677	8,543	1,467	21,151	6,216	12,251	(927)	53,378
Depreciation and amortization	1	-	-	359	-	974	798	2,132
Total assets	75,564	274,917	16,165	527,652	483,794	89,936	(320,274)	1,147,754
Total liabilities	70,233	218,243	15,164	461,724	421,930	59,609	(324,883)	922,020
Allocated equity	5,331	56,674	1,001	65,928	61,864	30,327	4,609	225,734
2016								
Net interest income	535	6,436	1,104	14,992	6,093	1,233	(493)	29,900
Net fee and commission income	3,863	1,082	1,808	3,537	(345)	3,885	148	13,978
Net financial income	(67)	(12)	(100)	115	332	4,617	277	5,162
Net insurance income	-	-	-	-	-	1,395	-	1,395
Share of profit of associates and net impairment	-	-	613	-	-	275	20	908
Other operating income	14	368	321	1,058	80	905	457	3,203
Operating income	4,345	7,874	3,746	19,702	6,160	12,310	409	54,546
Operating expense	(1,422)	(605)	(939)	(6,134)	(189)	(7,061)	(14,190)	(30,540)
Allocated expense	(882)	(2,386)	(827)	(6,149)	(876)	(20)	11,140	-
Bank levy	(209)	(609)	(41)	(980)	(1,033)	-	-	(2,872)
Net impairment	-	33	1,704	5,557	7	(65)	-	7,236
Earnings (loss) before tax	1,832	4,307	3,643	11,996	4,069	5,164	(2,641)	28,370
Net seg. rev. from ext. customers	1,908	15,919	3,225	31,064	(11,647)	12,875	1,202	54,546
Net seg. rev. from other segments	2,437	(8,121)	521	(11,287)	17,807	(565)	(792)	-
Operating income	4,345	7,798	3,746	19,777	6,160	12,310	410	54,546
Depreciation and amortization	-	1	-	336	-	727	778	1,842
Total assets	87,307	251,821	16,836	506,483	427,037	72,128	(325,588)	1,036,024
Total liabilities	81,733	193,571	13,856	433,074	394,797	43,722	(336,113)	824,640
Allocated equity	5,574	58,250	2,980	73,409	32,240	28,406	10,525	211,384

Income taxes and discontinued operations are excluded from the profit and loss segment information. From prior periods additional line of allocated expense from supporting divisions to business segments has been added. Those supporting divisions are Risk Management, Finance (excluding Treasury and Market Making), Legal, IT and Overhead. Bank levy has also been allocated to business segments. Comparative figures for 2016 have been updated accordingly.

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4. Operating segments, continued

Geographic information

2017	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	33,063	439	231	(4,268)	339	31	29,835
Net fee and commission income	12,578	253	313	2,194	16	3	15,357
Net financial income	2,228	143	411	339	961	9	4,091
Net insurance income	2,093	-	-	-	-	-	2,093
Share of profit of associates and net impairment	(925)	-	-	-	-	-	(925)
Other operating income	2,894	-	33	-	-	-	2,927
Operating income (loss)	51,931	835	988	(1,735)	1,316	43	53,378

2016	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	32,302	1,079	114	(4,424)	791	38	29,900
Net fee and commission income	11,815	548	50	1,495	62	8	13,978
Net financial income	(500)	79	5,242	323	19	(1)	5,162
Net insurance income	1,395	-	-	-	-	-	1,395
Share of profit of associates and net impairment	223	-	685	-	-	-	908
Other operating income	3,203	-	-	-	-	-	3,203
Operating income (loss)	48,438	1,706	6,091	(2,606)	872	45	54,546

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Quarterly statements

5. Operations by quarters, unaudited

2017	Q4	Q3	Q2	Q1	Total
Net interest income	7,265	7,250	8,160	7,160	29,835
Net fee and commission income	4,654	3,865	3,508	3,330	15,357
Net financial income	1,620	(734)	1,975	1,230	4,091
Net insurance income	324	716	606	447	2,093
Share of profit of associates and net impairment	(8)	17	(900)	(34)	(925)
Other operating income	69	483	1,811	564	2,927
Operating income	13,924	11,597	15,160	12,697	53,378
Salaries and related expense	(4,565)	(3,841)	(4,561)	(4,222)	(17,189)
Other operating expense	(4,016)	(3,699)	(1,223)	(3,834)	(12,772)
Bank levy	(784)	(814)	(777)	(797)	(3,172)
Net impairment	1,448	(2,551)	409	880	186
Earnings before tax	6,007	692	9,008	4,724	20,431
Income tax expense	(1,735)	(805)	(1,895)	(1,371)	(5,806)
Net earnings from continuing operations	4,272	(113)	7,113	3,353	14,625
Discontinued operations, net of tax	(206)	-	-	-	(206)
Net earnings	4,066	(113)	7,113	3,353	14,419

2016	Q4	Q3	Q2	Q1	Total
Net interest income	7,842	7,432	7,353	7,273	29,900
Net fee and commission income	3,765	3,466	3,528	3,219	13,978
Net financial income	823	844	3,796	(301)	5,162
Net insurance income	731	272	247	145	1,395
Share of profit of associates and net impairment	198	16	17	677	908
Other operating income	826	693	607	1,077	3,203
Operating income	14,185	12,723	15,548	12,090	54,546
Salaries and related expense	(4,407)	(3,826)	(4,318)	(4,108)	(16,659)
Other operating expense	(3,803)	(3,349)	(3,639)	(3,090)	(13,881)
Bank levy	(682)	(705)	(743)	(742)	(2,872)
Net impairment	409	5,882	1,448	(503)	7,236
Earnings before tax	5,702	10,725	8,296	3,647	28,370
Income tax expense	(1,227)	(3,222)	(1,419)	(763)	(6,631)
Net earnings from continuing operations	4,475	7,503	6,877	2,884	21,739
Discontinued operations, net of tax	-	-	-	-	-
Net earnings	4,475	7,503	6,877	2,884	21,739

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

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Notes to the Consolidated Statement of Comprehensive Income

6. Net interest income

	2017	2016
Interest income		
Cash and balances with Central Bank	6,449	4,584
Loans	47,832	51,910
Securities	1,964	4,347
Other	844	814
Interest income	57,089	61,655
Interest expense		
Deposits	(12,725)	(16,278)
Borrowings	(14,449)	(14,858)
Subordinated liabilities	-	(529)
Other	(80)	(90)
Interest expense	(27,254)	(31,755)
Net interest income	29,835	29,900
Net interest income from financial assets and financial liabilities at fair value	1,964	4,347
Interest income from financial assets not at fair value	55,125	57,308
Interest expense from financial liabilities not at fair value	(27,254)	(31,755)
Net interest income	29,835	29,900
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	2.9%	3.1%

7. Net fee and commission income

	2017			2016		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	4,529	(366)	4,163	4,225	(245)	3,980
Cards and payment solution	19,309	(13,177)	6,132	14,268	(8,975)	5,293
Collection and payment services	1,563	(94)	1,469	1,478	(80)	1,398
Investment banking	808	(43)	765	1,039	(46)	993
Lending and guarantees	2,198	-	2,198	1,685	-	1,685
Other	1,370	(740)	630	1,192	(563)	629
Net fee and commission income	29,777	(14,420)	15,357	23,887	(9,909)	13,978

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.

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8. Net financial income

	2017	2016
Dividend income	320	2,280
Net gain on financial assets and financial liabilities classified as held for trading	155	363
Net gain on fair value hedge of interest rate swap	336	-
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	3,158	(1,519)
Realized gain on financial assets available-for-sale	-	5,291
Net foreign exchange gain (loss)	122	(1,253)
Net financial income	4,091	5,162

Net gain on fair value hedge of interest rate swap

Fair value change of interest rate swaps designated as hedging instruments	(400)	-
Fair value change on bonds issued by the Group attributable to interest rate risk	736	-
Net gain on fair value hedge of interest rate swap	336	-

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

Equity instruments designated at fair value	2,971	(1,472)
Interest rate instruments designated at fair value	187	(47)
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	3,158	(1,519)

9. Net insurance income

Earned premiums, net of reinsurers' share

Premiums written	10,407	2,926
Premiums written, reinsurers' shares	(428)	(196)
Change in provision for unearned premiums	(810)	330
Change in provision for unearned premiums, reinsurers' share	1	1
Earned premiums, net of reinsurers' share	9,169	3,061

Claims incurred, net of reinsurers' share

Claims paid	(6,115)	(1,762)
Claims paid, reinsurers' share	142	66
Change in provision for claims	(1,057)	33
Changes in provision for claims, reinsurers' share	(46)	(3)
Claims incurred, net of reinsurers' share	(7,076)	(1,666)
Net insurance income	2,093	1,395

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10. Other operating income

	2017	2016
Fair value changes on investment property	1,036	290
Realized gain on investment property	15	400
Net gain on non-current assets held for sale	958	1,107
Other income	918	1,406
Other operating income	2,927	3,203

Net gain on non-current assets held for sale

Income from real estates and other assets	1,184	1,335
Expense related to real estates and other assets	(226)	(228)
Net gain on non-current assets held for sale	958	1,107

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

11. Personnel and salaries

	2017	2016
Number of employees		
Average number of full-time equivalent positions during the year	1,250	1,201
Full-time equivalent positions at the end of the year	1,284	1,239
Number of employees at Arion Bank		
Average number of full-time equivalent positions during the year	830	889
Full-time equivalent positions at the end of the year	844	869
Salaries and related expense		
Salaries	13,771	13,274
Defined contribution pension plans	1,963	1,885
Salary-related expense	1,802	1,884
Capitalization of salaries, due to internally developed software	(347)	(384)
Salaries and related expense	17,189	16,659
Salaries and related expense for Arion Bank		
Salaries	9,123	9,690
Defined contribution pension plans	1,300	1,376
Salary-related expense	1,346	1,553
Salaries and related expense	11,769	12,619

In 2017 the Group made a provision of ISK 311 million (2016: ISK 395 million) for performance plan payments, including salary-related expense, of which the Bank made a provision of ISK 223 million (2016: ISK 331 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for Financial Undertakings. At the end of the year the Group's accrual for performance plan payments amounted to ISK 942 million (31.12.2016: ISK 1,453 million), of which the Bank's accrual amounts to ISK 762 million (31.12.2016: ISK 1,177 million).

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11. Personnel and salaries, continued

Compensation of the Board of Directors	2017 Fixed remuner-ation*	2017 Additional remuner-ation**	2017 Total	2016 Fixed remuner-ation*	2016 Additional remuner-ation**	2016 Total
Eva Cederbalk, Chairman of the Board from 23.6.2017	10.4	0.2	10.6	-	-	-
Brynjólfur Bjarnason, Vice Chairman of the Board	5.2	4.6	9.8	4.7	3.8	8.5
Jakob Már Ásmundsson, Director from 9.3.2017	4.2	1.2	5.4	-	-	-
Kirstín Th. Flygenring, Director	5.0	4.0	9.0	4.7	3.3	8.1
Måns Höglund, Director	10.0	4.6	14.6	9.5	4.4	13.8
Steinunn K. Thórdardóttir, Director from 30.11.2017	0.4	-	0.4	-	-	-
Thóra Hallgrímsdóttir, Director	5.0	4.4	9.4	4.7	3.8	8.5
Monica Caneman, Chairman of the Board until 10.5.2017	7.3	0.9	8.2	19.0	2.5	21.4
Gudrún Johnsen, Director until 29.11.2017	7.2	4.2	11.4	7.1	4.4	11.5
Benedikt Olgeirsson, Director until 9.3.2017	1.0	1.2	2.2	4.7	3.3	8.1
Alternate directors of the Board	3.0	-	3.0	2.4	-	2.4
Total remuneration	58.7	25.3	84.0	56.9	25.4	82.3

John P. Madden, a member of the Board of Directors received no remunerations in 2017 (2016: nil).

Compensation of key management personnel	2017 Salaries	2017 Performance-based payments	2016 Salaries	2016 Performance-based payments
Höskuldur H. Ólafsson, CEO	62.0	9.2	58.2	7.1
Nine managing directors of the Bank's divisions who are members of the Bank's Executive Committee	295.6	34.2	262.7	30.3

Performance based payments in 2017 are based on the Group's performance in 2016.

Board Members receive remuneration for their involvement in board committees. In addition to 16 Board meetings (2016: 13) during the year 16 Board Credit Committee meetings (2016: 10), 8 Board Audit Committee (2016: 8), 10 Board Risk Committee meetings (2016: 11) and 5 Board Remuneration Committee meetings (2016: 7) were held. Four committee meetings with alternate directors of the Board were held in 2017 (2016: 4).

The 2017 Annual General Meeting of the Bank held on 9 March 2017 approved the monthly salaries for 2017 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 849,647, ISK 637,447 and ISK 425,000 (2016: ISK 796,950; 597,700; 398,500) respectively. It was also approved that the salary of Alternate Board Members would be ISK 215,273 (2016: ISK 201,850) per meeting, up to a maximum of ISK 425,000 (2016: ISK 398,500) per month. For Board Members resident abroad, the aforementioned amounts are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 170,000 (2016: ISK 159,400) per month for each committee they serve on and the Chairman of the board committees ISK 220,765 (2016: ISK 207,000).

* Fixed remuneration represents Board Member compensation for their attendance at meetings of the Board of Directors.

** Additional remuneration represents Board Member compensation for their participation in Board Committees.

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12. Other operating expense

	2017	2016
Administration expense	12,388	11,186
Depositors' and Investors' Guarantee Fund	(1,829)	804
Depreciation of property and equipment	816	865
Amortization of intangible assets	1,316	977
Other expense	81	49
Other operating expense	12,772	13,881

The Bank had recognized a liability of ISK 2,669 million against the Depositors' and Investors' Guarantee Fund. At the end of June 2017 the Bank received confirmation from the Fund stating that the claim would not be collected, see Note 35.

Auditor's fee	2017	2016
Audit and review of the Consolidated Financial Statements for the relevant fiscal year	185	140
Other audit related services for the relevant fiscal year	45	11
Auditor's fee	230	151
Of which fee to others than the auditor of the Parent company	4	12

13. Bank levy

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

14. Net impairment

	2017	2016
Net change in impairment of loans to corporates	(3,197)	(2,914)
Net change in impairment of loans to individuals	168	(2,248)
Net change in collective impairment on loans	1,362	427
Provision for losses	(1,667)	(4,735)
Other impairment	(3)	(9)
Increase in book value of loans to corporates	364	2,990
Increase in book value of loans to individuals	1,492	8,990
Net impairment	186	7,236

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15. Income tax expense

	2017	2016
Current tax expense	6,132	6,784
Deferred tax expense	(326)	(153)
Income tax expense	5,806	6,631

Reconciliation of effective tax rate	2017		2016	
Earnings before tax		20,431		28,370
Income tax using the Icelandic corporate tax rate	20.0%	4,086	20.0%	5,674
Additional 6% tax on Financial Undertakings	6.5%	1,319	4.9%	1,395
Non-deductible expenses	0.4%	86	0.0%	13
Tax exempt revenue	(1.6%)	(333)	(4.4%)	(1,247)
Non-deductible taxes	3.1%	634	2.0%	574
Tax incentives not recognized in the Statement of Comprehensive Income	0.6%	118	0.0%	-
Other changes	(0.5%)	(104)	0.8%	222
Effective tax rate	28.4%	5,806	23.4%	6,631

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

Tax exempt revenues consist mainly of profit from equity positions.

16. Discontinued operations, net of tax

	2017	2016
Loss on disposal groups held for sale	(254)	-
Income tax expense	48	-
Discontinued operations, net of tax	(206)	-

Net gain on non-current assets held for sale are classified as other operating income in the Consolidated Financial Statements 2017. In prior years they were classified as discontinued operations, net of tax. Comparative figures have been changed accordingly, see Note 1.

17. Earnings per share

	Continued operations		Discontinued operations		Continued and discontinued operations	
	2017	2016	2017	2016	2017	2016
Net earnings attributable to the shareholders of Arion Bank	14,606	21,147	(206)	-	14,400	21,147
Weighted average number of outstanding shares for the year, million	2,000	2,000	2,000	2,000	2,000	2,000
Basic earnings per share	7.30	10.57	(0.10)	-	7.20	10.57

There were no instruments at the end of the year that could potentially dilute basic earnings per share (2016: none).

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Notes to the Consolidated Statement of Financial Position

18. Cash and balances with Central Bank

	2017	2016
Cash on hand	9,954	7,448
Cash with Central Bank	120,641	70,854
Mandatory reserve deposit with Central Bank	9,224	9,332
Cash and balances with Central Bank	139,819	87,634

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

19. Loans to credit institutions

	2017	2016
Bank accounts	51,303	45,631
Money market loans	32,309	32,267
Other loans	2,997	2,218
Loans to credit institutions	86,609	80,116

20. Loans to customers

	Individuals		Corporates		Total	
2017	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	14,469	13,438	18,778	17,504	33,247	30,942
Credit cards	11,133	10,931	1,123	1,109	12,256	12,040
Mortgage loans	311,507	310,318	19,632	19,417	331,139	329,735
Other loans	33,629	30,600	368,312	361,784	401,941	392,384
Loans to customers	370,738	365,287	407,845	399,814	778,583	765,101
2016						
Overdrafts	14,805	13,381	19,314	17,630	34,119	31,011
Credit cards	11,363	11,099	1,180	1,151	12,543	12,250
Mortgage loans	285,784	282,996	16,298	15,975	302,082	298,971
Other loans	34,777	29,940	351,739	340,250	386,516	370,190
Loans to customers	346,729	337,416	388,531	375,006	735,260	712,422

The total book value of pledged loans that were pledged against amounts borrowed was ISK 183 billion at the end of the year (31.12.2016: ISK 165 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk Management Disclosures.

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20. Loans to customers, continued

Changes in the provision for losses on loans to customers

2017	Specific	Collective	Total
Balance at the beginning of the year	18,281	4,557	22,838
Provision for losses	3,029	(1,362)	1,667
Write-offs	(8,723)	-	(8,723)
Effects due to acquisition of subsidiary*	(2,421)	-	(2,421)
Exchange difference	3	-	3
Payment of loans previously written off	118	-	118
Balance at the end of the year	10,287	3,195	13,482

2016	Specific	Collective	Total
Balance at the beginning of the year	25,341	4,984	30,325
Provision for losses	5,162	(427)	4,735
Write-offs	(11,283)	-	(11,283)
Exchange difference	(1,138)	-	(1,138)
Payment of loans previously written off	199	-	199
Balance at the end of the year	18,281	4,557	22,838

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

21. Financial instruments

	2017	2016
Bonds and debt instruments	51,755	69,565
Shares and equity instruments with variable income	36,190	27,035
Derivatives	7,624	5,159
Securities used for economic hedging	13,881	15,697
Financial instruments	109,450	117,456

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22. Financial assets and financial liabilities

2017	Amortized cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	139,819	-	-	139,819
Loans to credit institutions	86,609	-	-	86,609
Loans to customers	765,101	-	-	765,101
Loans	991,529	-	-	991,529
Bonds and debt instruments				
Listed	-	2,452	46,638	49,090
Unlisted	-	23	2,642	2,665
Bonds and debt instruments	-	2,475	49,280	51,755
Shares and equity instruments with variable income				
Listed	-	1,677	5,380	7,057
Unlisted	-	1,303	10,397	11,700
Bond funds with variable income, unlisted*	-	1,782	15,651	17,433
Shares and equity instruments with variable income	-	4,762	31,428	36,190
Derivatives				
OTC derivatives	-	7,544	-	7,544
Derivatives used for hedge accounting	-	80	-	80
Derivatives	-	7,624	-	7,624
Securities used for economic hedging				
Bonds and debt instruments, listed	-	6,024	-	6,024
Shares and equity instruments with variable income, listed	-	7,846	-	7,846
Shares and equity instruments with variable income, unlisted	-	11	-	11
Securities used for economic hedging	-	13,881	-	13,881
Other financial assets	8,948	-	-	8,948
Financial assets	1,000,477	28,742	80,708	1,109,927
Liabilities at amortized cost				
Due to credit institutions and Central Bank	7,370	-	-	7,370
Deposits	462,161	-	-	462,161
Borrowings	384,998	-	-	384,998
Liabilities at amortized cost	854,529	-	-	854,529
Financial liabilities at fair value				
Short position in bonds	-	1,467	-	1,467
Short position in equity	-	67	-	67
Derivatives	-	1,722	-	1,722
Derivatives used for hedge accounting	-	345	-	345
Financial liabilities at fair value	-	3,601	-	3,601
Other financial liabilities	34,705	-	-	34,705
Financial liabilities	889,234	3,601	-	892,835

*Including share certificates in funds with underlying high rated bonds, as part of the Bank's liquidity.

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22. Financial assets and financial liabilities, continued

2016	Amortized cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	87,634	-	-	87,634
Loans to credit institutions	80,116	-	-	80,116
Loans to customers	712,422	-	-	712,422
Loans	880,172	-	-	880,172
Bonds and debt instruments				
Listed	-	5,284	61,055	66,339
Unlisted	-	102	3,124	3,226
Bonds and debt instruments	-	5,386	64,179	69,565
Shares and equity instruments with variable income				
Listed	-	2,949	9,125	12,074
Unlisted	-	1,348	10,579	11,927
Bond funds with variable income, unlisted*	-	1,027	2,007	3,034
Shares and equity instruments with variable income	-	5,324	21,711	27,035
Derivatives				
OTC derivatives	-	5,159	-	5,159
Derivatives	-	5,159	-	5,159
Securities used for economic hedging				
Bonds and debt instruments, listed	-	7,318	-	7,318
Shares and equity instruments with variable income, listed	-	8,365	-	8,365
Shares and equity instruments with variable income, unlisted	-	14	-	14
Securities used for economic hedging	-	15,697	-	15,697
Other financial assets	8,617	-	-	8,617
Financial assets	888,789	31,566	85,890	1,006,245
Liabilities at amortized cost				
Due to credit institutions and Central Bank	7,987	-	-	7,987
Deposits	412,064	-	-	412,064
Borrowings	339,476	-	-	339,476
Liabilities at amortized cost	759,527	-	-	759,527
Financial liabilities at fair value				
Short position in bonds	-	1,884	-	1,884
Derivatives	-	1,842	-	1,842
Financial liabilities at fair value	-	3,726	-	3,726
Other financial liabilities	36,350	-	-	36,350
Financial liabilities	795,877	3,726	-	799,603

*Including share certificates in funds with underlying high rated bonds, as part of the Bank's liquidity.

Arion Bank Consolidated Financial Statements 2017 34 Amounts are in ISK millions

22. Financial assets and financial liabilities, continued

Bonds and debt instruments designated at fair value, specified by issuer	2017	2016
Financial and insurance activities	4,415	5,564
Public sector	38,389	51,860
Corporates	6,476	6,755
Bonds and debt instruments designated at fair value	49,280	64,179

The total amount of pledged bonds was ISK 13.4 billion at the end of the year (31.12.2016: ISK 15.6 billion). Pledged bonds comprised Icelandic and foreign Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

23. Fair value hierarchy

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

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

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

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

2017

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	32,452	19,264	39	51,755
Shares and equity instruments with variable income	4,140	30,920	1,130	36,190
Derivatives	-	7,544	-	7,544
Derivatives used for hedge accounting	-	80	-	80
Securities used for economic hedging	13,713	168	-	13,881
Investment property	-	-	6,613	6,613
Assets at fair value	50,305	57,976	7,782	116,063
Liabilities at fair value				
Short position in bonds	1,467	-	-	1,467
Short position in equity	67	-	-	67
Derivatives	-	1,722	-	1,722
Derivatives used for hedge accounting	-	345	-	345
Liabilities at fair value	1,534	2,067	-	3,601

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23. Fair value hierarchy, continued

2016

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	22,787	46,689	89	69,565
Shares and equity instruments with variable income	11,863	15,154	18	27,035
Derivatives	-	5,159	-	5,159
Securities used for economic hedging	15,659	38	-	15,697
Investment property	-	-	5,358	5,358
Assets at fair value	50,309	67,040	5,465	122,814

Liabilities at fair value				
Short position in bonds	1,884	-	-	1,884
Derivatives	-	1,842	-	1,842
Liabilities at fair value	1,884	1,842	-	3,726

There was no transfer between Level 1 and Level 2 during the year (2016: No transfers).

Fair value of assets and liabilities

The fair value of asset and liabilities is the amount at which the asset and liability could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Group to measure assets and liabilities. If quoted prices for an asset fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

Methods for establishing fair value

The best evidence of the fair value of an asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of an asset in Note 22 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

Level 1: Fair value established from quoted market prices

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from quoted market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

Level 2: Fair value established using valuation techniques with observable market information

For assets and liabilities, for which the market is not active, the Group applies valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent market transactions between knowledgeable and willing parties, if available, reference to current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

For assets and liabilities for which quoted prices on active markets are not available, the fair value is derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

In most cases the valuation is based on theoretical financial models, such as the Black Scholes model or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

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

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23. Fair value hierarchy, continued

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

In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of assets with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organizations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

The Group applies management valuation for determining fair value of investment properties. Management valuation is either based on recent transactions and offers for similar assets or present value calculations which involve estimation of future cash flow and the assessment of appropriate discount rate.

Movements in Level 3 assets measured at fair value

	Investment	Financial assets		
2017	property	Bonds	Shares	Total
Balance at the beginning of the year	5,358	89	18	5,465
Net fair value changes	1,036	(617)	23	442
Net gain from disposals	15	-	-	15
Additions	767	-	234	1,001
Disposal	(563)	(147)	(15)	(725)
Transfers into Level 3*	-	714	870	1,584
Balance at the end of the year	6,613	39	1,130	7,782

2016				
Balance at the beginning of the year	7,542	182	5,874	13,598
Net fair value changes	290	(7)	2,835	3,118
Net gain from disposal	400	-	-	400
Additions	618	-	-	618
Disposal	(2,084)	(73)	(8,705)	(10,862)
Disposals through the sale of a subsidiary	(1,408)	-	-	(1,408)
Transfers into Level 3	-	-	13	13
Transfers out of Level 3	-	(13)	-	(13)
Balance at the end of the year	5,358	89	18	5,465

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

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23. Fair value hierarchy, continued

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

2017	Investment property	Financial assets Bonds	Shares	Total
Net interest income	-	27	-	27
Net financial income	-	(645)	23	(622)
Other operating income	1,051	-	-	1,051
Effects recognized in the Income Statement	1,051	(618)	23	456
Net loss on AFS financial assets, net of tax	-	-	-	-
Effects recognized in the Statement of Comprehensive Income	1,051	(618)	23	456
2016				
Net interest income	-	2	-	2
Net financial income	-	(9)	5,259	5,250
Other operating income	690	-	-	690
Effects recognized in the Income Statement	690	(7)	5,259	5,942
Net loss on AFS financial assets, net of tax	-	-	(2,903)	(2,903)
Effects recognized in the Statement of Comprehensive Income	690	(7)	2,356	3,039

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

2017	Carrying value	Fair value	Unrealized gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	139,819	139,819	-
Loans to credit institutions	86,609	86,609	-
Loans to customers	765,101	772,185	7,084
Other financial assets	8,948	8,948	-
Financial assets not carried at fair value	1,000,477	1,007,561	7,084
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,370	7,370	-
Deposits	462,161	462,161	-
Borrowings	384,998	402,355	(17,357)
Other financial liabilities	34,705	34,705	-
Financial liabilities not carried at fair value	889,234	906,591	(17,357)

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23. Fair value hierarchy, continued

2016 *Financial assets not carried at fair value*	Carrying value	Fair value	Unrealized gain (loss)
Cash and balances with Central Bank	87,634	87,634	-
Loans to credit institutions	80,116	80,116	-
Loans to customers	712,422	717,220	4,798
Other financial assets	8,617	8,617	-
Financial assets not carried at fair value	888,789	893,587	4,798
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,987	7,987	-
Deposits	412,064	412,064	-
Borrowings	339,476	348,413	(8,937)
Other financial liabilities	36,350	36,350	-
Financial liabilities not carried at fair value	795,877	804,814	(8,937)

Loans to customers are largely with variable interest rate. Those loans, including corporate loans, are presented at book value as they have generally short duration and very limited interest rate risk. Loans with fixed interest rate, mainly long term retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account mortgaging. Defaulted loans are presented at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value.

The fair value for deposits with stated maturities is calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Statement of Financial Position.

Derivatives	Notional	Fair value	
2017	value	Assets	Liabilities
Forward exchange rate agreements	52,914	563	251
Fair value hedge of interest rate swap	99,613	80	345
Interest rate and exchange rate agreements	199,723	6,265	1,392
Bond swap agreements	1,818	1	15
Share swap agreements	8,270	701	64
Options - purchased agreements	1,219	14	-
Derivatives	363,557	7,624	2,067
2016			
Forward exchange rate agreements	31,921	266	247
Interest rate and exchange rate agreements	210,143	4,288	1,104
Bond swap agreements	2,995	1	8
Share swap agreements	8,138	597	457
Options - purchased agreements	1,218	7	26
Derivatives	254,415	5,159	1,842

The Group applies fair value hedge accounting only with respect to certain foreign currency denominated interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate foreign currency denominated bonds, see Note 31, arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017.

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24. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

	Assets subject to netting arrangements			Netting potential not recognized in the balance sheet				
2017	Gross assets before balance sheet	Balance sheet nettings with gross	Assets recognized on balance	Financial	Collateral received	Assets after consideration of netting potential	Assets not subject to enforceable netting arr-angements	Total assets recognized on balance sheet
Reverse repurchase agreements	15,197	-	15,197	(82)	-	15,115	-	15,197
Derivatives	6,350	-	6,350	(1,210)	-	5,140	1,274	7,624
Total assets	21,547	-	21,547	(1,292)	-	20,255	1,274	22,821
2016								
Reverse repurchase agreements	15,644	(80)	15,564	(1,884)	-	13,680	-	15,564
Derivatives	4,100	-	4,100	(629)	-	3,471	1,059	5,159
Total assets	19,744	(80)	19,664	(2,513)	-	17,151	1,059	20,723

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the balance sheet				
2017	Gross liabilities before balance sheet	Balance sheet nettings with gross	Liabilities recognized on balance	Financial	Collateral pledged	Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arr-angements	Total liabilities recognized on balance sheet
Repurchase agreements	82	-	82	(82)	-	-	-	82
Derivatives	1,299	-	1,299	(1,210)	-	89	768	2,067
Total liabilities	1,381	-	1,381	(1,292)	-	89	768	2,149
2016								
Repurchase agreements	1,884	(80)	1,804	(1,884)	-	(80)	-	1,804
Derivatives	629	-	629	(629)	-	-	1,213	1,842
Total liabilities	2,513	(80)	2,433	(2,513)	-	(80)	1,213	3,646

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

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25. Investments in associates

The Group's interest in its principal associates	31.12.2017	31.12.2016
Audkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	25.4%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	35.8%	35.8%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	23.0%	23.0%
Urridaland ehf., Laugavegur 182, Reykjavík, Iceland	-	41.4%
220 Fjördur ehf., Fjardargötu 13-15, Hafnarfjördur, Iceland	35.3%	34.9%

Investments in associates		
Carrying amount at the beginning of the year	839	27,299
Acquisitions	961	76
Dividend received	(41)	(153)
Disposals	(74)	(27,291)
Share of profit of associates and net impairment	(925)	908
Investment in associates	760	839

In 2017 Arion Bank invested in United Silicon. With the investment United Silicon became associate of the Bank, see Note 28.

In November 2017 Eignarhaldsfélagid Landey ehf. sold its shareholding in the associated company Urridaland ehf. with minor effects on the Statement of Comprehensive Income.

Arion Bank holds 38.4% of share capital in Farice ehf., but holds 35.8% of voting rights, based on different classes of share capital of Farice ehf.

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26. Intangible assets

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

Infrastructure, which is capitalized as an intangible asset, is related to the asset management operation, payment solution and credit card operation and branding of the insurance operation. The business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as described below.

Customer relationships and related agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries and agreements bought. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationship related to individual customers through Retail Banking. The customer relationships is tested for impairment and related agreements are amortized over a period of five years with one year remaining. When deciding on the lifetime of those agreements it was based on experience of the Bank and the industry. As a result, those agreements are assessed as having an identified useful lifetime.

Acquired software and internally developed software is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

In 2017 the Bank's subsidiary Valitor Holding hf. acquired two companies: IPS - International Payment Services Ltd., a UK based company that specializes in providing a payment terminal (POS) gateway for pan-European retailers, and Chip and Pin Solutions Ltd., one of the premier and highly regarded ISOs (Independent Sales Organizations) in the UK, selling POS terminals and acquiring services to thousands of small and medium size merchants. Valitor Holding hf. acquired controlling interest in both companies. The purpose of the acquisition is to strengthen Valitor's direct channel in-store market position in the UK as the focus has been on partnerships in that market until now. The total purchase price of the two companies was ISK 2,123 million and preliminary purchase price allocation estimated intangible assets in total ISK 2,177 million, which will be assigned to goodwill, customer relationship and related agreements and software. The allocation of purchase price has not been completed at year end but Valitor Holding hf. will complete it within the 12 months permitted from the acquisition date.

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

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26. Intangible assets, continued

2017	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,202	3,705	1,608	3,542	11,057
Acquisition through business combination	1,773	-	297	107	2,177
Additions and transfers	174	-	(125)	1,310	1,359
Additions, internally developed	-	-	-	347	347
Exchange difference	166	-	20	41	227
Impairment	-	-	(3)	-	(3)
Amortization	-	-	(305)	(1,011)	(1,316)
Intangible assets	4,315	3,705	1,492	4,336	13,848

2016	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,407	3,021	854	3,003	9,285
Acquisition through business combination	496	684	904	457	2,541
Additions and transfers	(271)	-	110	638	477
Additions, internally developed	-	-	-	384	384
Exchange difference	(430)	-	(32)	(182)	(644)
Impairment	-	-	(9)	-	(9)
Amortization	-	-	(219)	(758)	(977)
Intangible assets	2,202	3,705	1,608	3,542	11,057

Impairment is recognized in the line item Net impairment in the Statement of Comprehensive income.

Goodwill is recognized in the segment Other divisions and subsidiaries, see Note 4.

Impairment testing

The methodology for impairment testing on the Infrastructure and Customer relationship, which is part of intangible assets, is based on discounted cash flow model which uses inputs that consider features of the business and the environment.

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis impairment of ISK 3 million was recognized in 2017 (2016: ISK 9 million).

Discount and growth rates	2017 Discount rates	2017 Growth rates	2016 Discount rates	2016 Growth rates
Asset Management operation	15.2%	2.5%	15.1%	2.5%
Payment solution and Credit card operation	13.7%	2.5%	15.1%	2-37%
Insurance operation	13-13.9%	2.5%	14.6%	2.5%

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27. Tax assets and tax liabilities

	2017		2016	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	6,329	-	6,630
Deferred tax	450	499	288	663
Tax assets and tax liabilities	450	6,828	288	7,293

Deferred tax assets and tax liabilities are attributable to the following:

	2017 Assets	2017 Liabilities	2016 Assets	2016 Liabilities
Foreign currency denominated assets and liabilities	293	-	1	(225)
Investment property and property and equipment	68	(1,050)	40	(689)
Financial assets	468	-	475	-
Other assets and liabilities	124	(383)	266	(407)
Deferred tax related to foreign exchange gain	-	(9)	-	(103)
Tax loss carry forward	440	-	267	-
	1,393	(1,442)	1,049	(1,424)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(943)	943	(761)	761
Deferred tax assets and tax liabilities	450	(499)	288	(663)

Subsidiaries own tax loss carry forward with asset value of the amount of ISK 493 million (31.12.2016: ISK 464 million) that is not recognized in the Consolidated Financial Statements, due to uncertainty about the utilization possibilities of the loss.

Changes in deferred tax assets and tax liabilities	At 1 Jan.	Addition related to Vördur	Recognized through equity	Recognized in profit or loss	At 31 Dec.
2017					
Foreign currency denominated assets and liabilities	(224)	-	-	517	293
Investment property and property and equipment	(649)	-	-	(333)	(982)
Financial assets	475	-	-	(7)	468
Other assets and liabilities	(141)	-	-	(118)	(259)
Deferred foreign exchange differences	(103)	-	-	94	(9)
Tax loss carry forward	267	-	-	173	440
Change in deferred tax assets and tax liabilities	(375)	-	-	326	(49)
2016					
Foreign currency denominated assets and liabilities	(218)	-	-	(6)	(224)
Investment property and property and equipment	(170)	(409)	-	(70)	(649)
Financial assets	(677)	8	1,171	(27)	475
Other assets and liabilities	(239)	-	-	98	(141)
Deferred foreign exchange differences	(141)	-	-	38	(103)
Tax loss carry forward	-	147	-	120	267
Change in deferred tax assets and tax liabilities	(1,445)	(254)	1,171	153	(375)

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

	2017	2016
Disposal groups held for sale	5,219	-
Real estate	2,879	4,371
Other assets	40	47
Non-current assets and disposal groups held for sale	**8,138**	**4,418**

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

United Silicon

At 31 December 2016, the Bank held a loan of ISK 6,277 million against United Silicon, collateralized with shares in the company ans other asstes. The Bank also had a 6% equity interest in United Silicon and an unsecured bond in the amount of ISK 877 million. In the second quarter of 2017, Arion Bank invested ISK 907 million in United Silicon, obtaining an interest ownership of 16.3%, with voting rights of 23.9% and thus United Silicon became an associate of Arion Bank, accounted for according to the equity method, less impairment. The purpose of the investment was to support the company in operating difficulties. Due to operating difficulties the Bank fully provisioned for the equity holdings in United Silicon of ISK 1,164 million at the end of the second quarter; ISK 907 million through Share of profit of associates and ISK 257 million through Net financial income in the Statement of Comprehensive Income.

In September 2017 the Bank foreclosed on collateral and took possession of the shares in United Silicon and became the largest shareholder of the company, with an interest ownership of 66.58% and voting rights of 66.68%. With this transaction the Bank acquired the control of United Silicon and thus the company became a subsidiary of the Bank. The fair value calculation of the underlying assets resulted in a provision on loans of ISK 2,962 million recognized in Net impairment as well as fair value loss of unsecured bond of ISK 708 million recognized in Net financial income of the Statement of Comprehensive Income.

The book value of assets of United Silicon was ISK 5,219 million at year-end 2017. As the company was acquired exclusively with a view to resale, it has been classified as an asset held for sale and as a discontinued operations as of 31 December 2017 in accordance with IFRS 5.

The effects on the Statement of Financial Position when United Silicon became subsidiary of the Bank was as follows:

Loans to customers	(4,535)
Non-current assets and disposal groups held for sale	4,479
Deposits	56
	-

29. Other assets

	2017	2016
Property and equipment	6,561	6,723
Accounts receivable	6,531	5,373
Unsettled securities trading	481	712
Investment for life assurance policyholders where risk is held by policyholder	869	820
Sundry assets	2,524	2,808
Other assets	**16,966**	**16,436**

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29. Other assets, continued

Property and equipment	Real estate	Equip-ment	Total 2017	Total 2016
Gross carrying amount at the beginning of the year	6,114	7,587	13,701	12,903
Acquisition	-	776	776	1,010
Acquisition through business combination	-	21	21	62
Disposals and transfers	(135)	(298)	(433)	(259)
Translation difference	-	5	5	(15)
Gross carrying amount at the end of the year	5,979	8,091	14,070	13,701
Accumulated depreciation at the beginning of the year	(1,728)	(5,250)	(6,978)	(6,137)
Depreciation	(143)	(673)	(816)	(865)
Disposals and transfers	31	254	285	24
Accumulated depreciation at the end of the year	(1,840)	(5,669)	(7,509)	(6,978)
Property and equipment	4,139	2,422	6,561	6,723

The official real estate value (Registers Iceland) amounted to ISK 5,677 million at the end of the year (31.12.2016: ISK 4,905 million) and the insurance value amounts to ISK 10,066 million (31.12.2016: ISK 8,818 million).

30. Other liabilities

	2017	2016
Accounts payable	26,394	22,627
Unsettled securities trading	527	668
Depositors' and Investors' Guarantee Fund*	218	2,870
Technical provision	12,129	10,243
Technical provision for life assurance policyholders were investment risk is held by policyholder	869	820
Withholding tax	1,414	1,745
Bank levy	3,172	2,872
Sundry liabilities	12,339	12,249
Other liabilities	57,062	54,094

Technical provision	Technical provision	Reinsurers' share	Total 2017	Technical provision	Reinsurers' share	Total 2016
Claims reported and loss adjustment expenses	5,587	(121)	5,466	4,842	(167)	4,675
Claims incurred but not reported	1,664	(99)	1,565	1,352	(99)	1,253
Claims outstanding	7,251	(220)	7,031	6,194	(266)	5,928
Provision for unearned premiums	4,878	(19)	4,859	4,049	(18)	4,031
Own technical provision	12,129	(239)	11,890	10,243	(284)	9,959

Insurance claim consists of claims outstanding and provision for unearned premiums. Claims outstanding present unsettled claims incurred. Claims outstanding is the total of claims reported and actuarial estimation of claims incurred but not reported. Provision for unearned premiums presents the current insurance risk that will be conditional on future fiscal years.

*In prior years the Bank had recognized a liability of ISK 2,669 million against the Depositors' and Investors' Guarantee Fund. At the end of June 2017 the Bank received confirmation from the Fund stating that the claim would not be collected, see Note 35.

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31. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	2017	2016
ARION CBI 19, ISK 4,500 million	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,586	4,502
ARION CB 19, ISK 2,740 million	2016	2019	At maturity	Fixed, 5.50%	1,789	580
ARION CBI 21, ISK 10,220 million	2014	2021	At maturity	Fixed, CPI linked, 3.50%	9,729	9,696
ARION CB 22, ISK 23,660 million	2015	2022	At maturity	Fixed, 6.50%	23,339	19,596
ARION CBI 25, ISK 23,080 million	2017	2025	At maturity	Fixed, CPI linked, 3.00%	22,875	-
ARION CBI 29, ISK 25,220 million	2014	2029	At maturity	Fixed, CPI linked, 3.50%	26,243	23,524
ARION CBI 34, ISK 2,500 million	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	2,152	2,207
Statutory covered bonds					90,713	60,105
ARION CB 1, ISK 21,877 million	2006	2033	Amortizing	Fixed, CPI linked, 3.75%	-	16,734
ARION CB 4, ISK 15,500 million	2008	2045	Amortizing	Fixed, CPI linked, 4.00%	-	6,199
ARION CB 2, ISK 51,125 million	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	78,267	78,239
Structured Covered bonds					78,267	101,172
Total Covered bonds					168,980	161,277
USD 30 million	2016	2017	At maturity	Floating, 3 month LIBOR +1.93%	-	3,406
EUR 21 million	2009	2018	Amortizing	Floating, EURIBOR +1.00%	348	662
ISK 3,835 million	2010	2018	Amortizing	Floating, REIBOR +1.00%	531	1,063
EUR 300 million	2015	2018	At maturity	Fixed, 3.125%	25,461	36,610
SEK 500 million	2016	2018	At maturity	Floating, 3 month STIBOR +1.09%	6,348	3,113
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	37,957	36,307
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	966	951
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	3,485	3,422
SEK 100 million	2017	2019	At maturity	Fixed, 0.29%	1,268	-
NOK 800 million	2015	2020	At maturity	Floating, NIBOR +2.95%	10,236	10,617
NOK 320 million	2016	2020	At maturity	Floating, NIBOR +1.95%	4,087	2,902
EUR 300 million*	2017	2020	At maturity	Fixed, 0.75%	37,356	-
SEK 300 million	2017	2020	At maturity	Floating, 3 month STIBOR +1.35%	3,811	-
SEK 250 million	2017	2020	At maturity	Floating, 3 month STIBOR +0.75%	3,173	-
EUR 500 million*	2016	2021	At maturity	Fixed, 1.625%	61,341	35,639
USD 747 million	2016	2023	At maturity	Floating, 3 month LIBOR +2.60%	-	29,317
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,231	-
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,240	-
Senior unsecured bonds					202,839	164,009
Bills issued					10,794	13,854
Other					2,385	336
Other loans/bills					13,179	14,190
Borrowings					384,998	339,476

*The Group applies fair value hedge accounting to these bond issuances and uses certain foreign currency denominated interest rate swaps as hedging instruments, see Note 23. The interest rate swaps are hedging the exposure of the Group's changes in the fair value of these fixed-rate foreign currency denominated bonds arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. The total carrying amount of the bond issuances is ISK 98,697 million and included in the amount are fair value changes amounting to ISK 736 million, see Note 8.

The book value of listed bonds was ISK 371 billion at the end of the year (31.12.2016: ISK 284 billion). The market value of those bonds was ISK 388 billion (31.12.2016: ISK 290 billion). The Group repurchased own debts in 2017 in the amount of ISK 20 billion (2016: nil) with minor effects on the Statement of Comprehensive Income.

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31. Borrowings, continued

In January 2016 the Bank reached an agreement with Kaupthing under which FX deposits held at Arion Bank would be converted into issued EMTN bond in USD and Kaupthing would prepay Arion Bank's Central Bank secured loan, in various currencies, of ISK 56 billion. The total issue was ISK 97 billion (USD 747 million) with mandatory prepayment requirement if the Bank should issue bonds in excess of USD 165 million. In 2016 Arion Bank's issue exceeded this benchmark twice and thus a prepayment of ISK 57 billion (USD 489 million) was made in 2016. The remaining outstanding amount of ISK 29 billion (USD 258 million) was prepaid in June 2017.

32. Pledged assets

Pledged assets against liabilities	2017	2016
Assets, pledged as collateral against borrowings	202,381	196,901
Assets, pledged as collateral against loans from credit institutions and short positions	13,364	15,644
Pledged assets against liabilities	215,745	212,545

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 202 billion at the end of the year (31.12.2016: ISK 197 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 169 billion at the end of the year (31.12.2016: ISK 161 billion).

The Group has pledged bonds against short term lending from the Central Bank of Iceland and against short positions, related to swap agreements, to hedge market risk of those assets.

33. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	2017	Number (million)	2016
Issued share capital	2,000	75,861	2,000	75,861

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

Other reserves	2017	2016
Statutory reserve	1,637	1,637
Reserve for investments in subsidiaries	14,011	17,012
Reserve for investments in associates	39	23
Reserve for investments in securities	901	899
Foreign currency translation reserve	186	190
Other reserves	16,774	19,761

In June 2016 the Icelandic parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank, see Note 66.

Other information

34. Legal matters

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, if appropriate, to account for any adverse effects which the claims may have on its financial standing. When the Group is of the opinion that it is to the detriment of the Group's case to disclose potential amounts relating to legal claims, it elects not to do so. At the end of the year, the Group had several unresolved legal claims.

Contingent liabilities

Legal proceedings regarding damages

With a writ issued in June 2013, Kortathjónustan hf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and the Bank's subsidiary Valitor hf. in the amount of ISK 1.2 billion plus interest, as a result of damage Kortathjónustan hf. contended the five parties caused the company due to violations of the Competition Act. In June the Supreme Court dismissed the case on procedural grounds. Kortathjónustan hf. issued a new writ in September 2017 regarding the same matter of dispute this time claiming damages in the amount of ISK 922 million plus interest from the same defendants. The defendants have brought forth a motion to dismiss. If the defendants would be ordered to pay damages they would be jointly responsible for the payment of damages. Therefore the Bank has not made any provision.

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., have filed two cases against the Bank claiming damages in the amount of more than ISK 4 billion plus interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagid Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. The Bank believes that it will be acquitted of the plaintiffs' claims in both cases and has therefore not made any provision.

In January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed a suit against Valitor hf. for compensatory damages amounting to approximately ISK 8.1 billion relating to Valitor hf.'s termination of Datacell's vendor agreement. The Icelandic Supreme Court ruled on 24 April 2013 in case no. 612/2012 that Valitor hf. did not have the authority to terminate the agreement. The plaintiffs had court-appointed appraisers evaluate the plaintiffs' alleged losses and they returned their report in March 2016. Valitor hf. disagreed with the assessment stated in the report and filed a motion to appoint three court appraisers to re-evaluate the plaintiffs' alleged losses. The district court agreed to Valitor hf.'s demand. The reassessment has been completed but it was not filed with the court. Valitor hf. has requested a new assessment, which will examine particular aspects which have not yet been assessed. The district court has not ruled on this motion.

When Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014-2015, the Bank signed agreements with the sellers (Landsbankinn and two savings banks) concerning losses which Valitor may potentially sustain in relation to the compensatory damages described above. Thus the Group may lodge a claim against the sellers for their share in the potential loss should Valitor lose the case. The Group has not made any provision in this case.

Other legal matters

Mortgage documents

Courts cases are being prosecuted against the Bank in which it is demanded that the mortgaging of part of a property be invalidated on the basis that the signature of the mortgagor on the mortgage documents was not correct. In 2017 the Supreme Court, in respect of cases which did not involve the Bank, ruled in several cases regarding this issue. In the majority of those cases the Supreme Court invalidated a mortgage. The district court has ruled in several court cases involving the Bank regarding the aforementioned dispute. In the majority of those cases the district court invalidated a mortgage. The Bank is awaiting further rulings from the Supreme Court to assess the possible impact of a negative outcome on the Bank's loan portfolio.

United Silicon

The company United Silicon was granted a moratorium on payments on 14 August 2017 and filed for bankruptcy on 22 January 2018. The Bank has collateral in the company's assets. During the moratorium period three unsecured creditors of the company sent the Bank a letter in which they asked for the cooperation of creditors in order to solve issues related to the company but they also submitted observations on the Bank's lien on the assets of United Silicon and reserved the right to lodge claims against the Bank if these liens are invalid. The Bank has examined these criticisms and rejects them all.

Off balance sheet information

35. Commitments

	2017	2016
Financial guarantees, unused overdraft and loan commitments the Group has granted its customers		
Financial guarantees	13,224	15,270
Unused overdrafts	45,897	46,379
Loan commitments	87,942	82,268

Depositors' and Investors' Guarantee Fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without reaching a conclusion on the matter. Even though the law has not been amended Icelandic banks have made quarterly payments to a separate division within the fund since 2010. The calculated liability from 2010 which is according to the old act, was ISK 2,669 million. At the end of June 2017 the Bank received confirmation from the Depositors' and Investors' Guarantee Fund that this liability would not be collected by the fund. Therefore the Bank reversed a previously expensed contribution to the Depositors' and Investors' Guarantee Fund amounting to ISK 2,669 million, in 2017.

36. Operating lease commitments

Group as a lessee

The Group has concluded lease agreements on some of the real estate it uses for its operations. These lease agreements are for a period of up to 10 years. The majority of the contracts include renewal options for various periods of time.

	2017	2016
Less than one year	547	507
Over 1 year and up to 5 years	1,481	1,371
Over 5 years	341	368
Future minimum lease payments under non-cancellable leases	2,369	2,246

Group as a lessor

The Group has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 9 years.

	2017	2016
Less than one year	69	68
Over 1 year and up to 5 years	233	147
Over 5 years	103	55
Future minimum lease payments under non-cancellable leases	405	270

37. Assets under management and under custody

Assets under management	984,653	1,054,759
Assets under custody	1,620,355	1,532,860

Assets under management represent the total market value of the financial assets which the Group manages on behalf of its customers.

The Group, acting as custodian, is responsible for safeguarding a firm's or individual's financial assets, hold in safekeeping securities such as stocks, bonds and securities funds, arrange the settlement of trades and movements of securities, process corporate actions such as income on bonds and dividends on shares; and pricing on securities.

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38. Events after the reporting period

At a shareholders' meeting on 12 February 2018 the Board of Directors of Arion Bank was given a mandate and the authorization to acquire up to 10% of issued shares in the Bank, in one or more transactions. This authorization is valid until 15 April 2018.

At the same shareholders' meeting approval was given for a conditional dividend payment of up to ISK 25 billion, which is contingent on Kaupskil, which owns 57.41% of the issued share capital in the Bank, having previously sold no less than 2% in Arion Bank in a private placement. This conditional authorization is valid until 15 April 2018.

At the shareholders' meeting it was also approved that the aforementioned acquisition of shares and dividend would be a maximum of ISK 25 billion.

On 14 February 2018 an announcement was made on the sale by Kaupskil of 5.34% of outstanding shares in Arion Bank to a number of funds managed by four Icelandic fund management companies, who come on board as new investors, and Trinity Investments (Attestor Capital LLP) and Goldman Sachs, who are increasing their stakes in the Bank. The conditions for the aforementioned dividend payment is therefore fulfilled.

Related party

39. Related party

The Group has a related party relationship with Kaupskil ehf., which is the ultimate controlling party with a 57.41% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., which is the parent company of Kaupskil ehf. Taconic Capital Advisors UK LLP through TCA New Sidecar III S.A.R.L. holds 9.99% shareholding in Arion Bank and Sculptor Investments S.A.R.L., an affiliated entity of Och-Ziff Capital Management Group manages 6.58% shareholding in Arion Bank, but the shareholding is managed by Kaupskil ehf. Taconic Capital Advisors UK LLP, TCA New Sidecar III S.A.R.L., Sculptor Investments S.A.R.L. and Och-Ziff Capital Management Group are thus defined as related party with control over the Group.

Attestor Capital LLP through Trinity Investment Designated Activity Company manages 10.44% shareholding in Arion Bank and Goldman Sachs International through ELQ Investors II Ltd. manages 2.57% shareholding in Arion Bank. Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13.00% shareholding in Arion Bank. All above-mentioned parties are defined as related party with influence over the Group.

Íslandsbanki hf. and Landsbankinn hf. are wholly owned by ISFI. The Group applies the partial exemption for government-related entities as described in IAS 24, paragraphs 25-27.

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

Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

2017

Balances with related parties	Assets	Liabilities	Net balance
Shareholders with control over the Group	57	(4,785)	(4,728)
Shareholders with influence over the Group	423	(151)	272
Board of Directors and key Management personnel	183	(101)	82
Associates and other related parties	-	(83)	(83)
Balances with related parties	663	(5,120)	(4,457)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(480)	-	-
Shareholders with influence over the Group	81	-	7	-
Board of Directors and key Management personnel	13	(5)	10	(184)
Associates and other related parties	-	(3)	-	(1,260)
Transactions with related parties	94	(488)	17	(1,444)

2016

Balances with related parties	Assets	Liabilities	Net balance
Shareholders with control over the Group	192	(7,255)	(7,063)
Board of Directors and key Management personnel	255	(242)	13
Associates and other related parties	181	(369)	(188)
Balances with related parties	628	(7,866)	(7,238)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	1	(89)	4	-
Board of Directors and key Management personnel	15	(7)	-	-
Associates and other related parties	28	(4)	2	(216)
Transactions with related parties	44	(100)	6	(216)

At the end of 2016 Kaupthing hf. held senior unsecured bonds, issued by Arion Bank in January 2016, for the amount of ISK 29,317 million. The amount is not included in the table above. The bond was paid up in 2017.

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Risk management disclosures

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

The Board of Directors is ultimately responsible for the Group's risk management framework and ensuring that satisfactory risk policies and governance for controlling the Group's risk exposure are in place. The Board allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board sets risk appetite, which is translated into exposure limits and targets monitored by the Bank's Risk Management division.

The Chief Executive Officer (CEO) is responsible for sustaining an effective risk management framework, processes and control as well as maintaining a high level of risk awareness among the employees, making risk everyone's business.

The Bank operates several committees to manage risk. The Board Risk Committee (BRIC) is responsible for supervising the Bank's risk management framework, risk appetite and the internal capital and liquidity adequacy assessment processes (ICAAP/ILAAP). The Asset and Liability Committee (ALCO), is responsible for managing the asset-liability mismatch, liquidity risk, market risk, and interest rate risk and capital management. The Underwriting and Investment Committee (UIC) decides on underwriting and principal investments. The Data Committee (DC) is responsible for ensuring that data is managed properly; and the Security Committee (SC) is responsible for security matters, both information security and physical security. The Bank operates four credit committees: The Board Credit Committee (BCC) which decides on all major credit risk exposures, the Arion Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's own funds, and the Corporate Credit Committee (CCC) and Retail Branch Committees (RBC) which operate within tighter credit granting limits.

The Bank's Internal Audit conducts independent reviews of the Bank's and several subsidiaries' operations, risk management framework, processes and measurements. Internal Audit discusses its results with management and reports its findings and recommendations to the BAC.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralized and reports directly to the CEO. The division is divided into three units: Credit Control, which monitors credit exposures on a customer-by-customer basis; Balance Sheet Risk, which oversees all risks related to asset and liability mismatch, including capital and is responsible for the Bank's ICAAP and ILAAP; and Operational Risk which monitors risks associated with the daily operation of the Bank. The Bank's Data Officer is part of the Risk Management division.

The most significant risks the Group is exposed to are credit risk, including concentration risk, liquidity risk, indexation risk and interest rate risk. These risk factors are to the largest extent encountered within the Bank. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities.

The Bank has no large exposure at the end of the year. The total sum of large exposures is therefore 0% as in the previous year. A large exposure is defined as an exposure to a group of financially related borrowers which is equal to or exceeds 10% of the Group's eligible capital.

The Group's operations are subject to interest rate risk associated with mismatches in the fixing of interest rates between assets and liabilities. Prepayment risk has increased due to favorable refinancing spreads in the domestic market where interest rates have decreased. The Group is exposed to indexation risk as index-linked assets exceed index-linked liabilities.

Liquidity risk is a large risk factor in the Group's operation due to maturity mismatch between assets and liabilities. The maturity of loans exceeds the maturity of deposits, of which 77% is on-demand or with less than 30 day term.

Further information on risk management and capital adequacy is provided in the annual Financial Statements for 2017 and in the Pillar 3 Risk Disclosures for 2017. The Pillar 3 Risk Disclosures 2017 will be published in March 2018 and be available on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not subject to external audit.

40. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off balance sheet items such as commitments and guarantees.

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

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

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

40. Credit risk, continued

Exposure to credit risk

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the year before the effect of mitigation due to collateral agreements or other credit enhancements. The Group uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard.

2017

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

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Cash and balances with Central Bank	-	-	-	-	-	139,819	-	-	-	-	-	139,819
Loans to credit institutions	-	-	-	-	-	86,609	-	-	-	-	-	86,609
Loans to customers	365,287	128,153	78,937	22,020	57,432	34,138	29,452	17,111	18,157	7,824	6,590	765,101
Financial instruments	295	1,118	252	-	25	22,889	9,110	3	2,162	42,930	-	78,784
Other assets with credit risk	2,380	324	93	24	43	5,542	118	213	156	54	1	8,948
Total on-balance sheet maximum exposure to credit risk	367,962	129,595	79,282	22,044	57,500	288,997	38,680	17,327	20,475	50,808	6,591	1,079,261

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

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	1,443	1,482	287	334	3,819	120	748	1,671	3,247	47	26	13,224
Unused overdrafts	28,898	2,462	640	546	4,511	1,058	2,200	380	2,330	2,453	419	45,897
Loan commitments	5,297	25,148	8,023	1,850	18,035	5,448	17,689	2,575	3,541	-	336	87,942
Total off-balance sheet maximum exposure to credit risk	35,638	29,092	8,950	2,730	26,365	6,626	20,637	4,626	9,118	2,500	781	147,063
Maximum exposure to credit risk	403,600	158,687	88,232	24,774	83,865	295,623	59,317	21,953	29,593	53,308	7,372	1,226,324

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40. Credit risk, continued

2016

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

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Cash and balances with Central Bank	-	-	-	-	-	87,634	-	-	-	-	-	87,634
Loans to credit institutions	-	-	-	-	-	80,116	-	-	-	-	-	80,116
Loans to customers	337,417	114,895	76,475	28,647	52,719	34,939	28,633	6,519	17,308	8,711	6,159	712,422
Financial instruments	307	1,106	261	-	7	18,865	10,942	3	557	59,253	-	91,301
Other assets with credit risk	443	779	14	19	22	6,708	10	7	540	72	3	8,617
Total on-balance sheet maximum exposure to credit risk	338,167	116,780	76,750	28,666	52,748	228,262	39,585	6,529	18,405	68,036	6,162	980,090

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

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	1,394	1,967	1,573	1,039	2,416	1,333	1,880	978	2,643	35	12	15,270
Unused overdrafts	27,609	2,226	640	574	5,951	1,546	2,363	381	2,845	1,895	349	46,379
Loan commitments	33	15,276	16,756	540	24,249	7,154	13,155	2,399	2,659	38	9	82,268
Total off-balance sheet maximum exposure to credit risk	29,036	19,469	18,969	2,153	32,616	10,033	17,398	3,758	8,147	1,968	370	143,917
Maximum exposure to credit risk	367,203	136,249	95,719	30,819	85,364	238,295	56,983	10,287	26,552	70,004	6,532	1,124,007

Amounts are in ISK millions

40. Credit risk, continued

Loans to customers specified by sectors	2017	2016
Individuals	47.7%	47.4%
Real estate activities and construction	16.7%	16.1%
Fishing industry	10.3%	10.7%
Information and communication technology	3.0%	4.1%
Wholesale and retail trade	7.5%	7.4%
Financial and insurance activities	4.5%	4.9%
Industry, energy and manufacturing	3.8%	4.0%
Transportation	2.2%	0.9%
Services	2.4%	2.4%
Public sector	1.0%	1.2%
Agriculture and forestry	0.9%	0.9%
	100.0%	100.0%

Collateral and other credit enhancements

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- Retail loans to individuals: Mortgages on residential properties.
- Corporate loans: Real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

The value of collateral is based on estimated market value. The valuation of real estate is built on market price, official valuation of the Icelandic Property Registry, or the opinion of internal or external specialists. The valuation of fishing vessels takes into account related fishing quotas.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses.

The collateral value in the table below is capped by the exposure amount.

Collateral held against different types of financial assets

2017	Cash and securities	Real estate	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	195	326,456	16	8,413	335,080
Real estate activities and construction	371	115,467	208	1,928	117,974
Fishing industry	24	8,569	52,693	10,580	71,866
Information and communication technology	541	1,103	-	2,035	3,679
Wholesale and retail trade	208	32,294	12	16,131	48,645
Financial and insurance activities	13,440	4,184	681	6,174	24,479
Industry, energy and manufacturing	660	19,367	-	5,747	25,774
Transportation	3	973	278	1,395	2,649
Services	15	7,365	98	3,047	10,525
Public sector	114	3,657	-	92	3,863
Agriculture and forestry	-	5,966	-	248	6,214
Financial instruments	5,948	-	-	-	5,948
Financial guarantees	871	3,343	1,598	3,343	9,155
Collateral held against different types of financial assets	22,390	528,744	55,584	59,133	665,851

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40. Credit risk, continued

2016	Cash and securities	Real estates	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	481	297,974	5	7,419	305,879
Real estate activities and construction	581	106,770	34	1,444	108,829
Fishing industry	564	8,100	57,092	8,041	73,797
Information and communication technology	27	2,598	-	18,363	20,988
Wholesale and retail trade	410	26,570	8	19,988	46,976
Financial and insurance activities	14,826	7,620	-	807	23,253
Industry, energy and manufacturing	3,287	15,332	-	6,875	25,494
Transportation	73	892	278	3,622	4,865
Services	20	7,221	71	3,650	10,962
Public sector	7	3,811	-	179	3,997
Agriculture and forestry	5	5,128	-	327	5,460
Financial instruments	5,953	-	-	-	5,953
Financial guarantees	1,038	3,871	1,249	2,375	8,533
Collateral held against different types of financial assets	27,272	485,887	58,737	73,090	644,986

Collateral repossessed

During the year the Group took possession of assets due to foreclosures. The total amount of real estates the Group took possession of during the year and still holds at the end of the year amount to ISK 833 million (31.12.2016: ISK 1,817 million) and other assets 2 million (31.12.2016: ISK 13 million). The assets are held for sale, see Note 29.

Credit quality

Credit quality by class of financial assets

2017	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Cash and balances with Central Bank	139,819	-	-	139,819
Loans to credit institutions	86,609	-	-	86,609
Loans to customers				
Loans to corporates	385,197	13,655	962	399,814
Loans to individuals	344,829	18,929	1,529	365,287
Financial instruments	78,784	-	-	78,784
Other assets with credit risk	8,948	-	-	8,948
Credit quality by class of financial assets	1,044,186	32,584	2,491	1,079,261

2016	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Cash and balances with Central Bank	87,634	-	-	87,634
Loans to credit institutions	80,116	-	-	80,116
Loans to customers				
Loans to corporates	358,709	14,251	2,046	375,006
Loans to individuals	312,259	21,854	3,303	337,416
Financial instruments	82,042	-	-	82,042
Other assets with credit risk	8,617	-	-	8,617
Credit quality by class of financial assets	929,377	36,105	5,349	970,831

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40. Credit risk, continued

Neither past due nor impaired loans

The Bank uses internal credit rating models to monitor credit risk. The Bank rates customers with one of four statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgement for large corporate exposures. Two models rate individuals' exposures – one for prime mortgages and another for other exposures. The models are updated annually and recalibrated with current data with the aim of improving their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement.

The table below shows loans to customers that are neither past due nor impaired, broken down by the Bank's classification scale, where 5 denotes the highest risk.

	Risk classification						
2017	1	2	3	4	5	Not rated	Total
Individuals	176,980	116,296	36,507	9,953	2,238	2,855	344,829
Real estate activities and construction	28,508	51,363	40,327	3,013	83	479	123,773
Fishing industry	37,742	28,908	9,129	1,498	653	-	77,930
Information and communication technology	17,691	1,162	2,958	21	-	3	21,835
Wholesale and retail trade	19,996	20,822	9,368	2,117	563	141	53,007
Financial and insurance activities	14,638	3,708	15,103	105	-	10	33,564
Industry, energy and manufacturing	17,236	6,394	4,233	794	187	-	28,844
Transportation	10,644	3,713	2,201	48	-	65	16,671
Services	2,392	6,227	5,224	432	2,443	3	16,721
Public sector	1,730	4,938	862	108	47	-	7,685
Agriculture and forestry	863	1,740	1,816	585	163	-	5,167
Neither past due nor impaired loans	328,420	245,271	127,728	18,674	6,377	3,556	730,026

2016							
Individuals	68,538	162,930	55,500	17,036	4,331	3,924	312,259
Real estate activities and construction	43,172	33,819	24,557	5,679	348	3,184	110,759
Fishing industry	24,480	36,143	9,700	2,579	604	79	73,585
Information and communication technology	18,372	3,207	966	5,476	-	12	28,033
Wholesale and retail trade	11,342	19,302	16,890	2,244	208	-	49,986
Financial and insurance activities	9,669	2,210	15,623	207	-	5,730	33,439
Industry, energy and manufacturing	7,908	7,854	10,101	719	635	351	27,568
Transportation	958	3,753	989	433	20	-	6,153
Services	2,303	5,312	7,263	847	28	3	15,756
Public sector	377	4,425	1,874	1,146	53	656	8,531
Agriculture and forestry	478	1,147	2,029	1,227	18	-	4,899
Neither past due nor impaired loans	187,597	280,102	145,492	37,593	6,245	13,939	670,968

Exposures that are 'Not rated' are typically due to newly formed entities and entities for which the Bank's rating models are not applicable.

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40. Credit risk, continued

Past due but not impaired loans by class of loans 2017	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	4,361	4,221	1,774	1,339	1,960	13,655
Loans to individuals	3,065	8,149	4,387	350	2,978	18,929
Past due but not impaired loans	7,426	12,370	6,161	1,689	4,938	32,584
2016						
Loans to corporates	5,388	4,282	1,589	1,211	1,781	14,251
Loans to individuals	3,196	8,708	4,989	391	4,570	21,854
Past due but not impaired loans	8,584	12,990	6,578	1,602	6,351	36,105

Loans past due up to three days are mainly overdrafts that were not renewed in time. The majority of the past due but not impaired loans are considered fully secured with collateral or have been acquired at discount. Loans acquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

	2017		2016	
Impaired loans to customers specified by sector	Impair-ment amount	Gross carrying amount	Impair-ment amount	Gross carrying amount
Individuals	4,010	5,539	7,069	10,372
Real estate activities and construction	467	762	770	1,056
Fishing industry	658	861	966	1,648
Information and communication technology	111	112	179	182
Wholesale and retail trade	490	702	540	868
Financial and insurance activities	297	314	261	298
Industry, energy and manufacturing	473	581	786	878
Transportation	1	1	4,301	4,307
Services	3,570	3,617	3,145	3,624
Public sector	45	45	89	113
Agriculture and forestry	165	244	175	284
Impaired loans to customers specified by sector	10,287	12,778	18,281	23,630

Large exposure

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

The Group had no large exposure at the end of the year before taking account of eligible credit risk mitigation (31.12.2016: no large exposure).

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41. Market risk

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

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

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

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

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

Interest rate risk

Interest rate risk arises from the possibility that changes in market rates adversely affect net interest income and fair value of interest-bearing instruments on the Group's balance sheet. The Group's operations are subject to interest rate risk due to mismatches in the fixing of interest rates between assets and liabilities, resulting in a repricing risk for the Group. The Group also faces interest basis risk between interest-bearing assets and interest-bearing liabilities due to different types of floating-rate indices in different currencies.

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

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

41. Market risk, continued

Interest rate risk in the banking book

The following table shows the Group's interest-bearing assets and liabilities by interest fixing periods. The figures for loans to customers and borrowings are shown on a fair value basis, see Note 23, and are therefore different from the amounts shown in these Consolidated Financial Statements. The fair value as of 31 December 2017 reflects the likelihood of prepayment. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category.

2017	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	129,864	-	-	-	-	129,864
Loans to credit institutions	86,609	-	-	-	-	86,609
Loans to customers	440,161	77,099	141,944	5,867	107,114	772,185
Financial instruments	27,342	3,033	8,186	-	1,866	40,427
Assets	683,976	80,132	150,130	5,867	108,980	1,029,085
Liabilities						
Due to credit institutions and Central Bank	7,370	-	-	-	-	7,370
Deposits	427,393	19,453	13,083	1,343	889	462,161
Borrowings	64,533	6,637	187,998	31,293	111,946	402,407
Liabilities	499,296	26,090	201,081	32,636	112,835	871,938
Derivatives and other off-balance sheet items (net position)	(99,372)	114	102,038	1,548	-	4,328
Net interest gap	85,308	54,156	51,087	(25,221)	(3,855)	161,475

2016	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	80,186	-	-	-	-	80,186
Loans to credit institutions	80,116	-	-	-	-	80,116
Loans to customers	382,928	63,694	138,540	4,457	127,601	717,220
Financial instruments	41,495	1,695	5,182	6,349	1,897	56,618
Assets	584,725	65,389	143,722	10,806	129,498	934,140
Liabilities						
Due to credit institutions and Central Bank	7,962	25	-	-	-	7,987
Deposits	376,424	21,111	12,450	1,263	816	412,064
Borrowings	62,830	8,653	126,836	20,670	129,424	348,413
Liabilities	447,216	29,789	139,286	21,933	130,240	768,464
Derivatives and other off-balance sheet items (net position)	(107,799)	(916)	111,083	(146)	-	2,222
Net interest gap	29,710	34,684	115,519	(11,273)	(742)	167,898

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41. Market risk, continued

Sensitivity analysis of interest rate risk in the banking book

The following table shows the sensitivity of the Group's net present value (NPV) of interest-bearing assets and liabilities and variation of annual net interest income (NII), due to changes in interest rates by currencies. The variation is calculated on the basis of simultaneous parallel shifts upwards or downwards of yield curves. The choice of shifts is not an estimate of risk likelihood. As mentioned above, behavioral maturities are taken into account in the NPV calculations at 31 December 2017, including prepayment likelihood and expected behavior of non-maturing deposits. The change to NII is however purely based on contractual interest rate adjustments where it is simplistically assumed that all rates are equally sensitive to the presumed change in market rates.

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

	2017		2016	
NPV change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(1,465)	2,411	414	(63)
ISK, Non index-linked	(76)	742	348	(508)
Foreign currencies	88	(113)	249	(295)

	2017		2016	
NII change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(693)	693	(145)	145
ISK, Non index-linked	(429)	429	(536)	536
Foreign currencies	353	(353)	94	(94)

Sensitivity analysis of interest rate risk in the trading book

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

	2017		2016	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	99	(95)	156	(152)
ISK, Non index-linked	19	(14)	127	(64)
Foreign currencies	27	(27)	2	(33)

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41. Market risk, continued

Indexation risk

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

Book value and maturity profile of indexed assets and liabilities

2017	Up to 1	1 to 5	Over 5	
Assets, CPI index-linked	year	years	years	Total
Loans to customers	16,928	100,149	233,292	350,369
Financial instruments	6,659	-	-	6,659
Off-balance sheet position	4,667	2,096	-	6,763
Assets, CPI index-linked	28,254	102,245	233,292	363,791
Liabilities, CPI index-linked				
Deposits	68,667	12,499	2,201	83,367
Borrowings	1,832	20,867	121,692	144,391
Other	982	203	1,369	2,554
Off-balance sheet position	-	539	-	539
Liabilities, CPI index-linked	71,481	34,108	125,262	230,851
Net on-balance sheet position	(47,894)	66,580	108,030	126,716
Net off-balance sheet position	4,667	1,557	-	6,224
CPI Balance	(43,227)	68,137	108,030	132,940

2016				
Assets, CPI index-linked				
Loans to customers	12,911	97,225	218,981	329,117
Financial instruments	7,100	-	-	7,100
Off-balance sheet position	851	6,619	-	7,470
Assets, CPI index-linked	20,862	103,844	218,981	343,687
Liabilities, CPI index-linked				
Deposits	69,621	12,121	2,050	83,792
Borrowings	2,253	24,437	114,747	141,437
Off-balance sheet position	-	518	-	518
Other	395	692	893	1,980
Liabilities, CPI indexed linked	72,269	37,768	117,690	227,727
Net on-balance sheet position	(52,258)	59,975	101,291	109,008
Net off-balance sheet position	851	6,101	-	6,952
CPI Balance	(51,407)	66,076	101,291	115,960

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41. Market risk, continued

Currency risk

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

Breakdown of assets and liabilities by currency

2017								
Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank .	137,399	943	293	266	265	117	536	139,819
Loans to credit institutions	17,678	15,033	27,117	8,518	1,910	10,621	5,732	86,609
Loans to customers	624,192	97,687	27,879	3,283	7,245	646	4,169	765,101
Financial instruments	56,240	39,891	11,309	102	9	1,691	208	109,450
Other financial assets	6,023	965	613	1,102	171	24	50	8,948
Assets	841,532	154,519	67,211	13,271	9,600	13,099	10,695	1,109,927
Liabilities and equity								
Due to credit inst. and Central Bank ..	6,989	292	38	3	-	1	47	7,370
Deposits	412,981	23,792	15,382	3,309	1,349	3,692	1,656	462,161
Financial liabilities at fair value	2,253	1,183	34	27	32	35	37	3,601
Other financial liabilities	20,150	3,870	2,183	5,505	1,393	565	1,039	34,705
Borrowings	181,787	162,486	1,832	14	-	20,794	18,085	384,998
Liabilities and equity	624,160	191,623	19,469	8,858	2,774	25,087	20,864	892,835
Net on-balance sheet position	217,372	(37,104)	47,742	4,413	6,826	(11,988)	(10,169)	
Net off-balance sheet position	(536)	34,743	(46,994)	(1,557)	(9,142)	12,331	11,155	
Net position	216,836	(2,361)	748	2,856	(2,316)	343	986	

Addition, for management reporting

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

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41. Market risk, continued

2016 *Assets*	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank .	85,052	775	627	364	197	108	511	87,634
Loans to credit institutions	18,946	16,963	17,444	8,522	1,826	10,064	6,351	80,116
Loans to customers	593,185	66,242	34,012	2,857	7,378	7	8,741	712,422
Financial instruments	91,566	13,403	9,572	311	244	2,245	115	117,456
Other financial assets	7,992	179	293	39	112	-	2	8,617
Assets	796,741	97,562	61,948	12,093	9,757	12,424	15,720	1,006,245
Liabilities and equity								
Due to credit inst. and Central Bank ..	6,857	978	84	3	-	1	64	7,987
Deposits	377,195	15,762	12,038	4,186	844	1,301	738	412,064
Financial liabilities at fair value	3,020	408	272	-	-	16	10	3,726
Other financial liabilities	27,457	2,546	1,066	4,251	754	229	47	36,350
Borrowings	176,530	109,217	32,723	-	-	13,520	7,486	339,476
Liabilities and equity	591,059	128,911	46,183	8,440	1,598	15,067	8,345	799,603
Net on-balance sheet position	205,682	(31,349)	15,765	3,653	8,159	(2,643)	7,375	
Net off-balance sheet position	279	31,775	(15,315)	(3,232)	(8,579)	2,335	(7,263)	
Net position	205,961	426	450	421	(420)	(308)	112	

Addition, for management reporting

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Investment property	5,358	-	-	-	-	-	-	5,358
Investments in associates	831	8	-	-	-	-	-	839
Intangible assets	6,978	-	-	-	4,079	-	-	11,057
Tax assets	272	-	-	-	16	-	-	288
Non-current assets and disposal groups held for sale	4,418							4,418
Other non-financial assets	6,946	471	263	103	23	13	-	7,819
Assets	24,803	479	263	103	4,118	13	-	29,779
Liabilities and equity								
Tax liabilities	7,075	-	-	-	218	-	-	7,293
Other non-financial liabilities	17,168	114	94	4	2	-	362	17,744
Shareholders' equity	211,212	-	-	-	-	-	-	211,212
Non-controlling interest	172	-	-	-	-	-	-	172
Liabilities and equity	235,627	114	94	4	220	-	362	236,421
Management reporting of currency risk*	(4,863)	791	619	520	3,478	(295)	(250)	

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

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41. Market risk, continued

Sensitivity analysis on currency risk

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

	2017		2016	
Currency	-10%	+10%	-10%	+10%
EUR	239	(239)	(79)	79
USD	(75)	75	(62)	62
GBP	(277)	277	(52)	52
DKK	232	(232)	(348)	348
NOK	(36)	36	30	(30)
Other	(101)	101	25	(25)

Equity risk

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

Sensitivity analysis of equity risk

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

	2017		2016	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(166)	166	(295)	295
Banking book - listed	(540)	540	(913)	913
Banking book - unlisted	(1,170)	1,170	(1,193)	1,193

Derivatives

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

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42. Liquidity and Funding risk

Liquidity risk is defined as the risk that the Group, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

The Group's primary source of funding is deposits from individuals, businesses and financial undertakings. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 72% is on-demand.

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

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

42. Liquidity and Funding risk, continued

Maturity analysis of assets and liabilities

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

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

Contractual cash flow of assets and liabilities

2017 *Assets*	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Cash and balances with Central Bank	31,281	99,340	9,362	-	-	-	139,983	139,819
Loans to credit institutions	52,320	34,294	-	-	-	-	86,614	86,609
Loans to customers	2,908	107,790	90,076	336,545	568,833	-	1,106,152	765,101
Financial instruments	8,512	15,082	14,641	20,028	5,926	44,047	108,236	109,450
Derivatives - assets leg	*1,436*	*38,718*	*18,153*	*71,627*	*678*	-	*130,612*	126,111
Derivatives - liabilities leg	*(1,423)*	*(37,084)*	*(18,084)*	*(68,879)*	*(585)*	-	*(126,055)*	(118,487)
Other financial assets	1,535	5,103	2,224	86	-	-	8,948	8,948
Assets	96,556	261,609	116,303	356,659	574,759	44,047	1,449,933	1,109,927
Liabilities								
Due to credit inst. and Central Bank ...	7,658	-	26	-	-	-	7,684	7,370
Deposits	331,796	86,524	30,244	13,071	2,246	-	463,881	462,161
Financial liabilities at fair value	-	2,182	(102)	593	(273)	-	2,400	3,601
Derivatives - assets leg	-	*(20,039)*	*(11,449)*	*(14,407)*	*(1,557)*	-	*(47,452)*	(40,930)
Derivatives - liabilities leg	-	*20,688*	*11,347*	*15,000*	*1,284*	-	*48,319*	42,998
Short position bonds and derivatives	-	*410*	-	-	-	-	*410*	410
Short position securities used for economic hedging	-	*1,124*	-	-	-	-	*1,124*	1,124
Other financial liabilities	25,538	7,296	28	1,843	-	-	34,705	34,705
Borrowings	-	37,110	23,066	239,210	175,845	-	475,231	384,998
Liabilities	364,992	133,112	53,262	254,717	177,818	-	983,901	892,835
Net position for assets and liabilities	(268,436)	128,497	63,041	101,942	396,941	44,047	466,032	217,092
Off-balance sheet items								
Financial guarantees	2,918	2,852	3,164	2,827	1,463	-	13,224	13,224
Unused overdraft	-	45,897	-	-	-	-	45,897	45,897
Loan commitments	2,966	45,788	17,751	9,559	11,878	-	87,942	87,942
Off-balance sheet items	5,884	94,537	20,915	12,386	13,341	-	147,063	147,063
Net contractual cash flow	(274,320)	33,960	42,126	89,556	383,600	44,047	318,969	70,029

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42. Liquidity and Funding risk, continued

2016 *Assets*	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Cash and balances with Central Bank .	6,091	72,233	9,472	-	-	-	87,796	87,634
Loans to credit institutions	54,104	26,013	-	-	-	-	80,117	80,116
Loans to customers	3,844	107,623	75,111	323,941	525,432	-	1,035,951	712,422
Financial instruments	12,715	2,485	4,466	56,547	81,098	35,414	192,725	117,456
Derivatives - assets leg	-	*28,323*	*20,388*	*33,816*	*579*	-	83,106	*75,527*
Derivatives - liabilities leg	-	*(27,689)*	*(19,906)*	*(28,877)*	*(279)*	-	(76,751)	*(70,368)*
Other financial assets	2,687	3,882	1,303	745	-	-	8,617	8,617
Assets	79,441	212,236	90,352	381,233	606,530	35,414	1,405,206	1,006,245
Liabilities								
Due to credit inst. and Central Bank ...	7,602	-	326	26	-	-	7,953	7,987
Deposits	288,388	80,876	32,336	12,558	2,106	-	416,264	412,064
Financial liabilities at fair value	-	2,403	523	3,232	384	-	6,542	3,726
Derivatives - assets leg	-	*(14,008)*	*(4,642)*	*(42,184)*	*(745)*	-	(61,579)	*(57,923)*
Derivatives - liabilities leg	-	*14,528*	*5,166*	*45,416*	*1,129*	-	66,239	*59,765*
Short position securities used for economic hedging	-	*1,884*	-	-	-	-	1,884	*1,884*
Other financial liabilities	21,824	7,414	3,446	3,660	6	-	36,350	36,350
Borrowings	-	13,568	20,956	189,073	219,346	-	442,943	339,476
Liabilities	317,814	104,262	57,587	208,548	221,841	-	910,052	799,603
Net position for assets and liabilities	(238,373)	107,974	32,765	172,685	384,689	35,414	495,154	206,642
Off-balance sheet items								
Financial guarantees	2,893	4,032	4,136	2,538	1,671	-	15,270	15,270
Unused overdraft	-	46,379	-	-	-	-	46,379	46,379
Loan commitments	48	46,931	10,250	21,040	4,000	-	82,268	82,268
Off-balance sheet items	2,941	97,342	14,386	23,578	5,671	-	143,917	143,917
Net contractual cash flow	(241,314)	10,633	18,379	149,107	379,018	35,414	351,237	62,725

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42. Liquidity and Funding risk, continued

Net Stable Funding Ratio

The net stable funding ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per the definition of the Central Bank of Iceland rules No. 1032/2014. In general, RSF is determined by applying different weights to different asset classes depending on the level of liquidity. ASF however is calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness. The NSFR for foreign currency shall exceed 100%.

Calculations of the NSFR are based on consolidated figures for the Bank and Arion Bank Mortgages Institutional Investor Fund. When calculating the ratio for foreign currencies, a negative foreign currency balance is subtracted from the numerator and a positive balance is subtracted from the denominator. The foreign currency balance used is different from that of this Consolidated Financial Statement due to the sub-consolidation applied.

2017	ISK	Foreign currency	Total
Available stable funding	663,850	199,770	863,620
Required stable funding	577,761	110,473	688,234
Foreign currency balance		7	
Net stable funding ratio	115%	181%	125%

2016	ISK	Foreign currency	Total
Available stable funding	612,964	169,821	782,785
Required stable funding	544,854	87,010	631,864
Foreign currency balance		(4,019)	
Net stable funding ratio	113%	191%	124%

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42. Liquidity and Funding risk, continued

Liquidity coverage ratio

The liquidity coverage ratio (LCR) is part of the standards introduced in the Basel III Accord. The LCR is the result of a stress test that is designed to ensure that banks have the necessary assets on hand to withstand short-term liquidity disruptions. More accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, assets must be non-pledged, liquid and easily priced on the market, repo-able at the Central Bank and not issued by the Group or related entities.

On 31 March 2017, new liquidity rules No. 266/2017 took effect. The rules are issued by the Central Bank of Iceland and effectively adopt the liquidity rules of the EU Capital Requirements Regulation (CRR), replacing the previous LCR rules No. 1031/2014. The Bank is required to maintain a 100% minimum LCR ratio for both foreign currencies and all currencies.

The following table shows the breakdown for the Group's LCR calculations broken down by currencies. All amounts are weighted by their respective LCR weights. The figures at 31 December 2017 are based on rules No. 266/2017 while the figures at 31 December 2016 are based on rules No. 1031/2014.

2017	ISK	Foreign currency	Total
Liquid assets level 1 *	131,197	27,716	158,913
Liquid assets level 2**	-	-	-
Liquid Assets	131,197	27,716	158,913
Deposits	108,442	24,738	133,180
Borrowing	2,426	96	2,522
Other cash outflows	6,067	9,500	15,567
Cash outflows	116,935	34,334	151,269
Short-term deposits with other banks ***	1,048	59,528	60,576
Other cash inflows	12,232	6,540	18,772
Cash inflows	13,280	66,068	79,348
Liquidity coverage ratio (LCR) ****	127%	323%	221%

2016	ISK	Foreign currency	Total
Liquid assets level 1 *	112,770	13,026	125,796
Liquid assets level 2 **	-	2,932	2,932
Liquid Assets	112,770	15,958	128,728
Deposits	93,584	16,885	110,469
Borrowing	3,192	371	3,563
Other cash outflows	12,426	7,013	19,439
Cash outflows	109,202	24,269	133,471
Short-term deposits with other banks ***	1,688	51,779	53,467
Other cash inflows	3,843	1,011	4,854
Cash inflows	5,531	52,790	58,321
Liquidity coverage ratio (LCR) ****	109%	263%	171%

* Level 1 assets include the Group's cash and balances with the Central Bank, domestic bonds eligible as collateral at the Central Bank and foreign government bonds which receive 100% weight. Under Rules No. 266/2017 the Group's covered bonds also classify as Level 1 assets and receive 93% weight.

** Level 2 assets include the Group's covered bonds with a minimum rating of AA- and receive a 85% weight in LCR calculations.

*** Short-term deposits in other banks are defined as cash inflows in LCR calculations.

**** LCR is defined as: LCR = Weighted liquid assets / (weighted cash outflows - weighted cash inflows) where weighted cash inflows are capped at 75% of weighted cash outflows.

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42. Liquidity and Funding risk, continued

Composition of liquid assets

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

2017	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	137,399	293	943	1,184	139,819
Short-term deposits in other banks	1,048	24,796	15,334	19,398	60,576
Domestic bonds eligible as collateral at the Central Bank	3,022	-	-	-	3,022
Foreign government bonds	-	6,401	16,291	-	22,692
Covered bonds with a minimum rating of AA-	-	-	1,262	1,538	2,800
Liquidity reserve	141,469	31,490	33,830	22,120	228,909

2016	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	85,053	627	775	1,179	87,634
Short-term deposits in other banks	1,688	16,018	14,090	21,671	53,467
Domestic bonds eligible as collateral at the Central Bank	27,718	-	-	-	27,718
Foreign government bonds	-	5,536	4,908	-	10,444
Covered bonds with a minimum rating of AA-	-	-	1,202	2,247	3,449
Liquidity reserve	114,459	22,181	20,975	25,097	182,712

LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. The table contains deposits at the Bank and at banking subsidiaries. Thus, amounts due to Central Bank and amounts due to credit institutions at non-banking subsidiaries are excluded.

LCR categorization - amounts and LCR outflow weights	Deposits maturing within 30 days					
2017	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Retail	163,542	11%	52,401	5%	68,741	284,684
Corporations	51,968	40%	811	20%	5,757	58,536
Sovereigns, central banks and PSE	14,583	40%	-	-	1,383	15,966
Pension funds	53,116	100%	-	-	15,391	68,507
Domestic financial entities	23,175	100%	-	-	15,949	39,124
Foreign financial entities	2,714	100%	-	-	-	2,714
Total	309,098		53,212		107,221	469,531
2016						
Retail	137,055	10%	44,331	5%	63,106	244,492
Corporations	55,094	40%	921	20%	5,850	61,865
Sovereigns, central banks and PSE	11,653	40%	-	-	1,379	13,032
Pension funds	31,157	100%	-	-	15,959	47,116
Domestic financial entities	24,310	100%	-	-	16,730	41,040
Foreign financial entities	2,150	100%	-	-	-	2,150
Other foreign parties	4,466	100%	3,276	25%	2,288	10,030
Total	265,885		48,528		105,312	419,725

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

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43. Capital management

Capital adequacy

The focus of capital management at the Group is to normalize the capital structure in the medium term and consequently maintain the Group's capitalization comfortably above the regulatory minimum, including capital buffers and Pillar 2 requirements.

The Group's capital ratios are calculated in accordance with Act No. 161/2002 on Financial Undertakings and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR), but has temporarily excluded Article 501 on capital requirements relief for small and medium enterprises. The Group uses the standardized approach to calculate capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

As at 31 December 2017, the Group's consolidated situation as stipulated in CRR is the Group's accounting consolidation without Vördur Insurance (Vördur). As the full accounting consolidation has been applied in prior statements, the figures as at 31 December 2016 are adjusted to reflect the defined consolidated situation. The capital position and solvency requirements of Vördur should be viewed independently from capital adequacy for the Group's consolidated situation. An adjustment is made to the Group's Pillar 2 requirements as the latest SREP result is based on the accounting consolidation which includes an add-on due to the solvency requirements of Vördur.

The Group's own funds at 31 December 2017 are affected by the foreseeable dividend distribution and purchase of own shares as mandated by the Bank's shareholders on 12 February 2018. For further details, see Note 38.

Own funds	2017	2016
Total equity	225,734	211,384
Deductions related to the consolidated situation	(8,635)	(8,126)
Non-controlling interest not eligible for inclusion in CET1 capital	(128)	(172)
Common Equity Tier 1 capital before regulatory adjustments	216,971	203,086
Intangible assets	(11,125)	(8,201)
Tax assets	(357)	(198)
Cash flow hedges	265	(22)
Foreseeable dividend	(25,000)	-
Additional value adjustments	(119)	(127)
Common equity Tier 1 capital	180,635	194,538
Non-controlling interest not eligible for inclusion in CET1 capital	128	172
Tier 1 capital	180,763	194,710
General credit risk adjustments	3,195	4,557
Tier 2 capital	3,195	4,557
Total own funds	183,958	199,267

Risk-weighted assets		
Credit risk, loans	605,058	577,470
Credit risk, securities and other	56,979	55,036
Counterparty credit risk	5,844	5,550
Market risk due to currency imbalance	4,895	5,449
Market risk other	5,473	12,966
Credit valuation adjustment	2,506	2,678
Operational risk	86,013	86,490
Total risk-weighted assets	766,768	745,639

Capital ratios		
CET1 ratio	23.6%	26.1%
Tier 1 ratio	23.6%	26.1%
Capital adequacy ratio	24.0%	26.8%

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43. Capital management, continued

Under the accounting standard IAS 39, the Bank's general provisions account as Tier 2 capital as stipulated in CRR. This applies to financial institutions that use the standardized approach as the capital requirement should reflect unexpected losses less expected losses as inherent in IRB methods. As of 1 January 2018, IAS 39 is replaced by IFRS 9 which introduces new methods for estimating expected future losses. The European Banking Authority (EBA) has issued an opinion* which states that "EBA believes that all IFRS 9 provisions should be considered SCRA [special credit risk adjustment]" as they “will not be freely and fully available to meet losses that subsequently materialize, as these provisions are ascribed to particular assets, whether individual or grouped”. FME has adopted EBA's opinion and as a result the Group's own funds will no longer include general credit risk adjustments and these shall be treated as SCRA, effectively reducing risk-weighted assets. Taking into account the expected changes to allowance from the adoption of IFRS 9, see Note 71, the Group's total capital ratio between 31 December 2017 and 1 January 2018 is reduced from 24.0% to 23.7%.

The following table outlines the implementation of the capital buffer requirements in accordance with the Financial Undertakings Act, as prescribed by the Financial Stability Council and approved by the FME.

Capital buffer requirement, % of RWA	1.1.2017	1.3.2017	1.11.2017
Capital conservation buffer	2.50%	2.50%	2.50%
Capital buffer for systematically important institutions	2.00%	2.00%	2.00%
Systemic risk buffer **	3.00%	3.00%	3.00%
Countercyclical capital buffer **	-	1.00%	1.25%
Combined capital buffer requirement	7.50%	8.50%	8.75%

The Bank carries out an ongoing process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Group has in place sufficient risk management processes and systems to identify, manage and measure the Group's total risk exposure. The ICAAP is aimed at identifying and measuring the Group's risk across all risk types and ensure that the Group has sufficient capital in accordance with its risk profile. The FME supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole following the Supervisory Review and Evaluation Process (SREP). The Group's own funds exceeds the FME's SREP requirements.

The Bank's Pillar 2R capital add-on, which is the result of the ICAAP/SREP, may comprise 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. With the current capital structure, the Pillar 2R requirement is solely met with CET1 capital.

*EBA/OP/2017/02, 06 March 2017, Opinion of the European Banking Authority on transitional arrangements and credit risk adjustments due to the introduction of IFRS 9

**The effective capital buffers for systemic risk and countercyclical effects are determined by calculating the weighted average of the corresponding buffer levels of each country, the weights being the total risk weighted exposures for credit risk against counterparties residing in those countries.

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43. Capital management, continued

Total capital requirement, % of RWA	2017
Pillar 1 capital requirement	8.0%
Pillar 2R capital requirement *	3.4%
Combined buffer requirement	8.4%
Total regulatory capital requirement	19.8%
Available capital	24.0%

CET1 requirement, % of RWA	
Pillar 1 CET1 requirement	4.5%
Pillar 2R CET1 requirement *	1.9%
Combined buffer requirement	8.4%
CET1 regulatory capital requirement	14.8%
Available CET1 capital	23.6%

* The SREP result based on the Group's financial statement at 31.12.2016. The Pillar 2 requirement is 3.7% of risk-weighted assets based on accounting consolidation. Based on the Group's consolidated situation under CRR, which excludes Vördur Insurance, the requirement is 3,4%.

Leverage ratio

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The ratio is calculated on the basis of the Group's consolidated situation as per the CRR, which excludes the Group's insurance subsidiaries. The figures for 31 December 2017 take into account a foreseeable dividend and share buyback of ISK 25 billion, see Note 38. The minimum leverage ratio requirement is 3% as stated in Act No. 161/2002 on Financial Undertakings.

	2017	2016
On-balance sheet exposures	1,074,207	995,063
Derivative exposures	10,957	8,226
Securities financing transaction exposures	8,925	9,330
Off-balance sheet exposures	83,058	83,156
Total exposure	1,177,147	1,095,775
Tier 1 capital	180,763	194,710
Leverage ratio	15.4%	17.8%

Solvency II

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vördur Group was 2,923 million at 31 December 2017 and calculated solvency of Vördur Group was ISK 4,971 million. The solvency ratio, which is the ratio of calculated solvency to the solvency requirements was 170.1% at 31 December 2017.

At the end of 2016 the Bank held the insurance companies Vördur tryggingar and Okkar líftryggingar. On 1 January 2017 Vördur tryggingar acquired the entire shareholding in Okkar líftryggingar and following the acquisition Vördur tryggingar merged its two life insurance subsidiaries. The solvency capital requirements as well as calculated solvency for Vördur Group is not available for 31 December 2016. The solvency capital requirement of Vördur was ISK 2,489 million at the end of 2016 and Okkar ISK 574 million and calculated solvency of Vördur was ISK 3,609 million and Okkar ISK 1,236 million. The solvency ratio of Vördur was 145.0% and Okkar 215,0% at the end of 2016.

44. Operational risk

Operational risk is the risk of direct or indirect loss, or damage to the Group's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Group's image and operational earnings.

Each business unit within the Group is primarily responsible for taking and managing their own operational risk. The operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Group's operational risk.

The Group uses the standardized approach for the calculation of capital requirements for operational risk.

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Notes to the Consolidated Financial Statements

Significant accounting policies

The accounting policies adopted in the preparation of these Consolidated Financial Statements are consistent with those followed in the preparation of the Group's Consolidated Financial Statements for the year ended 31 December 2016 except for new and amended IFRS adopted by the European Union, that became effective as of 1 January 2017, see Note 71, and amendments to Icelandic Annual Accounts Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

45. Going concern assumption

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

46. Principles underlying the consolidation

Subsidiaries

Subsidiaries are entities controlled by the Group. The Financial Statements of subsidiaries are included in the Consolidated Financial Statements from the date that control commences until the date that control ceases. The Financial Statements of the subsidiaries are prepared for the same reporting period as the parent entity, using consistent accounting policies.

Business combinations

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if, and only if, the Group has:

- power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee);
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect its returns.

Generally, there is a presumption that a majority of voting rights result in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an investee, the Group considers all relevant facts and circumstances in assessing whether it has power over an investee, including (i) the contractual arrangement with the other vote holders of the investee, (ii) rights arising from other contractual arrangements and (iii) the Group's voting rights and potential voting rights. The Group re-assesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

The Group measures goodwill at the acquisition date as:

- the fair value of the consideration transferred; plus
- the recognized amount of any non-controlling interests in the acquiree; less
- if the business combination is achieved in stages, the fair value of the pre-existing equity interest in the acquiree; less
- the net recognized amount (generally fair value) of the identifiable assets acquired and liabilities assumed.

When the excess is negative, a bargain purchase gain is recognized immediately in profit or loss.

Transaction costs incurred are expensed and included in administration expense.

Non-controlling interests

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Group; such interests are presented separately in the Statement of Comprehensive Income and are included in equity in the Statement of Financial Position, separately from equity attributable to owners of the Group.

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:

- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

46. Principles underlying the consolidation, continued

Changes in the Group's interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

Loss of control

On the loss of control, the Group derecognizes the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognized in profit or loss.

Transactions eliminated on consolidation

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Consolidated Financial Statements.

If an investment in a subsidiary is classified as held for sale the investment is accounted for as non-current asset and disposal groups held for sale from the date of classification.

Funds management

The Group manages and administers assets held in unit trusts and investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Consolidated Financial Statements except when the Group controls the entity.

When assessing whether to consolidate investment funds, the Group reviews all facts and circumstances to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal, and hence controls and consolidates a fund, when the Group acts as fund manager and cannot be removed without cause, has variable returns through significant holdings, and is able to influence the returns of the funds by exercising its power. The Group is defined as agent in all instances.

47. Associates

Associates are those entities over which the Group has a significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Group holds 20% or more of the voting power, including potential voting rights, unless it can be clearly demonstrated that this is not the case. Investments in associates are initially recognized at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The considerations made in determining significant influence are similar to those necessary to determine control over subsidiaries.

The Group's investments in its associate are accounted for using the equity method.

The Financial Statements include the Group's share of the total recognized income and expenses of associates from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its carrying value of associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognizing its share of those profits only after its share of the profits equals the share of losses not recognized.

Upon loss of significant influence over the associate, the Group measures and recognizes any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognized in profit or loss.

Impairment on investments in associates

After applying the equity method to account for investments in associates, the Group determines whether it is necessary to recognize any impairment loss with respect to its investments in associates. The Group first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Group then tests the entire carrying amount of the investment for impairment, by comparing its recoverable amount, which is the higher of value in use and fair value less costs to sell, with its carrying amount. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the Group. The excess of the carrying amount over the recoverable amount is recognized in the Statement of Comprehensive Income as an impairment loss. Impairment losses are subsequently reversed through the Statement of Comprehensive Income if the reasons for the impairment loss no longer apply.

48. Foreign currency

Items included in the Consolidated Financial Statements of each of the Group's subsidiaries are measured using the functional currency of the respective entity.

Foreign currency transactions

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. All differences arising on settlement or translation of monetary items are taken to the Statement of Comprehensive Income. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

49. Interest

Interest income and expense are recognized in the Statement of Comprehensive Income using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and financial liability and is not revised subsequently.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the Statement of Comprehensive Income include:

– interest on financial assets and liabilities at amortized cost on an effective interest rate basis;
– interest on financial assets and liabilities held for trading; and
– interest on financial assets designated at fair value through profit or loss.

50. Fee and commission

The Group provides various services to its clients and earns income therefrom, such as income from Corporate Banking, Retail Banking, Capital Markets, Corporate Finance, Asset Management and Private Banking. Fees earned from services that are provided over a certain period of time are recognized as the services are provided. Fees earned from transaction type services are recognized when the service has been completed. Fees that are performance linked are recognized when the performance criteria are fulfilled.

Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

51. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and financial liabilities classified as held for trading, Net gain on financial assets and liabilities at fair value, Net foreign exchange gain.

i) Dividend income is recognized when the right to receive dividend is established. Usually this is the ex-dividend date for equity securities.

ii) Net gain on financial assets and liabilities at fair value comprises all realized and unrealized fair value changes in trading portfolio and assets and liabilities designated at fair value through profit or loss, except for interest (which is included in Interest income and Interest expense) and foreign exchange gain and losses (which are included in Net foreign exchange gains as described below).

iii) Net foreign exchange gain comprise all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous Consolidated Financial Statements.

Net foreign exchange gain also include foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognized in profit or loss.

52. Net insurance income

Premiums recognized as income comprise the premiums contracted during the fiscal year including premiums transferred from last years but excluding next periods premiums, which are recognized as provision for unearned premiums. Provision for unearned premiums is a part of the technical provision in the Statement of Financial Position.

Claims recognized in the Statement of Comprehensive Income are the periods claims including increases or decreases due to claims from previous fiscal years. Outstanding claims included in technical provision in the Statement of Financial Position are the total amount of reported but unpaid claims as well as actuarial provision for claims occurred but unreported.

53. Income tax expense

Tax expense comprises current and deferred tax. Income tax for the year has been calculated and recognized in the Consolidated Financial Statements.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years. Taxable profit may differ from earnings before tax as reported in the statement of comprehensive income as it may exclude income or expense that is deductible in other years and it excludes income or expense that are never taxable or deductible.

Current and deferred tax relating to items recognized directly in equity is recognized in equity and not in the statement of profit or loss.

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities and the realization of foreign exchange gain or loss, for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantively enacted at the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Such deferred tax assets and liabilities are not recognized if the temporary difference arises from the initial recognition (other than in a business combination) of assets and liabilities in transaction that affects neither the taxable profit nor the accounting profit. In addition, tax liabilities are not recognized if the temporary difference arises from the initial recognition of goodwill.

54. Financial assets and financial liabilities

Recognition

The Group initially recognizes loans, deposits, debt securities issued and subordinated liabilities on the date that they are originated. Regular way purchases and sales of financial assets are recognized on the trade date at which the Group commits to purchase or sell the asset. All other financial assets and liabilities are recognized on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

54. Financial assets and financial liabilities, continued

Classification

The Group classifies its financial assets in one of the following categories:

- amortized cost;
- at fair value through profit or loss and within the category as:
  - held for trading; or
  - designated at fair value through profit or loss; or
- AFS financial assets at fair value through other comprehensive income.

The Group classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortized cost or held for trading.

Designation at fair value through profit or loss

The Group has designated financial assets and liabilities at fair value through profit or loss in either of the following circumstances:

- the assets or liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

Derecognition

Financial assets are derecognized when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

Financial liabilities are derecognized when the obligation of the Group specified in the contract is discharged or cancelled or expires.

Offsetting

Financial assets and liabilities are set off and the net amount reported in the Statement of Financial Position when, and only when, the Group has a legal right to offset the recognized amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains or losses arising from a group of similar transactions such as in the Group's trading activity.

Amortized cost measurement

The amortized cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount recognized and the maturity amount, minus any reduction for impairment.

All consumer price indexed assets and liabilities are revalued based on the index rate at the end of the year.

Fair value measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Group measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses, and option pricing models. The Group uses widely recognized valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

54. Financial assets and financial liabilities, continued

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the Statement of Financial Position.

Identification and measurement of impairment

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

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

The Group considers evidence of impairment for loans at both a borrower-specific and a collective level. Borrowers for specific assessment are sampled based on a combination of the borrowers' exposure, days in default and an internal classification where customers are classified according to financial position, defaults and credit rating. In determining specific provisions for impairment on individually assessed borrowers, the following factors are considered:

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

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow.

Collective provisions are taken for all loans other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default, but have been determined not to require specific impairment.

In assessing collective impairment, two deciding, quantitative components need to be addressed in order to perform the calculation i.e. one-year probability of default (PD) and loss given default (LGD). By using one-year probability of default the Bank assumes loss emergence period of one year. The Group uses internally developed probability-of-default models, which are regularly benchmarked against actual outcomes to ensure the predictive power of the models. For loss given default the Group uses internally developed models as well.

Clients in risk class 5 are examined for specific impairment. If they do not require specific impairment, this is because there is a good level of collateral and any collective provisions would be minimal. Larger clients who are examined for specific impairment and are not in risk class 5 still contribute to collective impairment, if specific impairment is deemed unnecessary.

54. Financial assets and financial liabilities, continued

Impairment losses are recognized in profit or loss and reflected in an allowance account against loans. When an event occurring after the impairment was recognized causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognized as an increase in value of loans in profit or loss when recalculation results in an increase in carrying amount and impairment when there is a decrease in carrying amount.

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

Hedge accounting

During the first quarter of 2017, the Group started applying fair value hedge accounting with respect to designated hedging relationship of certain fixed-rate foreign currency denominated notes issued by the Bank as the hedged items and certain foreign currency denominated interest rate swaps as the hedging instruments. The Group recognizes the changes in fair value of the interest rate swaps together with changes in the fair value of bonds attributable to interest rate risk immediately in profit or loss in the line item of Note 8, Net gain on fair value hedge of interest rate swap. Calculated accrued interest on both swaps and bonds are included in the line item of Note 7, Interest expense.

Other derivatives, not designated in a qualifying hedge relationship, are used to manage its exposure to foreign currency, interest rate, equity market and credit risk. The financial instruments used include, but are not limited to, interest rate swaps, cross-currency swaps, forward contracts, futures, options, credit swaps and equity swaps.

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80–125%.

If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. Any adjustments, up to the point of discontinuation, to a hedged item for which the effective interest method is used, is amortized to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

55. Cash and cash equivalents

Cash and cash equivalents in the Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition. Cash and cash equivalents are carried at amortized cost in the Statement of Financial position.

56. Loans

Loans are financial instruments with fixed or determinable payments that are not quoted in an active market and that the Group does not intend to sell immediately or in the near term. Loans include loans provided by the Group to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

Loans are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortized cost using the effective interest method.

When the Group is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, the arrangement is classified as a capital lease and a receivable equal to the net investment in the lease is recognized and presented within loans.

When the Group purchases an asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date reverse repo or stock borrowing, the arrangement is accounted for as a loan, and the underlying asset is not recognized in the Group's Consolidated Financial Statements.

57. Financial instruments

Trading assets and liabilities

Trading assets and liabilities are financial instruments acquired principally for the purpose of generating profits from short term price fluctuations or from a dealer's margin, short positions in listed bonds and derivative financial instruments.

Securities used for economic hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts. Those assets are not subject to hedge accounting.

Financial assets designated at fair value through profit or loss

Assets classified designated at fair value through profit or loss consist of equity and debt instruments which are acquired by the Group with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial instruments and trading liabilities are initially and subsequently measured at fair value in the Statement of Financial position, with transaction costs recognized in profit or loss. All changes in fair value are recognized as part of net financial income in profit or loss.

Interest and dividend income that arises from these assets are included in Interest income and Net financial income, respectively.

Available-for-sale financial assets designated at fair value through Other comprehensive income

AFS financial assets include equity investments. Equity investments classified as AFS are those that are neither classified as held for trading nor designated at fair value through profit or loss. After initial measurement, AFS financial assets are subsequently measured at fair value with unrealized gains or losses recognized in OCI and credited in the AFS reserve until the investment is derecognized, at which time, the cumulative gain or loss is recognized in other operating income, or the investment is determined to be impaired, when the cumulative loss is reclassified from the AFS reserve to the statement of profit or loss in finance costs.

58. Derivatives

A derivative is a financial instrument or other contract, the value of which changes in response to a change in an underlying variable, such as share, commodity or bond prices, an index value or an exchange or interest rate, which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

Derivatives are recognized at fair value. Fair value changes are recognized in the Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and net financial gain or loss. Interest income is recognized on an accrual basis. Derivatives with positive fair values are recognized as Financial instruments and derivatives with negative fair values are recognized as Financial liabilities at fair value.

59. Intangible assets

Goodwill

Goodwill that arises on the acquisition of subsidiaries is presented with intangible assets. Subsequent to initial recognition goodwill is measured at cost less accumulated impairment losses.

Infrastructure and customer relationship

Infrastructure and customer relationship and related agreements are measured at cost less any accumulated impairment losses.

Software

Software acquired by the Group is measured at cost less accumulated amortization and any accumulated impairment losses.

Subsequent expenditure on software is capitalized only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Amortization of intangible assets

Amortization of intangible assets is recognized in the Statement of Comprehensive Income on a straight-line basis over the estimated useful life, from the date that it is available for use. The estimated useful life of intangible assets for the current and comparative periods is three to ten years.

60. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both.

Investment property is initially measured at cost and subsequently at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the statement of comprehensive income.

61. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than non-current assets held for resale, investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The recoverable amount of intangible assets is assessed annually.

An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in profit or loss.

The recoverable amount of an asset is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss in respect of other assets, where impairment losses have been recognized in prior periods, are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

62. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortized cost using the effective interest method.

63. Borrowings

Borrowings are measured at amortized cost with any difference between cost and redemption amount being recognized in the Statement of Comprehensive Income over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

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

The Group classifies a non-current asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset or disposal group and the sale must be highly probable.

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognized at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement. Revaluation through the reversal of impairment in subsequent periods is limited so that the carrying amount of the held for sale, non-current assets or disposal group does not exceed the carrying amount that would have been determined had no impairment loss been recognized in prior years.

65. Other assets and other liabilities

Property and equipment

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses. When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

Subsequent expenditure is capitalized only when it is probable that the future economic benefits of the expenditure will flow to the Group. Ongoing repairs and maintenance are expensed as incurred.

The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives are as follows:

Buildings	33-50 years
Equipment	3-7 years

The depreciation methods, useful lives and residual values are reassessed annually.

Other assets and other liabilities

Other assets and other liabilities are stated at cost less impairment.

Insurance claim

Estimate is made in accordance with Solvency II rules. Data from the company's claim system are extrapolated to predict the final amount of the claims that will be paid at the end of the reporting period with corresponding expected payments from reporting date until the settlement of claims that occurred prior to the reporting date. In addition, estimation of settlement cost, risk and other factors is made in accordance with the instructions in Solvency II rules. This approach is consistent with the valuation of insurance liabilities in IFRS 4.

66. Equity

Dividends

Dividends on shares are recognized in equity in the period in which they are approved by Arion Bank's shareholders.

Statutory reserve

According to the Icelandic Companies Act No. 2/1995 at least 10% of the profit of the Group which is not devoted to meeting losses from previous years and is not contributed to other legal reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital. When that limit has been reached the contribution must be at least 5% of the profit until the statutory reserve amounts to 25% of the share capital of the Bank.

Reserve for investments in subsidiaries and associates

According to the Financial Statements Act No. 3/2006 the difference between share of profit of subsidiary or associate in excess of dividend payment or dividend payment pending, shall be transferred to a restricted shareholding equity reserve, net of tax, which is not subject to dividend payments. When shareholding in subsidiary or associate is sold or written off the shareholding equity reserve shall be released and the amount transferred to retained earnings.

Reserve for investments in securities

According to the Financial Statements Act No. 3/2006 fair value changes of financial assets from the initial reporting, shall be transferred from retained earnings to a fair value equity reserve, net of tax. The fair value equity reserve is not subject to dividend payments. The fair value equity reserve shall be released in accordance with fair value changes recognized when financial asset is sold or redeemed or the assumptions for the fair value change is no longer in force.

Available-for-sale reserve

AFS reserve comprises all unrealized gain or losses related to fair value measurements of AFS financial assets.

Foreign currency translation reserve

The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the Consolidated Financial Statements of foreign operations.

67. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to the shareholders of Arion Bank hf. by the weighted average number of ordinary shares outstanding during the year.

68. Financial guarantees

In the ordinary course of business, the Group gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognized in the Consolidated Financial Statements at fair value, being the premium received. Subsequent to initial recognition, the Group's liability under each guarantee is measured at the higher of the amount initially recognized less, when appropriate, cumulative amortization recognized in the Statement of Comprehensive Income, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is recorded in the Statement of Comprehensive Income. The premium received is recognized in the Statement of Comprehensive Income in Net fees and commission income on a straight line basis over the life of the guarantee.

69. Fiduciary activities

The Group provides asset custody, asset management, investment management and advisory services to its clients. These services require the Group to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Group's custody are not reported in its Statement of Financial Position.

70. Employee benefits

All entities with employees within the Group have defined contribution plans. The entities pay fixed contributions to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid. The contributions are recognized as an expense in the Statement of Comprehensive Income when they become due. The Group does not operate any pension fund which confers pension rights.

71. New standards and amendments to standards

The Consolidated Financial Statements are presented in accordance with the new and revised IFRS standards and new interpretations (IFRIC), applicable in the year 2017. These new and revised IFRSs did not have material effect on amounts nor information reported in the Consolidated Financial Statements.

Amendments to IAS 12 Income Taxes clarify that an entity needs to consider whether tax law restricts the sources of taxable profits against which it may make deductions on the reversal of deductible temporary difference related to unrealized losses. Furthermore, the amendments provide guidance on how an entity should determine future taxable profits and explain the circumstances in which taxable profit may include the recovery of some assets for more than their carrying amount. The amendments had no effect on the Group’s financial position and performance as the Group has no deductible temporary differences or assets that are in the scope of the amendments.

Amendments to IAS 7 Statement of Cash Flows require entities to provide disclosure of changes in their liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes (such as foreign exchange gains or losses). The amendment was effective from 1 January 2017 but did not have major impacts on the Consolidated Financial Statements.

Notes to the Consolidated Financial Statements

71. New standards and amendments to standards, continued

A number of new standards, amendments to standards and interpretations have been issued but are not yet effective for the year ended 31 December 2017, and have not been applied in preparing these Consolidated Financial Statements. Relevant to the Group's reporting are:

IFRS 9 Financial Instruments

Financial impacts of Adoption of IFRS 9

The IASB issued IFRS 9: Financial Instruments in July 2014. The standard replaces IAS 39 Financial instruments: Recognition and measurement and takes effect for annual periods beginning on or after 1 January 2018, with early adoption permitted. The Arion Bank Group (‘the Group’) will apply IFRS 9 from 1 January 2018.

Changes in accounting policies resulting from the adoption of IFRS 9 will be applied retrospectively. The Group will take advantage of the exemption allowing it not to restate comparative information for prior periods. Differences in the carrying amounts of financial assets and financial liabilities resulting from the adoption of IFRS 9 will be recognized in retained earnings and other reserves as at 1 January 2018.

The following assessments have to be made on the basis of the facts and circumstances that exist at the date of initial application:

- the determination of the business model within which a financial asset is held;
- the designation and revocation of previous designations of certain financial assets and financial liabilities as measured at FVPL;
- the designation of certain investments in equity instruments not held for trading at FVOCI. For a financial liability designated at FVPL,
- FVPL, the determination of whether presenting the effects of changes in the financial liability´s credit risk in OCI would create or enlarge an accounting mismatch in profit or loss.

Based on the Group’s assessment up to date, the total estimated adjustment (net of tax) resulting from the adoption of IFRS 9 on the opening balance equity of the Group at 1 January 2018 is approximately ISK 1.0 billion, comprised of:

- Increase of approximately ISK 0.6 billion because of reduction in impairment due to changes in impairment calculations.
- Increase of approximately ISK 0.4 billion due to changes in classification and measurement requirements, other than impairment.

During the implementation phase the Group set up a multidisciplinary implementation team ('the Team') with members from Risk, Finance and other relevant divisions to prepare for IFRS 9 implementation ('the Project'). The IFRS 9 steering committee consists of Chief Risk and Finance officers as well as senior managers from Corporate Banking and Retail Banking, who regularly report to the Bank's Audit Committee (BAC). The steering committee will continue its role as a governing body following the implementation date for all matters related to IFRS 9, such as IFRS 9 impairment model oversight, review and approval.

Classification

Financial assets

From a classification and measurement perspective, the new standard requires debt instruments to be classified based on their business model and cash flows characteristics, rather than based on reasons for individual purchases. IFRS 9 is combined of three classification categories: amortized cost, fair value through other comprehensive income (FVOCI) and fair value through profit and loss (FVPL). They replace the IAS 39 classification categories held to maturity, loans and receivables, available for sale, held for trading and designated at fair value through profit or loss (FVPL). The Group makes an assessment of the objective of the business model in which a financial asset is held at portfolio level.

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

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

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

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

All other debt instruments are carried at FVPL.

71. New standards and amendments to standards, continued

IFRS 9 allows entities to irrevocably designate, at initial recognition, instruments that qualify for amortized cost or fair value through OCI instruments as FVPL, if doing so eliminates or significantly reduces a measurement or recognition inconsistency.

Equity instruments must be measured at FVPL unless other IFRS standards apply or are irrevocably designated as FVOCI, with no subsequent reclassification of gains or losses to the Statement of Comprehensive Income.

Financial liabilities

IFRS 9 largely retains the existing requirements of IAS 39 for the classification of financial liabilities. However, under IAS 39 all fair value changes of financial liabilities designated as at FVPL are recognized in profit or loss, whereas under IFRS 9 the fair value changes attributable to own credit risk will be presented in OCI, and the remaining amount will be presented in profit and loss, unless an accounting mismatch in profit or loss would arise. As of 1 January 2018 no liabilities within the Group will be designated at FVPL.

Classification impact assessment

Having completed its initial assessment, the Group has concluded that:

- all loans to credit institutions and loans to customers that are classified as loans and receivables under IAS 39 will be measured at amortised cost under IFRS 9,
  - Loans that have failed the SPPI test will be held at FVPL. Such instruments are uncommon.
- financial assets and liabilities held for trading and financial assets and liabilities designated at FVPL are expected to be measured at FVPL,
- all debt instruments held by Arion Bank hf. treasury will be re-classified from FVPL to FVOCI; and
- all equity investments and derivatives will be measured at FVPL.

The Group has estimated that, on the date of adoption of IFRS 9, the impact of these changes will be an increase in the Group's equity of ISK 0.4 billion net of tax.

Impairment

IFRS 9 replaces the "incurred credit loss" model used under IAS 39 with an "expected credit loss" (ECL) model. The changes from incurred to expected losses requires professional judgement over various factors used in the calculation of ECLs. Such as, how macroeconomic scenarios affect the ECL calculation. The new "expected credit" impairment models apply to financial assets that are debt instruments (including loans to customers) measured at amortized cost or FVOCI, lease receivables, loan commitments and financial guarantee contracts. Equity instruments are not subject to impairment. The application of the IFRS 9 impairment requirements might increase volatility in profit and loss of the Group.

Definition of default

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

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

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

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

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

71. New standards and amendments to standards, continued

Probability of default and credit risk rating

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

The Group's rating scale is shown below.

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

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

PD term structures

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

Arion Bank Consolidated Financial Statements 2017 91 Amounts are in ISK millions

71. New standards and amendments to standards, continued

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

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

Significant increase in credit risk

In determining whether the risk of default for an exposure has increased significantly since initial recognition, the Group considers relevant, reasonable and supportable information on an ongoing basis. Assumptions are drawn based on the Group's historical experience and expert judgement including forward-looking expectations. If a debt investment security has low credit risk at 1 January 2018, the Group will determine that the credit risk on the asset has not increased significantly since initial recognition.

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

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

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

Staging allocation

The Group's staging criteria is the following:

Stage	Criteria	Assessment of expected credit
1	Exposures not in default and with no significant increase in credit risk	12 month expected credit loss
2	Exposures not in default with significant increase in credit risk	Lifetime expected credit loss
3	Exposures in default	Lifetime expected credit loss

71. New standards and amendments to standards, continued

Expected credit loss measurement

The expected credit loss (ECL) calculations are based on three main components:
- probability of default (PD),
- loss given default (LGD); and
- exposure at default (EAD).

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

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

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

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

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

Forward-looking scenarios

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

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

71. New standards and amendments to standards, continued

Impairment impact assessment

As of 1 January 2018, the collective provisions are effectively replaced by the IFRS 9 impairments in stage 1 and 2. The impact is largely twofold; impairments generally increase for exposures in stage 2 as the ECL is assessed by lifetime calculations under IFRS 9, while impairments generally decrease as a result of a more refined assessment of risk through increased number of risk factors and better information around various inputs into the impairment calculations needed to comply with the IFRS 9 expected credit loss model. The impact is a reduction in impairments of ISK 0.6 billion net of tax.

Impact on regulatory capital

Under the Basel III regulatory capital framework, general provisions (general credit risk adjustments in Act No. 161/2002 on Financial Undertakings) are eligible as Tier 2 capital for financial institutions that apply the standardized approach for capital requirement calculations. General provisions reduce Common Equity Tier 1 capital through reduction of assets but are effectively reintroduced into own funds through Tier 2 capital as they are loss absorbing. In contrast, for financial institutions that apply internal models (IRB) for capital requirement calculations, expected loss reduces risk-weights as capital is meant to meet unexpected losses in excess of expected losses as the latter should be accounted for in the pricing of credit exposures. Any excess of accounting allowances to expected losses under IRB is included as Tier 2 capital for IRB banks.

The European Banking Authority (EBA) has issued an opinion stating that "EBA believes that all IFRS 9 provisions should be considered SCRA [special credit risk adjustment]" as they “will not be freely and fully available to meet losses that subsequently materialize, as these provisions are ascribed to particular assets, whether individual or grouped”. The Financial Supervisory Authority in Iceland has adopted this opinion and as a result, as of 1 January 2018, the Group's own funds will no longer include general credit risk adjustments. All impairments under IFRS 9 shall be treated as SCRA and changes to IFRS 9 provisions will be directly reflected in the Common Equity Tier 1 (CET1) capital, without re-adjustment through Tier 2 capital.

Transitional rules that mitigate the impact of IFRS 9 on own funds have been introduced into European law through Regulation (EU) 2017/2395. The arrangements have not been adopted in Iceland and therefore the Group does not apply transitional rules but recognizes the full impact on 1 January 2018.

Hedge accounting

When initially applying IFRS 9, the Group may choose as its accounting policy to continue to apply the hedge accounting requirements of IAS 39 instead of the requirements in Chapter 6 of IFRS 9. The Group has elected to continue to apply IAS 39. However, the Group will provide the expanded disclosures on hedge accounting introduced by IFRS 9’s amendments to IFRS 7, as the accounting policy election does not provide an exemption from the new disclosure requirements under IFRS 7.

Disclosures

IFRS 9 will require extensive new disclosures, in particular about hedge accounting, credit risk and ECL’s that will be included in the Group’s first reporting period after the adoption of the standard.

IFRS 15 Revenue from Contracts with Customers

The standard defines principles for recognizing revenue and establishes a five-step model to account for revenue arising from contracts with customers. However, interest and fee income integral to financial instruments and leases will continue to fall outside the scope of IFRS 15 and will be regulated by the other applicable standards. Under IFRS 15, revenue is recognized at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to customer. The standard specifies a comprehensive set of disclosure requirements. The standard is effective from 1 January 2018. Based on analysis performed to assess the impacts of implementation of the standard it is considered to have minor impacts on the Statement of Comprehensive Income.

IFRS 16 Leases

The standard does not significantly change the accounting for leases for lessors. However, it does require lessees to recognize most leases on their balance sheet as lease liabilities, with the corresponding right-to-use assets. Lessees must apply a single model for all recognized leases, but will have the option not to recognize short-term leases and leases of low-value assets. The standard is effective for annual periods beginning 1 January 2019. The Group is currently assessing the potential effect of the new standard.

Consolidated Financial Statements

– for the year 2016

Arion Bank

Endorsement and statement by the Board of Directors and the CEO

The Financial Statements of Arion Bank for the period from 1 January to 31 December 2016 include the Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Outlook

2016 was an eventful year for the Icelandic economy. During the first nine months of the year gross domestic product grew by 6.2% from the previous year as a result of both investment and private consumption. Despite growing private consumption, national savings have also increased, which indicates that higher purchasing power does not entirely pass through to consumption but also results in higher savings. Robust economic growth can also be linked to the rapid growth of the tourist industry, as there was a 40% year-on-year increase in the number of tourists visiting Iceland. Tourism has firmly established itself and is now Iceland’s main export sector. Foreign exchange earnings generated by increased exports have fuelled the appreciation of the nominal exchange rate of the króna, while the average exchange rate has strengthened by almost 11% between years. Unemployment averaged 3% in 2016, compared with 4% in 2015. Inflation was 1.7%, which is below the Central Bank of Iceland’s target rate. Robust economic growth of 5% is still expected and most forecasts suggest that private consumption will be stronger this year than it was last year. Unemployment is expected to decrease slightly and inflation is forecast to remain low, averaging around 1.8%, owing to the further appreciation of the króna. The conditions are therefore excellent for Arion Bank, whose operations are primarily concentrated on the domestic market.

In October Standard & Poor's upgraded Arion Bank's credit rating from BBB- with a positive outlook to BBB with a positive outlook. The upgrade reflects Arion Bank's solid financial position and good liquidity position which builds on improving conditions in the Icelandic economy and the deleveraging of Icelandic households and corporations. It also takes into account Arion Bank's enhanced access to international funding markets.

Arion Bank is a leading, well balanced universal relationship bank operating on the Icelandic financial market. The Bank has moderate risk profile and enjoys a strong position in all its business segments: Retail Banking, Corporate Banking, Asset Management and Investment Banking. The Bank's subsidiaries further supplement its service offering and form an integral part of the Group. The main subsidiaries include Valitor hf., which is a market leader in Iceland in acquiring services and payment solutions and also has operations in Scandinavia and the United Kingdom. The Bank also owns Stefnir hf., Iceland's largest fund management company, Vörður tryggingar hf., the fourth largest insurance company in Iceland and Okkar líftryggingar hf., Iceland's second largest life insurance company. Work is under way to merge Okkar lítryggingar hf. into Vörður líftryggingar hf., which is a subsidary of Vörður tryggingar hf.

Arion Bank places great importance on innovation and efficiency in its operations. A key area of focus for many years has been developing online banking and in recent years mobile banking has been a priority. These new distribution channels have already had, and will continue to have, an impact on how the Bank meets the needs of its customers. As a result the number of branches has been substantially reduced in recent years and the Bank will continue to seek ways to bring greater efficiency to the branch network. Another area of focus at Arion Bank is digital future, which is critical in order to both onhance customer experience and reduce operating expenses across the Bank in the long term.

Arion Bank is financially robust as demonstrated by a leverage ratio of 18.0% (see Note 44). Its liquidity position is strong, with a liquidity coverage ratio of 171%, (see Note 42). All the ingredients are in place to enable Arion Bank to continue to offer its customers quality services in the areas which are important to them, whether in Retail Banking, Corporate Banking, Asset Management or Investment Banking. The Bank's financial strength enables it to grow alongside its customers and to pay competitive dividends to its owners.

Kaupthing ehf., now a holding company, has expressed its interest in exploring its options in respect to its 87% shareholding in Arion Bank, held by its subsidiary Kaupskil ehf. On 15 June Arion Bank and Kaupthing issued the following press release: “In the context of the continued strong development of the Icelandic economy, Arion Bank and Kaupthing, its majority owner, are currently assessing a range of strategic alternatives with regards to Kaupthing's shares held in the Bank. This may include a possible IPO; however, no decision has been made at this point in time with respect to any specific transaction and timing thereof”.

Operations during the year

Net earnings amounted to ISK 21,739 million for 2016, and the Group's equity amounted to ISK 211,384 million at the end of the year. Return on equity was 10.5% for the year. The capital ratio of the Group, according to the Financial Undertakings Act No. 161/2002 was 27.1% and the corresponding Tier 1 ratio was 26.5%, which comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also strong at year-end and well above the regulatory minimum.

The Board of Directors proposes that net earnings be added to equity and that no dividend be paid in 2017 for the fiscal year 2016, for now. The Board of Directors has a broad authority to suggest that the Bank pay dividends or other disbursement of equity and may convene a special shareholders' meeting later in the year to propose a payment.

Endorsement and statement by the Board of Directors and the CEO

On 30 September 2016 Arion Bank completed the acquisition of all shares in the insurance company Vörður tryggingar hf., which is classified as subsidiary of the Bank.

In June the Bank's subsidiary Valitor Holding hf. completed the sale of its shareholding in Visa Europe Ltd. to Visa Inc. The profit from the sale was ISK 5,291 million, after taking into account conditional payments to Landsbankinn hf. and two savings funds, which formed part of the agreement when Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014. The profit was recognized as Net financial income in the Statement of Comprehensive Income in the second quarter of 2016. The shareholding was classified as Financial assets available for sale at year-end 2015.

The main changes on the Balance Sheet from year-end 2015 relate to changes in the structure of funding, increased lending and increased liquidity. Loans to customers have increased by ISK 32.1 billion, or 4.7%, during the year. Approximately 17% of total loans to customers are in foreign currency. New lending is mainly to individuals, real estate and industry, energy and manufacturing.

One of Arion Bank's main tasks in recent years has been to improve the quality of its loan portfolio and to reduce the amount of problem loans. The Bank has succeeded in this respect as the distribution of loans between individuals and companies is satisfactory and the ratio of problem loans has decreased to 1.6%.

In January, the subsidiary BG12 slhf. sold its entire shareholding in Bakkavor Group Ltd. The main effect from the sale was recognized as a valuation change in the Statement of Comprehensive Income in 2015. During the first quarter of 2016 the total effect through the Statement of Comprehensive Income was ISK 498 million.

In May Arion Bank opened its first branch for several years with a new branch at Keflavík International Airport. It is a state-of-the-art branch which enables the Bank to provide a wide range of first-class services to the growing number of tourists visiting Iceland.

Arion Bank improved its funding during 2016. In January Arion Bank reached an agreement with Kaupthing under which Arion Bank issued a bond in the amount of USD 747 million (ISK 97 billion). The bond was issued under Arion Bank's EMTN programme and is a 7-year instrument, callable on interest payment dates during the first two years. The bond bears floating LIBOR plus 2.6% interest for the first two years and will then be repriced at market terms. The bond offsets loans in foreign currency, taken by Arion Bank from the Central Bank of Iceland and later purchased by Kaupthing, and Kaupthing deposits in foreign currency at Arion Bank. The bond issue forms part of the capital control liberalization process relating to Kaupthing, first announced by the Ministry of Finance and Economic Affairs on 8 June 2015. Arion Bank settled large share of the bond in 2016.

In April Arion Bank issued bonds for a total of EUR 300 million, or ISK 42 billion. It was the Bank's second issue in euros to a diverse group of investors. The bonds are 2-year instruments and bear a fixed 2.5% coupon and were sold at terms equivalent to 2.7% margin over interbank rates. In November Arion Bank held a second issue and issued a total of EUR 300 million (ISK 36 billion) in senior unsecured bonds. Orders totalling over EUR 400 million from more than 50 investors were received. The 5-year bonds have a fixed coupon of 1.625% and were sold at rates corresponding to a 1.65% margin over interbank rates. A significant proportion of the above issue was used to pay approximately 65% of the Bank's issue from January 2016 which is owned by Kaupthing.

In September Arion Bank settled the subordinated liabilities with the Ministry of Finance with a prepayment. The Bank partly used proceeds from the Bank's bond issues in foreign currencies to pay off these loans. Paying off subordinated loans significantly reduces the Bank's future interest expenses.

The Bank has also focused on several other sources of funding. A number of smaller private placements were completed in NOK, SEK and other currencies during the year, continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. In 2016 the Bank issued a total of ISK 24.8 billion of covered bonds. The Bank has also continued to issue commercial paper on the domestic market and this has further diversified the Bank's funding. Commercial paper amounting to ISK 23.5 billion was issued in 2016.

The Group had 1,239 full-time equivalent positions at the end of the year, compared with 1,147 at the end of 2015; 869 of these positions were at Arion Bank, compared with 876 at the end of 2015. The number of employees increased by 30 in connection with the new branch at Keflavík International Airport. With the acquisition of Vörður tryggingar the number of full-time equivalent employees in the Group increased by 67. The number of employees at Valitor increased by 37 during the year. Arion Bank has invested heavily in Valitor's international operations which have grown rapidly in recent years. Salary increases in accordance with collective wage agreements, which came into effect on 1 January, raised the group's salary expenses substantially. As a consequence the Bank sought ways to reduce salary expenses and in September it reduced the number of employees by approximately 6%. Redundancies were made in all divisions of the Bank.

The tax environment did not change for Arion Bank during the year even though taxes paid by the main Icelandic banks are much higher than those paid by other companies. Most significant in this respect are the special 6% tax on earnings exceeding ISK 1 billion and the bank levy of 0.376% on liabilities exceeding ISK 50 billion.

Endorsement and statement by the Board of Directors and the CEO

Group ownership

On behalf of its creditors, Kaupthing ehf., through its subsidiary Kaupskil ehf., holds 87% of the shares in Arion Bank hf. The remaining shareholding of 13% is held by Icelandic State Financial Investments on behalf of the Icelandic government.

The Board of Directors has eight members, four women and four men. The ratio of men to women is therefore in compliance with the law which states that companies with more than 50 employees should ensure that the ratio of either sex on the board of directors should not be less than 40%. Seven directors are appointed by Kaupskil ehf. and one by Icelandic State Financial Investments.

Risk management

The Group faces various risks arising from its day-to-day operations as a financial undertaking. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels. The Group's risk management, its structure and main risk factors are described in the notes, starting at Note 40.

Corporate governance

The Board of Directors of Arion Bank hf. is committed to good corporate governance and endeavors to promote responsible behavior and corporate culture within the Bank for the benefit of all stakeholders. Arion Bank has to this end devised a corporate governance statement which is designed to help foster open and honest communication between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. In December 2015 Arion Bank was recognized as a company which had achieved excellence in corporate governance. The recognition is valid for three years unless significant changes are made to the Bank's management or ownership.

The Board of Directors is the supreme authority in the affairs of the Bank between shareholders' meetings. The Board tends to those operations of the Bank which are not considered part of the Bank's day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. The Board of Directors appoints a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The CEO hires the Executive Management. There are four Board subcommittees: the Board Audit Committee, the Board Risk Committee, the Board Credit Committee and the Board Remuneration Committee. The committee members are all Directors and there is furthermore one external expert member of the Board Audit Committee and the Board Risk Committee.

The Board of Directors is the supreme authority in the affairs of the Bank between shareholders' meetings. The Board tends to those operations of the Bank which are not considered part of the Bank's day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. The Board of Directors appoints a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The CEO hires the Executive Management. There are four Board subcommittees: the Board Audit Committee, the Board Risk Committee, the Board Credit Committee and the Board Remuneration Committee. The committee members are all Directors and there is furthermore one external expert member of the Board Audit Committee and the Board Risk Committee.

Corporate governance at Arion Bank is described in more detail in the Bank's Corporate Governance Statement which is contained in the unaudited appendix to the financial statement and on the website www.arionbanki.is. The Corporate Governance Statement is based on the legislation, regulations and recognized guidelines in force when the Bank's annual Financial Statement are adopted by the Board of Directors. This statement is prepared in accordance with the Financial Undertakings Act No. 161/2002 and Guidelines on Corporate Governance, 5th edition, issued by the Icelandic Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland in May 2015. Corporate governance at Arion Bank complies with the guidelines with a few exceptions, which are explained in more detail in the Corporate Governance Statement.

Sustainability

Arion Bank takes an active role in our society and its development. Financial institutions are one of the pillars of society and our role is to help our customers, both individuals and companies, reach their goals. The employees are guided by the Bank's cornerstones: we make a difference, we say what we mean and we get things done. The Bank's code of ethics also serve as a key to responsible decision-making at Arion Bank. The code of ethics is approved by the Board of Directors.

Arion Bank has played an important role in the regeneration of the Icelandic economy, not least in the rebuilding of the Icelandic stock market. The Bank has played an active role in more than 60% of stock offerings in recent years, including all offerings in 2015 and 2016. The Bank is dedicated to supporting the Icelandic business sector. With this aim in mind it has actively supported innovation and it has helped to set up two business accelerators, Startup Reykjavík and Startup Energy Reykjavík, where entrepreneurs are given the opportunity to develop their business ideas. Startup Reykjavík is fully owned by Arion Bank, while Startup Energy Reykjavík is a joint project with several leading players on the Icelandic energy market. During the year Arion Bank invested in 17 startups which participated in the business accelerators and it has now invested in more than 70 such companies in the last few years. The Bank has also invested more than ISK 1 billion in the venture capital fund Eyrir Sprotar and supported innovation at primary and secondary level schools across Iceland.

Lean management has been introduced across the Bank with the aim of improving service and eliminating waste. Constant improvements are integral to the Bank's culture. Improvements are recorded, targets set and then followed up on. During the year an average of eight improvements were made for each employee, exceeding the set goals. To this end there has been a strong focus on increasing digital services and five new digital solutions for customers were introduced during the year. Digital solutions reduce the ecological footprint of the Bank and its customers by reducing the number of trips made by customers to branches and cutting back on the use of paper. The Bank also places great importance on being able to provide quality advice at its branches and its employees also provide financial instruction to customers in order to help customers gain a better understanding of their own finances.

Since the Bank was founded one its key objectives has been to run an efficient and profitable business and to maintain the Bank's financial strength by meeting all capital and liquidity requirements. Internal control has been systematically reinforced and at the end of 2016 around 50 people worked in this area. Arion Bank has been recognized for good corporate governance. Arion Bank has been awarded equal pay certification by the labour union VR and has implemented a quality system which aims to eliminate the gender pay gap. In 2016 the unexplained gender pay gap measured 3.7% and the goal in 2017 is to reduce this to 3%.

In 2016 the Bank reviewed its policy on sustainability and in late 2016 a new policy was approved by the Board of Directors and presented to the employees. In 2015 Arion Bank signed the City of Reykjavík and Festa's Declaration on Climate Change and in collaboration with an Icelandic innovation company, Klappir Green Solutions, the Bank assessed its ecological footprint and set itself a target on how to reduce it. This will be discussed in more detail in the Bank's 2016 annual report. The Bank will also be guided by the list of non-financial factors highlighted by Nasdaq Iceland and the 10 principles in the UN Global Compact in which Arion Bank became a participant in 2016. Environmental and social issues will be covered in more depth in the 2016 annual report.

In 2017 the Bank will continue the good work carried out in 2016. The new policy on sustainable banking will be implemented, one of the objectives being to increase the number of non-financial performance indicators and to cement the role of sustainability in the Bank's procedures and management systems.

Endorsement and statement by the Board of Directors and the CEO

Endorsement of the Board of Directors and the Chief Executive Officer

The Financial Statements of Arion Bank for the year ended 31 December 2016 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

It is our opinion that the Financial Statements give a true and fair view of the financial performance of the Group for the year 2016 and its financial position as at 31 December 2016.

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

The Board of Directors and the CEO have today discussed the Financial Statements of Arion Bank for the year 2016 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 13 February 2017

Board of Directors

Monica Caneman
Chairman

Benedikt Olgeirsson

Brynjólfur Bjarnason

Kirstín Þ. Flygenring

Måns Höglund

Þóra Hallgrímsdóttir

Guðrún Johnsen

John P. Madden

Chief Executive Officer

Höskuldur H. Ólafsson

Independent Auditor's report

To the Board of Directors and Shareholders of Arion Bank hf.

Opinion

We have audited the Consolidated Financial Statements of Arion Bank hf. for the year ended December 31, 2016 which comprise the Consolidated Statement of Comprehensive Income, the Consolidated Statement of Financial Position, the Consolidated Statement of Changes in Equity, the Consolidated Statement of Cash Flows for the year then ended and the notes to the Consolidated Financial Statements, including a summary of significant accounting policies.

In our opinion, the accompanying Consolidated Financial Statements give a true and fair view of the consolidated financial position of Arion Bank hf. as at December 31, 2016, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of Arion Bank hf. in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) and the Icelandic Institute of State Authorized Public Accountants (FLE), Code of Ethics and we have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the Consolidated Financial Statements of the current period. These matters were addressed in the context of our audit of the Consolidated Financial Statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key Audit Matters	***How the matter was addressed in the audit***
Loan valuation and loss provisioning	
Loans to customers is the largest class of asset on the Consolidated Statement of Financial Position. The management of the Bank exercise significant judgement when determining both when and how much to record as loan impairment provisions. Because of the significance of these judgements and the size of loans to customers, the audit of loan impairment provisions is a key audit matter. The basis of the provisions is summarized in the accounting policies in notes 53 and 55 to the Consolidated Financial Statements.	We have examined loan valuation policies and tested the relevant controls over the impairment process and assessed the technique management uses to estimate incurred but not reported losses. This includes testing of controls the Bank has in place for capturing loans that needs to be reviewed for impairment and their forbearance strategy. We selected a sample of loans from the full population, both performing and non-performing loans. For selected sample we have challenged the appropriateness of management's key processes and assumptions used in the calculations of impairment for loans and advances and assessed whether the provisions are in accordance with IFRS. This included the impaired accounts and valuation of underlying collateral.
Revenue recognition	
Interest income and fee and commission income are key elements to the core business of the Bank. Those are the largest items of the Statement of Comprehensive Income. Both revenue sources are subject to contractual terms and highly reliant on IT controls and other controls within the Bank's control environment. Therefore, we consider the interest income and fee and commission income as key audit matter. The basis for revenue recognition and accounting policies are presented in notes 49-51 to the Consolidated Financial Statements.	We reviewed the policies, processes and controls surrounding the revenue recognition. We have tested relevant controls related to accounting for interest income and fee and commission income. We have tested the appropriateness of the interest calculation in accordance with IAS 39. We tested interest income by select sample of loans and compare the underlying data to the loans system. We also tested the interest income and fee income using analytical procedures. We selected sample of loans to ensure that interest is being accrued correctly.

Key Audit Matters	*How the matter was addressed in the audit*
IT controls	
Arion Bank is significantly dependent on their IT-systems to, serve customers, support their business processes, ensure complete and accurate processing of financial transactions and support the overall internal control framework. Many of the Bank's internal controls over financial reporting are depending upon automated application controls and completeness and integrity of reports generated by the IT-systems. Given the high dependency on technology, we consider this to be a key audit matter for our audit.	We have reviewed the policies and processes related to IT applications. We have tested relevant controls related to change management, access rights and IT operation of material IT systems related to financial reporting. A large majority of controls were operating effectively and did not require further action. For the remaining few we performed additional testing in order to determine whether we could place reliance on the completeness and accuracy of system generated information.

Other information

The Board of Directors and CEO are responsible for the other information. The other information comprises the unaudited appendix to the Financial Statements, 5-year overview, key figures, unaudited quarterly statements in note number 5 and Endorsement and statements by the Board of Directors and the CEO.

Our opinion on the Consolidated Financial Statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon, except the confirmation regarding the Endorsement and statements by the Board of Directors and the CEO as

In connection with our audit of the Consolidated Financial Statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the Consolidated Financial Statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

In accordance with Paragraph 2 article 104 of the Icelandic Financial Statement Act no. 3/2006, we confirm to the best of our knowledge that the accompanying the Endorsement and the statement by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statement Act that is not disclosed elsewhere in the Consolidated Financial Statements.

Responsibilities of the Board of Directors and the CEO for the Consolidated Financial Statements

The Board of Directors and the CEO are responsible for the preparation and fair presentation of the Consolidated Financial Statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act, and for such internal control as the Board of Directors and the CEO determines is necessary to enable the preparation of Consolidated Financial Statements that are free from material misstatement, whether due to fraud or error.

In preparing the Consolidated Financial Statements, the Board of Directors and the CEO are responsible for assessing Arion Bank hf.'s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the company or to cease operations, or has no realistic alternative but to do so.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the Consolidated Financial Statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Consolidated Financial Statements.

Independent Auditor's report

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the Consolidated Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Arion Banks hf.'s internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the Consolidated Financial Statements, including the disclosures, and whether the Consolidated Financial Statements represent the underlying transactions and events in a manner that achieves fair presentation.

- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the Consolidated and Separate Financial Statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with the Board of Directors and the Board Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the Board of Directors and the Board Audit Committee with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with the Board of Directors and the Board Audit committe, we determine those matters that were of most significance in the audit of the Consolidated Financial Statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Kópavogur, 13 February 2017

Deloitte ehf.

Páll Grétar Steingrímsson
State Authorised Public Accountant

Gunnar Þorvarðarson
State Authorised Public Accountant

Consolidated Statement of Comprehensive Income for the year 2016

INCOME STATEMENT

	Notes	2016	2015
Interest income		61,655	54,546
Interest expense		(31,755)	(27,554)
Net interest income	6	29,900	26,992
Fee and commission income		23,887	21,234
Fee and commission expense		(9,909)	(6,750)
Net fee and commission income	7	13,978	14,484
Net financial income	8	5,162	12,844
Net insurance income	9	1,395	760
Share of profit of associates	25	908	29,466
Other operating income	10	2,096	1,624
Operating income		53,439	86,170
Salaries and related expense	11	(16,659)	(14,892)
Other operating expense	12	(13,881)	(12,919)
Bank levy	13	(2,872)	(2,818)
Net impairment	14	7,236	(3,087)
Earnings before tax		27,263	52,454
Income tax expense	15	(6,410)	(3,135)
Net earnings from continuing operations		20,853	49,319
Net gain from discontinued operations, net of tax	16	886	360
Net earnings		21,739	49,679
Attributable to			
Shareholders of Arion Bank		21,147	41,968
Non-controlling interest	25	592	7,711
Net earnings		21,739	49,679
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	17	10.13	20.80

OTHER COMPREHENSIVE INCOME

	Notes	2016	2015
Net earnings		21,739	49,679
Net gain on AFS financial assets, net of tax		(2,903)	2,903
Exchange difference on translating foreign subsidiaries	33	182	13
Net other comprehensive income to be reclassified to profit or loss in subsequent periods		(2,721)	2,916
Total comprehensive income		19,018	52,595
Attributable to			
Shareholders of Arion Bank		18,426	44,884
Non-controlling interest		592	7,711
Total comprehensive income		19,018	52,595

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2016 12 Amounts are in ISK millions

Consolidated Statement of Financial Position
as at 31 Desember 2016

Assets	Notes	2016	2015
Cash and balances with Central Bank	18	87,634	48,102
Loans to credit institutions	19	80,116	87,491
Loans to customers	20	712,422	680,350
Financial instruments	21-23	117,456	133,191
Investment property	23	5,358	7,542
Investments in associates	25	839	27,299
Intangible assets	26	11,057	9,285
Tax assets	27	288	205
Other assets	28	20,854	17,578
Total Assets		1,036,024	1,011,043
Liabilities			
Due to credit institutions and Central Bank	22	7,987	11,387
Deposits	22	412,064	469,347
Financial liabilities at fair value	22	3,726	7,609
Tax liabilities	27	7,293	4,922
Other liabilities	29	54,094	49,461
Borrowings	22, 30	339,476	256,058
Subordinated liabilities	22, 31	-	10,365
Total Liabilities		824,640	809,149
Equity			
Share capital and share premium	33	75,861	75,861
Other reserves	33	19,761	4,548
Retained earnings		115,590	112,377
Total Shareholders' Equity		211,212	192,786
Non-controlling interest		172	9,108
Total Equity		211,384	201,894
Total Liabilities and Equity		1,036,024	1,011,043

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2016 13 Amounts are in ISK millions

Consolidated Statement of Changes in Equity for the year 2016

	Share capital and share premium	Other reserves	Retained earnings	**Total share-holders' equity**	Non-controlling interest	**Total equity**
Equity 1 January 2016	75,861	4,548	112,377	192,786	9,108	201,894
Net earnings	-	-	21,147	21,147	592	21,739
Net gain on AFS financial assets	-	(2,903)	-	(2,903)	-	(2,903)
Translation difference	-	182	-	182	-	182
Total comprehensive income	-	(2,721)	21,147	18,426	592	19,018
Reserve for investments in subsidiaries	-	17,012	(17,012)	-	-	-
Reserve for investments in associates	-	23	(23)	-	-	-
Reserve for investments in securities	-	899	(899)	-	-	-
Decrease due to sale of subsidiary	-	-	-	-	(141)	(141)
Disbursement of share capital and dividend to non-controlling interest	-	-	-	-	(9,387)	(9,387)
Equity 31 December 2016	75,861	19,761	115,590	211,212	172	211,384
Equity 1 January 2015	75,861	1,632	83,218	160,711	1,501	162,212
Net earnings	-	-	41,968	41,968	7,711	49,679
Net gain on AFS financial assets	-	2,903		2,903	-	2,903
Translation difference	-	13		13	-	13
Total comprehensive income	-	2,916	41,968	44,884	7,711	52,595
Dividend paid	-	-	(12,809)	(12,809)	-	(12,809)
Acquisition of non-controlling interest	-	-	-	-	(104)	(104)
Equity 31 December 2015	75,861	4,548	112,377	192,786	9,108	201,894

In June 2016 the Icelandic Parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank. See Note 33.

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2016 14 Amounts are in ISK millions

Consolidated Statement of Cash flows for the year 2016

Operating activities	2016	2015
Net earnings	21,739	49,679
Non-cash items included in net earnings	(31,623)	(51,720)
Changes in operating assets and liabilities	5,625	16,109
Interest received	48,030	41,178
Interest paid*	(25,543)	(22,108)
Dividend received	2,280	7,954
Income tax paid	(3,032)	(4,499)
Net cash from operating activities	17,476	36,593
Investing activities		
Acquisition of associates	(76)	(262)
Proceeds from sale of associates	27,291	17,148
Dividends received from associates	153	611
Acquisition of subsidiary	(5,300)	-
Disposal of subsidiary	293	-
Acquisition of intangible assets	(1,247)	(790)
Acquisition of property and equipment	(1,040)	(711)
Proceeds from sale of property and equipment	224	30
Net cash from investing activities	20,298	16,026
Financing activities		
Payment of subordinated liabilities	(8,785)	(19,883)
Dividend paid to shareholders of Arion Bank	-	(12,809)
Disbursement of share capital and dividend to non-controlling interest	(9,386)	-
Acquisition of non-controlling interest	-	(118)
Net cash used in financing activities	(18,171)	(32,810)
Net increase in cash and cash equivalents	19,603	19,809
Cash and cash equivalents at beginning of the year	110,000	91,715
Cash and cash equivalents acquired through acquisitions of subsidiary	1,068	-
Effect of exchange rate changes on cash and cash equivalents	(6,738)	(1,524)
Cash and cash equivalents	123,933	110,000
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	1,830	2,768
Settlement of loans through foreclosure on collateral from customers with view to resale	(1,830)	(2,768)
Non-cash changes due to funding agreement with Kaupthing		
Deposits	41,409	-
Borrowings	(41,409)	-

Financial effects due to the acquisition of Vörður tryggingar hf. is described in Note 3.

* Interest paid includes interest credited to deposit accounts at the end of the year.

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

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Notes to the Consolidated Statement of Cash flows for the year 2016

Non-cash items included in net earnings	2016	2015
Net interest income	(29,900)	(26,992)
Net impairment	(7,236)	3,087
Income tax expense	6,410	3,135
Bank levy	2,872	2,818
Net foreign exchange loss	1,253	182
Net gain on financial instruments	(4,135)	(5,072)
Depreciation and amortisation	1,842	1,656
Share of profit of associates and fair value change	(908)	(29,466)
Investment property, fair value change	(290)	(422)
Net gain from discontinued operations, net of tax	(886)	(360)
Other changes	(645)	(286)
Non-cash items included in net earnings	(31,623)	(51,720)

Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	3,303	(3,700)
Loans to credit institutions, excluding bank accounts	(22,698)	13,637
Loans to customers	(34,765)	(29,588)
Financial instruments and financial liabilities at fair value	13,100	(23,655)
Investment property	1,440	54
Other assets	1,804	2,660
Due to credit institutions and Central Bank	(3,151)	(11,266)
Deposits	(9,586)	19,704
Borrowings	62,638	53,070
Other liabilities	(6,460)	(4,807)
Changes in operating assets and liabilities	5,625	16,109

Cash and cash equivalents		
Cash and demand deposits	87,634	48,102
Due from credit institutions	45,631	74,533
Mandatory reserve with Central Bank	(9,332)	(12,635)
Cash and cash equivalents	123,933	110,000

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2016 16 Amounts are in ISK millions

Notes to the Consolidated Financial Statements
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Notes to the Consolidated Financial Statements

GENERAL INFORMATION

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Financial Statements for the year ended 31 December 2016 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union and additional requirements in the Icelandic Annual Accounts Act, Financial Undertakings Act and rules on Accounting for Credit Institutions.

The Financial Statements were approved and authorized for issue by the Board of Directors of Arion Bank on 13 February 2017.

Basis of measurement

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

- financial assets and financial liabilities held for trading are measured at fair value;
- financial assets and financial liabilities at fair value are measured at fair value;
- financial assets classified as available-for-sale are measured at fair value;
- investment properties are measured at fair value; and
- non-current assets and disposal groups classified as held for sale are stated at the lower of their carrying amount and fair value, less costs to sell.

Functional and presentation currency

The Financial Statements are presented in Icelandic krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the year the exchange rate of the ISK against the USD was 112.90 and 119.18 for the EUR (31.12.2015: USD 130.08 and EUR 141.28).

2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Financial Statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

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

The key sources of estimation uncertainty are within impairment losses and reversal of impairment losses on loans.

3. The Group

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

	Operating activity	Currency	Equity interest 2016	2015
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland	Retail banking	ISK	100.0%	100.0%
BG12 slhf., Katrínartún 2, Reykjavík, Iceland	Holding company	ISK	62.0%	62.0%
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Eignarhaldsfélagið Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland	Real estate	ISK	100.0%	100.0%
Kolufell ehf., Borgartún 19, Reykjavík, Iceland	Real estate	ISK	-	68.9%
Okkar líftryggingar hf., Laugavegur 182, Reykjavík, Iceland	Life insurance	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjörður, Iceland	Payment solutions	ISK	100.0%	100.0%
Vörður tryggingar hf., Borgartún 25, Reykjavík, Iceland	Insurance	ISK	100.0%	-

In July 2016 Arion Bank sold majority of its shareholding in the subsidiary Kolufell ehf. The main asset of Kolufell ehf. is investment property. The profit from the sale and valuation change on the remaining shareholding amounted to ISK 493 million and is recognized in the Statement of Comprehensive Income. The remaining shareholding is classified as Financial instruments.

On 30 September 2016 Arion Bank acquired a 100% shareholding in the insurance company Vörður tryggingar hf. Vörður tryggingar hf. is classified as a subsidiary of Arion Bank from the day of acquisition. The transaction is as follows:

Purchase price, paid in cash	5,300
Fair value of asset and liabilities	
Loans to credit institutions (Bank accounts)	1,068
Financial instruments	8,773
Intangible assets, other than goodwill	2,045
Tax assets	147
Other assets	2,355
Tax liabilities	(409)
Other liabilities	(9,175)
Fair value of asset and liabilities	4,804
Calculated goodwill	496

The net impact of Vörður tryggingar hf. on the Statement of Comprehensive Income for the period 1 October to 31 December was ISK 384 million. For further information on intangible assets and goodwill, see Note 26.

Arion Bank Consolidated Financial Statements 2016 19 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

OPERATING SEGMENT REPORTING

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. In presenting the geographic information, segment revenue has been based on the geographic location of customers or assets.

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

Operating segments

The Group comprises the following operating segments:

Asset Management comprises Institutional Asset Management, Private Banking, Investment Services and Pension Fund Administration. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Asset Management also administers pension funds. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

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

Investment Banking is divided into Corporate Finance, Capital Markets and Research. Corporate Finance arranges the buying and selling of companies and advises on all other major financial decisions undertaken by companies and investors such as financial restructuring, IPO's and stock market listings. Capital Markets buys and sells securities and FX on behalf of Arion Bank's clients. Capital Markets manages securities issuance for clients and advises on hedges used in business operations often in co-operation with Corporate Finance. Research is an independent research team covering the Icelandic economy and financial markets.

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

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

Other divisions and subsidiaries include market making in domestic securities and currencies. The subsidiaries are Valitor Holding hf., Vörður tryggingar hf., Okkar líftryggingar hf., Eignarhaldsfélagið Landey ehf., EAB 1 ehf., BG12 slhf. and other smaller entities of the Group.

Headquarters includes Overhead, Risk Management, Finance (excluding Treasury), Legal, IT and Operations.

4. Operating segments

2016	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub- sidiaries	Head- quarters and Elimination	Total
Net interest income	535	6,436	1,104	14,992	6,093	1,233	(493)	29,900
Net fee and commission income	3,863	1,082	1,808	3,537	(345)	3,885	148	13,978
Net financial income	(67)	(12)	(100)	115	332	4,617	277	5,162
Net insurance income	-	-	-	-	-	1,395	-	1,395
Share of profit of associates	-	-	613	-	-	275	20	908
Other operating income	14	292	321	26	80	905	458	2,096
Operating income	4,345	7,798	3,746	18,670	6,160	12,310	410	53,439
Operating expense	(1,422)	(605)	(939)	(6,134)	(189)	(7,061)	(14,190)	(30,540)
Bank levy	-	-	-	-	-	-	(2,872)	(2,872)
Net impairment	-	33	1,704	5,557	7	(65)	-	7,236
Earnings before tax	2,923	7,226	4,511	18,093	5,978	5,184	(16,652)	27,263
Net seg. rev. from ext. customers	1,908	15,919	3,225	29,957	(11,647)	12,875	1,202	53,439
Net seg. rev. from other segments	2,437	(8,121)	521	(11,287)	17,807	(565)	(792)	-
Operating income	4,345	7,798	3,746	18,670	6,160	12,310	410	53,439
Depreciation and amortization	-	1	-	336	-	727	778	1,842
Total assets	5,302	251,822	16,835	476,369	190,418	68,750	26,528	1,036,024
Total liabilities	(272)	193,572	13,855	402,960	158,178	40,344	16,003	824,640
Allocated equity	5,574	58,250	2,980	73,409	32,240	28,406	10,525	211,384

2015	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub- sidiaries	Head- quarters and Elimination	Total
Net interest income	462	6,023	101	13,877	5,803	708	18	26,992
Net fee and commission income	4,183	1,059	2,153	2,656	(313)	4,106	640	14,484
Net financial income	226	(37)	8,304	158	872	814	2,507	12,844
Net insurance income	-	-	-	-	-	760	-	760
Share of profit of associates	-	-	25,436	-	-	513	3,517	29,466
Other operating income	11	(33)	440	(345)	396	360	795	1,624
Operating income	4,882	7,012	36,434	16,346	6,758	7,261	7,477	86,170
Operating expense	(1,451)	(547)	(1,152)	(6,011)	(256)	(5,616)	(12,778)	(27,811)
Bank levy	-	-	-	-	-	-	(2,818)	(2,818)
Net impairment	-	(3,074)	3,030	(2,258)	11	(868)	72	(3,087)
Earnings before tax	3,431	3,391	38,312	8,077	6,513	777	(8,047)	52,454
Net seg. rev. from ext. customers	2,589	14,245	37,119	26,947	(9,809)	7,648	7,431	86,170
Net seg. rev. from other segments	2,293	(7,233)	(685)	(10,601)	16,567	(387)	46	-
Operating income	4,882	7,012	36,434	16,346	6,758	7,261	7,477	86,170
Depreciation and amortization	-	-	-	287	-	576	793	1,656
Total assets	5,884	236,621	62,904	448,547	179,375	50,166	27,546	1,011,043
Total liabilities	1,027	180,588	22,114	396,514	161,154	30,615	17,137	809,149
Allocated equity	4,857	56,033	40,790	52,033	18,221	19,551	10,409	201,894

Following the acquisition of Vörður tryggingar hf. the presentation of Insurance Income was changed and are presented in a separate line item in the Statement of Comprehensive income.

Discontinued operations are excluded from the profit and loss segment information.

Arion Bank Consolidated Financial Statements 2016 21 Amounts are in ISK millions

4. Operating segments, continued

Geographic information

2016	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	32,302	1,079	114	(4,424)	791	38	29,900
Net fee and commission income	11,815	548	50	1,495	62	8	13,978
Net financial income	(500)	79	5,242	323	19	(1)	5,162
Net insurance income	1,395	-	-	-	-	-	1,395
Share of profit of associates	223	-	685	-	-	-	908
Other income	2,096	-	-	-	-	-	2,096
Operating income	47,331	1,706	6,091	(2,606)	872	45	53,439

2015	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	26,614	772	17	(851)	375	65	26,992
Net fee and commission income	8,376	1,731	605	3,672	95	5	14,484
Net financial income	10,315	(60)	(175)	2,850	(106)	20	12,844
Net insurance income	760	-	-	-	-	-	760
Share of profit of associates	8,621	-	20,845	-	-	-	29,466
Other income	1,624	-	-	-	-	-	1,624
Operating income	56,310	2,443	21,292	5,671	364	90	86,170

Arion Bank Consolidated Financial Statements 2016 22 Amounts are in ISK millions

QUARTERLY STATEMENTS

5. Operations by quarters, unaudited

2016	Q4	Q3	Q2	Q1	Total
Net interest income	7,842	7,432	7,353	7,273	29,900
Net fee and commission income	3,765	3,466	3,528	3,219	13,978
Net financial income	823	844	3,796	(301)	5,162
Net insurance income	731	272	247	145	1,395
Share of profit of associates	198	16	17	677	908
Other operating income	431	435	283	947	2,096
Operating income	13,790	12,465	15,224	11,960	53,439
Salaries and related expense	(4,407)	(3,826)	(4,318)	(4,108)	(16,659)
Other operating expense	(3,803)	(3,349)	(3,639)	(3,090)	(13,881)
Bank levy	(682)	(705)	(743)	(742)	(2,872)
Net impairment	409	5,882	1,448	(503)	7,236
Earnings before tax	5,307	10,467	7,972	3,517	27,263
Income tax expense	(1,149)	(3,170)	(1,354)	(737)	(6,410)
Net earnings from continuing operations	4,158	7,297	6,618	2,780	20,853
Net gain from discontinued operations, net of tax	317	206	259	104	886
Net earnings	4,475	7,503	6,877	2,884	21,739

2015	Q4	Q3	Q2	Q1	Total
Net interest income	6,705	7,112	7,392	5,783	26,992
Net fee and commission income	3,758	3,292	3,677	3,757	14,484
Net financial income	2,668	453	2,184	7,539	12,844
Net insurance income	216	156	218	170	760
Share of profit of associates	22,510	2,739	6	4,211	29,466
Other operating income	201	430	745	248	1,624
Operating income	36,058	14,182	14,222	21,708	86,170
Salaries and related expense	(4,572)	(3,153)	(3,675)	(3,492)	(14,892)
Other operating expense	(4,168)	(2,889)	(3,039)	(2,823)	(12,919)
Bank levy	(650)	(779)	(659)	(730)	(2,818)
Net impairment	(2,973)	(33)	(1,863)	1,782	(3,087)
Earnings before tax	23,695	7,328	4,986	16,445	52,454
Income tax expense	504	(1,272)	(647)	(1,720)	(3,135)
Net earnings from continuing operations	24,199	6,056	4,339	14,725	49,319
Net gain from discontinued operations, net of tax	83	15	79	183	360
Net earnings	24,282	6,071	4,418	14,908	49,679

Arion Bank Consolidated Financial Statements 2016 23 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

6. Net interest income

	2016	2015
Interest income		
Cash and balances with Central Bank	4,584	2,757
Loans	51,910	47,393
Securities	4,347	3,532
Other	814	864
Interest income	61,655	54,546
Interest expense		
Deposits	(16,278)	(15,453)
Borrowings	(14,858)	(11,344)
Subordinated liabilities	(529)	(701)
Other	(90)	(56)
Interest expense	(31,755)	(27,554)
Net interest income	29,900	26,992
Net interest income from assets and liabilities at fair value	4,347	3,532
Interest income from assets not at fair value	57,308	51,014
Interest expense from liabilities not at fair value	(31,755)	(27,554)
Net interest income	29,900	26,992
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	3.1%	3.0%

Interest income from money market loans is classified as Cash and balances with Central Bank. Previously it was classified as Loans. Comparative figures have been adjusted accordingly.

7. Net fee and commission income

	2016			2015		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	4,225	(245)	3,980	4,463	(218)	4,245
Cards and payment solution	14,268	(8,975)	5,293	11,532	(5,945)	5,587
Collection and payment services	1,478	(80)	1,398	1,349	(93)	1,256
Investment banking	1,039	(46)	993	1,740	(56)	1,684
Lending and guarantees	1,685	-	1,685	1,431	-	1,431
Other	1,192	(563)	629	719	(438)	281
Net fee and commission income	23,887	(9,909)	13,978	21,234	(6,750)	14,484

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.

Arion Bank Consolidated Financial Statements 2016 24 Amounts are in ISK millions

8. Net financial income

	2016	2015
Dividend income	2,280	7,954
Net gain on financial assets and financial liabilities classified as held for trading	363	1,157
Net gain on financial assets and financial liabilities designated at fair value through profit or loss	(1,519)	3,915
Realised gain on financial assets available-for-sale	5,291	-
Net foreign exchange loss	(1,253)	(182)
Net financial income	5,162	12,844

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

	2016	2015
Equity instruments designated at fair value	(1,472)	3,692
Interest rate instruments designated at fair value	(47)	223
Net gain on financial assets and financial liabilities designated at fair value through profit or loss	(1,519)	3,915

In November 2015 Visa Inc. and Visa Europe Ltd. announced a definitive agreement on the acquisition by Visa Inc. of Visa Europe Ltd. Arion Bank was a member of Visa Europe Ltd. through its subsidiary Valitor Holding hf. In June 2016 the sale was formally completed, resulting in a total profit of ISK 5,291 million after taking into account conditional payments to Landsbankinn hf. and two savings funds, which formed part of the agreement when Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014. The shareholding in Visa Europe Ltd. was classified as Financial assets available for sale.

9. Net insurance income

	2016	2015
Earned premiums, net of reinsurers' share		
Premiums written	2,927	1,314
Premiums written, reinsurers' shares	(196)	(139)
Change in provision for unearned premiums	330	(30)
Change in provision for unearned premiums, reinsurers' share	1	-
Earned premiums, net of reinsurers' share	3,061	1,145
Claims incurre, net of reinsurers' share		
Claims paid	(1,762)	(383)
Claims paid, reinsurers' share	66	67
Change in provision for claims	33	(59)
Changes in provision for claims, reinsurers' share	(3)	(10)
Claims incurred, net of reinsurers' share	(1,666)	(385)
Net insurance income	1,395	760

In the Financial Statements 2015 earned premium of the subsidiary Okkar was classified as Other operating income and claims incurred as Other operating expense. After the acquisition of the subsidiary Vörður Net insurance income is presented separately in the Statement of Comprehansive Income, due to increased weight in the operation of the Group. Comparison figures have been changed

10. Other operating income

	2016	2015
Fair value changes on investment property	290	422
Realized gain on investment property	400	286
Other income	1,406	916
Other operating income	2,096	1,624

Prior to the acquisition of Vörður tryggingar hf. earned premium was classified as Other operating income, see Note 9.

Arion Bank Consolidated Financial Statements 2016 25 Amounts are in ISK millions

11. Personnel and salaries

	2016	2015
Number of employees in the Group		
Average number of full-time equivalent positions during the year	1,201	1,139
Full-time equivalent positions at the end of the year	1,239	1,147
Number of employees at Arion Bank		
Average number of full-time equivalent positions during the year	889	885
Full-time equivalent positions at the end of the year	869	876
Salaries and related expense		
Salaries	13,274	11,811
Defined contribution pension plans	1,885	1,637
Salary-related expense	1,884	1,733
Capitalization of salaries, due to internally developed software	(384)	(289)
Salaries and related expense	16,659	14,892
Salaries and related expense for the Bank		
Salaries	9,690	8,780
Defined contribution pension plans	1,376	1,216
Salary-related expense	1,553	1,432
Salaries and related expense	12,619	11,428

During the year the Group made a provision of ISK 395 million (2015: ISK 599 million) for performance plan payments, including salary-related expense, of which the Bank made a provision of ISK 331 million (2015: ISK 461 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for Financial Undertakings. At the end of the year the Group's accrual for performance plan payments amounted to ISK 1,453 million (31.12.2015: ISK 1,056 million), of which the Bank's accrual amounts to ISK 1,177 million (31.12.2015: ISK 852 million).

	2016			2015		
Compensation of the Board of Directors	Fixed remuner-ation*	Additional remuner-ation**	Total	Fixed remuner-ation*	Additional remuner-ation**	Total
Monica Caneman, Chairman of the Board	19.0	2.5	21.4	18.4	2.4	20.7
Guðrún Johnsen, Vice Chairman of the Board	7.1	4.4	11.5	6.9	4.7	11.6
Benedikt Olgeirsson, Director	4.7	3.3	8.1	4.6	1.8	6.4
Brynjólfur Bjarnason, Director	4.7	3.8	8.5	4.6	1.4	6.0
Kirstín Þ. Flygenring, Director	4.7	3.3	8.1	4.6	1.8	6.4
Måns Höglund, Director	9.5	4.4	13.8	9.3	4.2	13.5
Þóra Hallgrímsdóttir, Director	4.7	3.8	8.5	4.6	3.7	8.3
Alternate directors of the Board	2.4	-	2.4	2.5	-	2.5
Total remuneration	56.9	25.4	82.3	55.4	20.0	75.4

John P. Madden became member of the Board of Directors 15 September 2016. He received no remunerations in 2016.

Arion Bank Consolidated Financial Statements 2016 26 Amounts are in ISK millions

11. Personnel and salaries, continued

Compensation of key management personnel	2016 Salaries	2016 Performance-based payments	2015 Salaries	2015 Performance-based payments
Höskuldur H. Ólafsson, CEO	58.2	7.1	55.9	7.2
Nine managing directors of the Bank's divisions who are members of the Bank's Executive Committee	262.7	30.3	254.7	26.4

Performance based payments in 2016 are based on the Group's performance in 2015.

Board Members receive remuneration for their involvement in board committees. In addition to 13 Board meetings (2015: 16) during the year 10 Board Credit Committee meetings (2015: 11), in all 15 Board Audit Committee and Board Risk Committee meetings (2015: 7) and 7 Board Remuneration Committee meetings (2015: 7) were held. Four committee meetings with alternate directors of the Board were held in 2016 (2015: 4).

The 2016 Annual General Meeting of the Bank held on 17 March 2016 approved the monthly salaries for 2016 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 796,950, ISK 597,700 and ISK 398,500 (2015: ISK 770,000; 577,500; 385,000) respectively. It was also approved that the salary of Alternate Board Members would be ISK 201,850 (2015: ISK 195,000) per meeting, up to a maximum of ISK 398,500 (2015: ISK 385,000) per month. For Board Members resident abroad, the aforementioned figures are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 159,400 (2015: ISK 154,000) per month for each committee they serve on and the Chairman of the board committees ISK 207,000 (2015: ISK 200,000).

* Fixed remuneration represents Board Member compensation for their attendance at meetings of the Board of Directors.

** Additional remuneration represents Board Member compensation for their participation in Board Committees.

12. Other operating expense

	2016	2015
Administration expense	11,186	10,330
Depositors' and investors' guarantee fund	804	836
Depreciation of property and equipment	865	849
Amortization of intangible assets	977	807
Other expense	49	97
Other operating expense	13,881	12,919

Prior to the acquisition of Vörður tryggingar hf. claims incurred of Okkar líftryggingar hf. was classified as Other operating expense, see Note 9.

Auditor's fee	2016	2015
Audit and review of the Financial Statements for the relevant fiscal year	140	150
Other audit related services for the relevant fiscal year	11	3
Auditor's fee	151	153
Of which fee to others than the auditor of the Parent company	12	3

13. Bank levy

The Bank levy is 0.376% on total debt excluding tax liabilities, in excess of ISK 50 billion. Non-financial subsidiaries are exempt from this tax. The tax is assessed on Financial Undertakings to meet the funding of a special index and interest relief provided to individual tax payers.

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14. Net impairment

	2016	2015
Increase in book value of loans to corporates	2,990	2,488
Increase in book value of loans to individuals	8,990	2,208
Net change in impairment of loans to corporates	(2,914)	(3,818)
Net change in impairment of loans to individuals	(2,248)	(3,421)
Net change in collective impairment on loans	427	(517)
Impairment of intangible assets	(9)	(27)
Net impairment	7,236	(3,087)

15. Income tax expense

	2016	2015
Current tax expense	6,563	1,659
Deferred tax expense	(153)	1,476
Income tax expense	6,410	3,135

Reconciliation of effective tax rate	2016		2015	
Earnings before tax		27,263		52,454
Income tax using the Icelandic corporation tax rate	20.0%	5,453	20.0%	10,491
Additional 6% tax on Financial Undertakings	5.1%	1,395	1.2%	628
Non-deductible expenses	0.0%	13	0.0%	13
Tax exempt revenue	(4.6%)	(1,247)	(16.4%)	(8,597)
Non-deductible taxes	2.1%	574	1.1%	564
Other changes	0.8%	222	0.1%	36
Effective tax rate	23.5%	6,410	6.0%	3,135

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

Tax exempt revenues consist mainly of profit from equity positions.

16. Net gain from discontinued operations, net of tax

	2016	2015
Income from real estates and other assets	1,335	709
Expense related to real estates and other assets	(449)	(349)
Net gain from discontinued operations, net of tax	886	360

17. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2016	2015	2016	2015
Net earnings attributable to the shareholders of Arion Bank	20,261	41,608	21,147	41,968
Weighted average number of outstanding shares for the year, million	2,000	2,000	2,000	2,000
Basic earnings per share	10.13	20.80	10.57	20.98

There were no instruments at the end of the year that could potentially dilute basic earnings per share (31.12.2015: none).

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NOTES TO THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

18. Cash and balances with Central Bank

	2016	2015
Cash on hand	7,448	4,921
Cash with Central Bank	70,854	30,546
Mandatory reserve deposit with Central Bank	9,332	12,635
Cash and balances with Central Bank	87,634	48,102

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

19. Loans to credit institutions

Bank accounts	45,631	74,533
Money market loans	32,267	7,976
Other loans	2,218	4,982
Loans to credit institutions	80,116	87,491

20. Loans to customers

	Individuals		Corporates		Total	
2016	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	14,805	13,381	19,314	17,630	34,119	31,011
Credit cards	11,363	11,099	1,180	1,151	12,543	12,250
Mortgage loans	285,784	282,996	16,298	15,975	302,082	298,971
Other loans	34,777	29,940	351,739	340,250	386,516	370,190
Loans to customers	346,729	337,416	388,531	375,006	735,260	712,422
2015						
Overdrafts	16,840	14,833	24,248	22,387	41,088	37,220
Credit cards	10,842	10,560	1,054	997	11,896	11,557
Mortgage loans	271,895	268,048	12,889	12,601	284,784	280,649
Other loans	38,058	31,178	334,849	319,746	372,907	350,924
Loans to customers	337,635	324,619	373,040	355,731	710,675	680,350

The total book value of pledged loans that were pledged against amounts borrowed was ISK 165 billion at the end of the year (31.12.2015: ISK 199 billion). At the end of the year pledged loans comprised mortgage loans to individuals. At year-end 2015 pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies.

Further analysis of loans is provided in Risk Management Disclosures.

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20. Loans to customers, continued

Changes in the provision for losses on loans to customers

2016	Specific	Collective	Total
Balance at the beginning of the year	25,341	4,984	30,325
Provision for losses	5,162	(427)	4,735
Write-offs	(11,283)	-	(11,283)
Exchange difference	(1,138)	-	(1,138)
Payment of loans previously written off	199	-	199
Balance at the end of the year	18,281	4,557	22,838

2015			
Balance at the beginning of the year	22,214	4,467	26,681
Provision for losses	7,239	517	7,756
Write-offs	(6,547)	-	(6,547)
Exchange difference	1,055	-	1,055
Payment of loans previously written off	1,380	-	1,380
Balance at the end of the year	25,341	4,984	30,325

Significant accounting estimates and judgements

Key sources of estimation uncertainty are impairment losses on loans.

The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 53. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realizable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the Credit Risk function.

21. Financial instruments

	2016	2015
Bonds and debt instruments	69,565	78,794
Shares and equity instruments with variable income	27,035	35,504
Derivatives	5,159	2,401
Securities used for hedging	15,697	16,492
Financial instruments	117,456	133,191

Arion Bank Consolidated Financial Statements 2016 30 Amounts are in ISK millions

22. Financial assets and financial liabilities

2016	Amortised cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	87,634	-	-	87,634
Loans to credit institutions	80,116	-	-	80,116
Loans to customers	712,422	-	-	712,422
Loans	880,172	-	-	880,172
Bonds and debt instruments				
Listed	-	5,284	61,055	66,339
Unlisted	-	102	3,124	3,226
Bonds and debt instruments	-	5,386	64,179	69,565
Shares and equity instruments with variable income				
Listed	-	2,949	9,125	12,074
Unlisted	-	1,348	10,579	11,927
Bond funds with variable income, unlisted	-	1,027	2,007	3,034
Shares and equity instruments with variable income	-	5,324	21,711	27,035
Derivatives				
OTC derivatives	-	5,159	-	5,159
Derivatives	-	5,159	-	5,159
Securities used for hedging				
Bonds and debt instruments, listed	-	7,318	-	7,318
Shares and equity instruments with variable income, listed	-	8,365	-	8,365
Shares and equity instruments with variable income, unlisted	-	14	-	14
Securities used for hedging	-	15,697	-	15,697
Other financial assets	8,617	-	-	8,617
Financial assets	888,789	31,566	85,890	1,006,245
Liabilities at amortized cost				
Due to credit institutions and Central Bank	7,987	-	-	7,987
Deposits	412,064	-	-	412,064
Borrowings	339,476	-	-	339,476
Liabilities at amortized cost	759,527	-	-	759,527
Financial liabilities at fair value				
Short position in bonds	-	1,884	-	1,884
Derivatives	-	1,842	-	1,842
Financial liabilities at fair value	-	3,726	-	3,726
Other financial liabilities	36,350	-	-	36,350
Financial liabilities	795,877	3,726	-	799,603

Financial assets classified as available for sale at year-end 2015 were sold in June 2016, see Note 8.

Arion Bank Consolidated Financial Statements 2016 31 Amounts are in ISK millions

22. Financial assets and financial liabilities, continued

2015	Amortised cost	Trading	Designated at fair value	Available for sale	Total
Loans					
Cash and balances with Central Bank	48,102	-	-	-	48,102
Loans to credit institutions	87,491	-	-	-	87,491
Loans to customers	680,350	-	-	-	680,350
Loans	815,943	-	-	-	815,943
Bonds and debt instruments					
Listed	-	2,526	74,757	-	77,283
Unlisted	-	99	1,412	-	1,511
Bonds and debt instruments	-	2,625	76,169	-	78,794
Shares and equity instruments with variable income					
Listed	-	2,138	13,869	-	16,007
Unlisted	-	1,668	10,665	5,852	18,185
Bond funds with variable income, unlisted	-	1,090	222	-	1,312
Shares and equity instruments with variable income	-	4,896	24,756	5,852	35,504
Derivatives					
OTC derivatives	-	2,401	-	-	2,401
Derivatives	-	2,401	-	-	2,401
Securities used for hedging					
Bonds and debt instruments, listed	-	1,519	-	-	1,519
Shares and equity instruments with variable income, listed	-	14,276	-	-	14,276
Shares and equity instruments with variable income, unlisted	-	697	-	-	697
Securities used for hedging	-	16,492	-	-	16,492
Other financial assets	4,581	-	-	-	4,581
Financial assets	820,524	26,414	100,925	5,852	953,715
Liabilities at amortized cost					
Due to credit institutions and Central Bank	11,387	-	-	-	11,387
Deposits	469,347	-	-	-	469,347
Borrowings	256,058	-	-	-	256,058
Subordinated liabilities	10,365	-	-	-	10,365
Liabilities at amortized cost	747,157	-	-	-	747,157
Financial liabilities at fair value					
Short position in bonds	-	4,616	-	-	4,616
Derivatives	-	2,993	-	-	2,993
Financial liabilities at fair value	-	7,609	-	-	7,609
Other financial liabilities	38,667	-	-	-	38,667
Financial liabilities	785,824	7,609	-	-	793,433

Arion Bank Consolidated Financial Statements 2016 32 Amounts are in ISK millions

22. Financial assets and financial liabilities, continued

	2016	2015
Bonds and debt instruments designated at fair value specified by issuer		
Financial and insurance activities	5,564	9,258
Public sector	51,860	59,246
Corporates	6,755	7,665
Bonds and debt instruments designated at fair value	64,179	76,169

The total amount of pledged bonds was ISK 15.6 billion at the end of the year (31.12.2015: ISK 21.5 billion). Pledged bonds comprise Icelandic and foreign Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

23. Fair value hierarchy

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

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

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

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

2016

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	22,787	46,689	89	69,565
Shares and equity instruments with variable income	11,863	15,154	18	27,035
Derivatives	-	5,159	-	5,159
Securities used for hedging	15,659	38	-	15,697
Investment property	-	-	5,358	5,358
Assets at fair value	50,309	67,040	5,465	122,814
Liabilities at fair value				
Short position in bonds	1,884	-	-	1,884
Derivatives	-	1,842	-	1,842
Liabilities at fair value	1,884	1,842	-	3,726

Arion Bank Consolidated Financial Statements 2016 33 Amounts are in ISK millions

23. Fair value hierarchy, continued

2015

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	32,813	45,799	182	78,794
Shares and equity instruments with variable income	14,331	15,299	5,874	35,504
Derivatives	-	2,401	-	2,401
Securities used for hedging	15,706	786	-	16,492
Investment property	-	-	7,542	7,542
Assets at fair value	62,850	64,285	13,598	140,733

Liabilities at fair value				
Short position in bonds	4,616	-	-	4,616
Derivatives	-	2,993	-	2,993
Liabilities at fair value	4,616	2,993	-	7,609

There was no transfer between Level 1 and Level 2 during the year (2015: Transfers from Level 2 to Level 1 ISK 8,106 million. No transfers from Level 1 to Level 2).

The level of the fair value hierarchy of assets is determined at the end of each reporting period.

Fair value of assets and liabilities

The fair value of asset and liabilities is the amount at which the asset and liability could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Group to measure assets and liabilities. If quoted prices for an asset fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

Methods for establishing fair value

Level 1: Fair value established from quoted market prices

The best evidence of the fair value of an asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of an asset in Note 22 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from the market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

Level 2: Fair value established using valuation techniques with observable market information

For assets and liabilities, for which the market is not active, the Group applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable and willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

For assets and liabilities for which quoted prices on active markets are not available, the fair value is derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

Arion Bank Consolidated Financial Statements 2016 34 Amounts are in ISK millions

23. Fair value hierarchy, continued

In most cases the valuation is based on theoretical financial models, such as the Black Scholes model or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

The fair value for deposits with stated maturities is calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Statement of Financial Position.

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

In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of assets with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organizations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

The Group applies management valuation for determining fair value of investment properties. Management valuation is either based on recent transactions and offers for similar assets or present value calculations which involve estimation of future cash flow and the assessment of appropriate discount rate.

Movements in Level 3 assets measured at fair value	Investment property		Financial assets		Total	
	2016	2015	2016	2015	2016	2015
Balance at the beginning of the year	7,542	6,842	6,056	1,276	13,598	8,118
Net fair value changes	290	422	2,828	5,857	3,118	6,279
Additions	618	1,026	-	77	618	1,103
Disposal	(1,684)	(843)	(8,778)	(1,154)	(10,462)	(1,997)
Disposals through the sale of a subsidiary	(1,408)	-	-	-	(1,408)	-
Transfers into Level 3	-	95	13	-	13	95
Transfers out of Level 3	-	-	(12)	-	(12)	-
Balance at the end of the year	5,358	7,542	107	6,056	5,465	13,598

Line items where effects of Level 3 assets are recognized in the Statement of Comprehensive Income	2016	2015
Net interest income	2	25
Net financial income	5,255	(20)
Other operating income	690	708
Net loss on AFS financial assets, net of tax	(2,903)	2,903
Effects recognized in the Statement of Comprehensive Income	3,044	3,616

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23. Fair value hierarchy, continued

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

2016	Carrying value	Fair value	Unrealised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	87,634	87,634	-
Loans to credit institutions	80,116	80,116	-
Loans to customers	712,422	717,220	4,798
Other financial assets	8,617	8,617	-
Financial assets not carried at fair value	888,789	893,587	4,798
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,987	7,987	-
Deposits	412,064	412,064	-
Borrowings	339,476	348,412	(8,936)
Other financial liabilities	36,350	36,350	-
Financial liabilities not carried at fair value	795,877	804,813	(8,936)

2015			
Financial assets not carried at fair value			
Cash and balances with Central Bank	48,102	48,102	-
Loans to credit institutions	87,491	87,491	-
Loans to customers	680,350	688,196	7,846
Other financial assets	4,581	4,581	-
Financial assets not carried at fair value	820,524	828,370	7,846
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	11,387	11,387	-
Deposits	469,347	469,347	-
Borrowings	256,058	264,839	(8,781)
Subordinated liabilities	10,365	10,365	-
Other financial liabilities	38,667	38,667	-
Financial liabilities not carried at fair value	785,824	794,605	(8,781)

Financial assets and financial liabilities predominantly bear interest at floating rates. For assets and liabilities not at floating rates fair value is determined by Level 2 methods for which the valuation input is market observable interest rates.

Retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account mortgaging. Defaulted loans are presented at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value. Other loans, including corporate loans, are presented at book value as they are generally of a shorter duration than retail mortgages and the interest rate risk on them is therefore limited.

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23. Fair value hierarchy, continued

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

2015			
Forward exchange rate agreements, unlisted	49,435	231	287
Interest rate and exchange rate agreements, unlisted	103,369	1,948	710
Bond swap agreements, unlisted	3,811	43	28
Share swap agreements, unlisted	13,099	178	1,934
Options - purchased agreements, unlisted	30	1	34
Derivatives	169,744	2,401	2,993

Arion Bank Consolidated Financial Statements 2016 37 Amounts are in ISK millions

24. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

	Assets subject to netting arrangements			Netting potential not recognized in the balance sheet				
2016	Gross assets before balance sheet nettings	Balance sheet nettings with gross liabilities	Assets recognized on balance sheet, net	Financial liabilities	Collateral received	Assets after consideration of netting potential	Assets not subject to enforceable netting arr-angements	Total assets recognized on balance sheet
Reverse repurchase agreements	15,644	(80)	15,564	(1,884)	-	13,680	-	15,564
Derivatives	4,100	-	4,100	(629)	-	3,471	1,059	5,159
Total assets	19,744	(80)	19,664	(2,513)	-	17,151	1,059	20,723
2015								
Reverse repurchase agreements	22,100	(490)	21,610	(4,929)	-	16,681	-	21,610
Derivatives	964	-	964	(400)	-	564	1,437	2,401
Total assets	23,064	(490)	22,574	(5,329)	-	17,245	1,437	24,011

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the balance sheet				
2016	Gross liabilities before balance sheet nettings	Balance sheet nettings with gross assets	Liabilities recognized on balance sheet, net	Financial assets	Collateral pledged	Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arr-angements	Total liabilities recognized on balance sheet
Repurchase agreements	1,884	-	1,884	(1,884)	-	-	-	1,884
Derivatives	629	-	629	(629)	-	-	1,213	1,842
Total liabilities	2,513	-	2,513	(2,513)	-	-	1,213	3,726
2015								
Repurchase agreements	4,929	-	4,929	(4,929)	-	-	-	4,929
Derivatives	400	-	400	(400)	-	-	2,593	2,993
Total liabilities	5,329	-	5,329	(5,329)	-	-	2,593	7,922

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25. Investments in associates

The Group's interest in its principal associates	2016	2015
Auðkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	22.4%
Bakkavor Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	-	46.0%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	38.4%	39.3%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	23.0%	23.0%
Urriðaland ehf., Laugavegur 182, Reykjavík, Iceland	41.4%	41.4%
220 Fjörður ehf., Fjarðargötu 13-15, Hafnarfjörður, Iceland	34.9%	38.5%

Investments in associates		
Carrying amount at the beginning of the year	27,299	21,966
Additions	76	262
Dividend received	(153)	(611)
Transfers	-	(6,458)
Disposals	(27,291)	(17,148)
Exchange difference	-	(178)
Share of profit of associates and reversal of impairment	908	29,466
Investment in associates	839	27,299

In January 2016 the Bank's subsidiary BG12 slhf. sold its 46% shareholding in Bakkavor Group Ltd. The main effect related to the sale was a valuation change recognized in the Statement of Comprehensive Income in 2015. During the year the total effects from the sale through the Statement of Comprehensive Income was ISK 685 million.

The Group accounts for investments in associates based on the equity method less applicable impairment. The impairment testing uses management valuation techniques and assumptions such as EBITDA multiples. Alternative assumptions could potentially result in significantly different carrying values but the management is of the opinion that the impaired value is based on the most probable outcomes under current market conditions.

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Notes to the consolidated financial statements

26. Intangible assets

Intangible assets comprise four categories: Goodwill, Infrastructure, Customer relationships and related agreements and Software. Goodwill arises on the acquisition of subsidiaries. Infrastructure and Customer relationships and related agreements originate as a premium in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Group's operations.

On 30 September 2016 Arion Bank acquired the insurance company Vörður tryggingar hf. The purchase price of the shareholding in Vörður totalled ISK 5,300 million, paid in full with cash. A total of ISK 2,541 million in intangible assets were recognized, of which ISK 904 million is customer relationship and related agreements, ISK 684 million as trade name included in infrastructure, ISK 424 million as software and ISK 496 million as goodwill. When allocating the purchase price to separate assets the free cash flow method and management forecasts on the operations of Vörður were used. The allocation of purchase price was close to be completed at year-end 2016 and Arion Bank will complete it within the 12 months permitted timeframe from acquisition date.

At the end of 2014 Valitor Holding hf. acquired the Danish group AltaPay A/S, to support operation in the Nordic region. A total of ISK 4,217 million in intangible assets were recognized, mainly relating to the expertise of the employees of AltaPay A/S and the business opportunities inherent in a rapidly growing market and the synergy with Valitor hf. in the future. When allocating the purchase price to separate assets the free cash flow method and management forecasts on the operations of AltaPay A/S were used. The original allocation of purchase price was revisited in 2015 and 2016, and thus within the 12 months permitted timeframe from the acquisition date. Following this revisit there was a transfer of ISK 376 million to goodwill and ISK 20 million to software from customer relationship and related agreements.

Infrastructure, which is capitalized as an intangible asset, is related to Asset Management in the parent company and in the Bank’s subsidiary Stefnir, payment solution and credit card operation at the Bank's subsidiary Valitor Holding and branding of the newly acquired subsidiary Vörður. The business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as described below.

Customer relationships and related agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries and agreements bought. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationships related to individual customers through SPRON and the subsidiaries Okkar and Vörður. The customer relationship is tested for impairment and related agreements are amortized over a period of five years, with two years left of the period.

Acquired software and internally developed software is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

26. Intangible assets, continued

2016	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,407	3,021	854	3,003	9,285
Acquisition through business combination	496	684	904	457	2,541
Additions and transfers	(271)	-	110	638	477
Additions, internally developed	-	-	-	384	384
Exchange difference	(430)	-	(32)	(182)	(644)
Impairment	-	-	(9)	-	(9)
Amortization	-	-	(219)	(758)	(977)
Intangible assets	2,202	3,705	1,608	3,542	11,057

2015	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,171	3,046	1,539	2,840	9,596
Additions and transfers	506	-	(435)	530	601
Additions, internally developed	-	-	-	289	289
Exchange difference	(270)	-	(40)	(57)	(367)
Impairment	-	(25)	(2)	-	(27)
Amortization	-	-	(208)	(599)	(807)
Intangible assets	2,407	3,021	854	3,003	9,285

Impairment testing

The methodology for impairment testing on the Infrastructure, which is part of intangible assets, is based on discounted cash flow model which uses inputs that consider features of the business and the environment.

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis impairment of ISK 9 million was recognized in 2016 (2015: ISK 27 million).

	2016		2015	
Discount and growth rates	Discount rates	Growth rates	Discount rates	Growth rates
Asset Management operation	15.1%	2.5%	12.6%	2.5%
Payment solution and Credit card operation	15.1%	2-37%	12.6%	3-25%
Insurance operation	14.6%	2,5%	-	-

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27. Tax assets and tax liabilities

	2016		2015	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	6,630	-	3,272
Deferred tax	288	663	205	1,650
Tax assets and tax liabilities	288	7,293	205	4,922

Deferred tax assets and tax liabilities are attributable to the following:

	2016 Assets	2016 Liabilities	2015 Assets	2015 Liabilities
Foreign currency denominated assets and liabilities	1	(225)	4	(222)
Investment property and property and equipment	40	(689)	101	(271)
Financial assets	475	-	494	(1,171)
Other assets and liabilities	266	(407)	256	(495)
Deferred tax related to foreign exchange gain	-	(103)	-	(141)
Tax loss carry forward	267	-	-	-
	1,049	(1,424)	855	(2,300)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(761)	761	(650)	650
Deferred tax assets and tax liabilities	288	(663)	205	(1,650)

Subsidiaries own tax loss carry forward with asset value of the amount of ISK 464 million (31.12.2015: ISK 546 million) that is not recognized in the Financial Statements, due to uncertainty about the utilization possibilities of the loss.

Changes in deferred tax assets and tax liabilities	At 1 Jan.	Addition related to Vörður	Recognized through equity	Recognized in profit or loss	At 31 Dec.
2016					
Foreign currency denominated assets and liabilities	(218)	-	-	(6)	(224)
Investment property and property and equipment	(170)	(409)	-	(70)	(649)
Financial assets	(677)	8	1,171	(27)	475
Other assets and liabilities	(239)	-	-	98	(141)
Deferred foreign exchange differences	(141)	-	-	38	(103)
Tax loss carry forward	-	147	-	120	267
Change in deferred tax assets and tax liabilities	(1,445)	(254)	1,171	153	(375)
2015					
Foreign currency denominated assets and liabilities	(198)	-	-	(20)	(218)
Investment property and property and equipment	(238)	-	-	68	(170)
Financial assets	564	-	(1,171)	(70)	(677)
Other assets and liabilities	(341)	-	-	102	(239)
Deferred foreign exchange differences	(78)	-	-	(63)	(141)
Tax loss carry forward	322	-	-	(322)	-
Change in deferred tax assets and tax liabilities	31	-	(1,171)	(305)	(1,445)

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28. Other assets

	2016	2015
Non-current assets and disposal groups held for sale	4,418	5,082
Property and equipment	6,723	6,766
Accounts receivable	5,373	2,433
Unsettled securities trading	712	685
Investment for life assurance policyholders where risk is held by the policyholder	820	914
Sundry assets	2,808	1,698
Other assets	20,854	17,578

Vast majority of the Non-current assets and disposal groups held for sale consist of real estates that are generally the result of foreclosures on companies and individuals.

Property and equipment	Real estate	Equip-ment	Total 2016	Total 2015
Gross carrying amount at the beginning of the year	6,151	6,752	12,903	12,425
Additions	166	844	1,010	711
Acquisition through business combination	-	62	62	-
Disposals and transfers	(203)	(56)	(259)	(233)
Translation difference	-	(15)	(15)	-
Gross carrying amount at the end of the year	6,114	7,587	13,701	12,903
Accumulated depreciation at the beginning of the year	(1,545)	(4,592)	(6,137)	(5,355)
Depreciation	(198)	(667)	(865)	(849)
Disposals and transfers	15	9	24	67
Accumulated depreciation at the end of the year	(1,728)	(5,250)	(6,978)	(6,137)
Property and equipment	4,386	2,337	6,723	6,766

The official real estate value (Registers Iceland) amounts to ISK 4,905 million at the end of the year (31.12.2015: ISK 4,603 million) and the insurance value amounts to ISK 8,818 million (31.12.2015: ISK 9,597 million).

29. Other liabilities

	2016	2015
Accounts payable	22,627	23,296
Provision for settled FX loans	-	2,882
Unsettled securities trading	668	754
Depositors' and investors' guarantee fund	2,870	2,873
Technical provision	10,243	1,660
Technical provision for life assurance policyholders investment risk by policyholder	820	914
Withholding tax	1,745	1,643
Bank levy	2,872	2,811
Sundry liabilities	12,249	12,628
Other liabilities	54,094	49,461

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29. Other liabilities, continued

Technical provision	Technical provision	Reinsurers' share	Total 2016	Technical provision	Reinsurers' share	Total 2015
Claims reported and loss adjustment expenses	4,842	(167)	4,675	406	(94)	313
Claims incurred but not reported	1,352	(99)	1,253	274	(56)	218
Claims outstanding	6,194	(266)	5,928	680	(150)	531
Provision for unearned premiums	4,049	(18)	4,031	979	-	979
Own technical provision	10,243	(284)	9,959	1,659	(150)	1,510

Insurance claim consists of claims outstanding and provision for unearned premiums. Claims outstanding present unsettled claims incurred. Claims outstanding is the total of claims reported and actuarial estimation of claims incurred but not reported. Provision for unearned premiums presents the current insurance risk that will be conditional to future fiscal years.

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30. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	2016	2015
ISK 4,500 million	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,502	4,483
ISK 1,540 million	2016	2019	At maturity	Fixed, 5.50%	580	-
ISK 10,220 million	2014	2021	At maturity	Fixed, CPI linked, 3.50%	9,696	5,096
ISK 20,160 million	2015	2022	At maturity	Fixed, 6.50%	19,596	7,737
ISK 23,080 million	2014	2029	At maturity	Fixed, CPI linked, 3.50%	23,524	15,279
ISK 2,500 million	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	2,207	2,249
Statutory covered bonds					60,105	34,844
ISK 21,877 million	2006	2033	Amortizing	Fixed, CPI linked, 3.75%	16,734	17,108
ISK 15,500 million	2008	2045	Amortizing	Fixed, CPI linked, 4.00%	6,199	6,182
ISK 51,125 million	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	78,239	77,916
Structured Covered bonds					101,172	101,206
Total Covered bonds					161,277	136,050
NOK 500 million	2013	2016	At maturity	Floating, NIBOR +5.00%	-	1,547
USD 30 million	2016	2017	At maturity	Floating, 3 month LIBOR +1.93%	3,406	-
EUR 21 million	2009	2018	Amortizing	Floating, EURIBOR +1.00%	662	1,177
ISK 3,835 million	2010	2018	Amortizing	Floating, REIBOR +1.00%	1,063	1,600
EUR 300 million	2015	2018	At maturity	Fixed, 3.125%	36,610	43,350
SEK 250 million	2016	2018	At maturity	Floating, 3 month STIBOR + 1.09%	3,113	-
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	36,307	-
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	951	-
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	3,422	-
NOK 300 million	2015	2020	At maturity	Floating, NIBOR +2.95%	10,617	11,900
NOK 220 million	2016	2020	At maturity	Floating, NIBOR +1.95%	2,902	-
EUR 300 million	2016	2021	At maturity	Fixed, 1.625%	35,639	-
USD 747 million	2016	2023	At maturity	Floating, 3 month LIBOR +2.60%	29,317	-
Senior unsecured bonds					164,009	59,574
Central Bank, secured, various curr.	2010	2022	At maturity	Floating, LIBOR + 3.00%	-	56,024
Bills issued					13,854	4,081
Other					336	329
Other loans/bills					14,190	60,434
Borrowings					339,476	256,058

Book value of listed bonds was ISK 283,871 million at the end of the year (31.12.2015: ISK 196,927 million). Market value of those bonds was ISK 290,196 million (31.12.2015: ISK 205,720 million).

The Group did not repurchase own debt during the period (2015: ISK 10 billion).

In January 2016 the Bank reached an agreement with Kaupthing regarding FX deposits held at Arion Bank to be converted into issued EMTN bond in USD and that Kaupthing would prepay Arion Bank's Central Bank secured loan, in various currencies, of ISK 56 billion at year-end 2015. The total issue was ISK 97 billion (USD 747 million) with mandatory prepayment requirement if the Bank should issue bonds in excess of USD 165 million. In 2016 Arion Bank's issue exceeded this benchmark twice and therefore a prepayment of ISK 57 billion (USD 490 million) was made in 2016. At year-end outstanding bonds held by Kaupthing amounted to ISK 29.3 billion (USD 258 million).

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31. Subordinated liabilities

	Issued	Maturity	Maturity type	Terms of interest	2016	2015
Tier II capital in various currencies	2010	2020	At maturity	Floating, EURIBOR/LIBOR + 5.00% .	-	10,365
Subordinated liabilities					-	10,365

Arion Bank settled the subordinated liabilities with the Ministry of Finance with a prepayment in September.

32. Pledged assets

Pledged assets against liabilities

	2016	2015
Assets, pledged as collateral against borrowings	196,901	222,046
Assets, pledged as collateral against loans from credit institutions and short positions	15,644	21,611
Pledged assets against liabilities	212,545	243,657

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 197 billion at the end of the year (31.12.2015: ISK 222 billion). At the end of the year those assets were pool of mortgage loans to individuals but at year-end 2015 pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies. The book value of those borrowings was ISK 161 billion at the end of the year (31.12.2015: ISK 192 billion).

The Group has pledged bonds against short term lending from the Central Bank of Iceland and against short positions, related to swap agreements, to hedge market risk of those assets.

33. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	2016	Number (million)	2015
Issued share capital	2,000	75,861	2,000	75,861

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

Other reserves	2016	2015
Statutory reserve	1,637	1,637
Reserve for investments in subsidiaries	17,012	-
Reserve for investments in associates	23	-
Reserve for investments in securities	899	-
Available for sale reserve	-	2,903
Foreign currency translation reserve	190	8
Other reserves	19,761	4,548

In June 2016 the Icelandic Parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank. See Note 65.

There is some uncertainty over the interpretation and implementation of the amendments and thus the Note may be subject to change in the near term.

OTHER INFORMATION

34. Legal matters

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, if appropriate, to account for any adverse effects which the claims may have on its financial standing. When the Group is of the opinion that it is to the detriment of the Group's case to disclose potential amounts relating to legal claims, it elects not to do so. At the end of the period, the Group had several unresolved legal claims.

Contingent liabilities

Investigation and legal proceedings regarding alleged breaches of competition law

The Icelandic Competition Authority (ICA) has opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including Arion Bank. The investigation was initiated by separate complaints from BYR hf. and MP Banki hf. made in 2010. The complaints from BYR hf. and MP Banki 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 ICA has sent the Bank a letter proposing concluding the matter with an agreement. The Bank is looking into the conditions of the proposed agreement.

With a writ issued in June 2013, Kortaþjónustan ehf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and the Bank's subsidiary Valitor hf. to the amount of ISK 1.2 billion plus interest, due to damage Kortaþjónustan hf. contends the five parties caused the company due to violations of the Competition Act. The Bank has put forward its arguments in the case and has demanded the rejection of Kortaþjónustan's claims. Kortaþjónustan's court-appointed evaluator has given a report on Kortaþjónustan's alleged loss. The Bank and other defendants in the case have demanded that a reassessment be carried out.

Legal proceedings regarding damages

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., have filed two cases against the Bank claiming damages in the amount of more than ISK 4 billion plus interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagið Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. The Bank believes it likely that it will be acquitted of the plaintiffs' claims in both cases and has not therefore made any provision.

In January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed suit against Valitor hf. for compensatory damages relating to Valitor hf.’s cessation of Datacell’s vendor agreement. The Icelandic Supreme Court ruled on 24 April 2013 in case no. 612/2012 that Valitor hf. did not have a premise to rescind the agreement. The plaintiffs had court appointed appraisers evaluate their alleged losses. The appraisers returned their report in March 2016. Valitor disagreed with the assessment stated in the report and filed a motion for appointing three court appraisers to re-evaluate plaintiffs' alleged losses. The district court approved the motion and they have been appointed. Conclusion is pending.

Other legal matters

Mortgage documents

Courts cases are being prosecuted against the Bank in which it is demanded that the mortgaging of part of a property be invalidated on the basis that the signature of the mortgagor on the mortgage documents was not correct. Recently the district court, in respect of a case which did not involve the Bank, invalidated a mortgage under similar circumstances to these. The Bank is assessing the possible impact of a negative outcome on the Bank's loan portfolio.

34. Legal matters, continued

The uncertainty regarding the book value of foreign currency loans

Some uncertainty over the legality of FX loans has continued in 2016 and the Group constantly monitors judgements involving itself and others to refine its provisions on foreign currency loans. Although there is much more clarity in the matters of FX loans there still remains some uncertainty regarding foreign currency linked loans in certain respects, such as regarding the recalculation of particular loans and compensations on account of enforcement actions that have been made on the basis of currency-linked loans. Nevertheless, the Group considers its portfolio of foreign currency linked loans to be fully provisioned for the most likely outcome.

Legal matters concluded

In April 2013 the ICA imposed an ISK 500 million fine on Valitor hf. for abusing its dominant position on the payment card market and violating conditions set out in an earlier decision of the ICA. The Supreme Court ruled in April 2016 on upholding the ICA's decision from April 2013. Valitor paid the fine in 2013.

OFF BALANCE SHEET INFORMATION

35. Obligations

	2016	2015
Financial guarantees, unused overdraft and loan commitments the Group has granted its customers		
Financial guarantees	15,270	19,162
Unused overdrafts	46,379	42,100
Loan commitments	82,268	126,068

Depositors' and Investors' Guarantee fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. Even though the law has not been amended Icelandic banks have made quarterly payments to a separate division within the fund since 2010. Despite this change in execution and due to uncertainty over the shape of future legislation the liability brought forward from previous years has not changed from the balance of ISK 2,669 million. The Group has granted the Fund a guarantee for obligations amounting to ISK 3,210 million.

36. Operating lease commitments

Group as a lessee

The Group has concluded lease agreements on some of the real estate it uses for its operations. These lease agreements are for a period of up to 10 years. The majority of the contracts include renewal options for various periods of time.

	2016	2015
Less than one year	507	279
Over 1 year and up to 5 years	1,371	684
Over 5 years	368	346
Future minimum lease payments under non-cancellable leases	2,246	1,309

Group as a lessor

The Group has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 10 years, with the majority being non-cancellable agreements.

	2016	2015
Less than one year	68	120
Over 1 year and up to 5 years	147	127
Over 5 years	55	25
Future minimum lease payments under non-cancellable leases	270	272

37. Assets under management and under custody

Assets under management	1,054,759	996,648
Assets under custody	1,356,997	1,427,269

Assets under management represent the total market value of the financial assets which the Group manages on behalf of its customers.

The Group, acting as custodian, is responsible for safeguarding a firm's or individual's financial assets, hold in safekeeping securities such as stocks, bonds and securities funds, arrange the settlement of trades and movements of securities, process corporate actions such as income on bonds and dividends on shares; and pricing on securities.

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38. Events after Balance Sheet date

In January 2017 Arion Bank issued an additional 200 million Euro tap of the Euro benchmark bond issued December 2016. The Bank previously issued 300 million Euro bringing the total to 500 million Euro, or approximately ISK 60 billion. As before, part of the issue will be used to pay down existing loans. The bonds have a 2021 maturity and bear a fixed 1.625% coupon.

RELATED PARTY

39. Related party

The Group has a related party relationship with Kaupskil ehf., being the ultimate controlling party with 87% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., being the parent company of Kaupskil ehf.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13% stake in Arion Bank and thus has an influence over the Group. ISFI and related entities are defined as related parties.

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

No unusual transactions took place with related parties during the year. Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

2016

Balances with related parties	Assets	Liabilities	Net balance
Shareholders with control over the Group	192	(7,255)	(7,063)
Board of Directors and key Management personnel	255	(242)	13
Associates and other related parties	181	(369)	(188)
Balances with related parties	628	(7,866)	(7,238)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	1	(89)	4	-
Shareholders with influence over the Group	-	-	6	-
Board of Directors and key Management personnel	15	(7)	-	-
Associates and other related parties	28	(4)	2	(216)
Transactions with related parties	44	(100)	12	(216)

2015

Balances with related parties	Assets	Liabilities	Net balance
Shareholders with control over the Group	212	(50,158)	(49,946)
Board of Directors and key Management personnel	232	(59)	173
Associates and other related parties	2,132	(241)	1,891
Balances with related parties	2,576	(50,458)	(47,882)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(762)	16	-
Shareholders with influence over the Group	-	(4)	15	(13)
Board of Directors and key Management personnel	12	(2)	5	-
Associates and other related parties	1,288	(617)	344	(276)
Transactions with related parties	1,300	(1,385)	380	(289)

Through the ownership of ISFI the Group has a related party relationship with Landsbankinn hf. and Íslandsbanki hf. but they provide banking services to the Bank's subsidiary Valitor hf. and have a traditional bank to bank relationship with Arion Bank hf. The Group holds assets amounting to ISK 5,832 million (31.12.2015: ISK 14,038 million) by these aforementioned Financial Undertakings and liabilities amounting to ISK 791 million at the end of the year (31.12.2015: ISK 1,499 million). Total interest income was ISK 632 million in 2016 (2015: ISK 120 million) and interest expense ISK 42 million (2015: ISK 48 million). Other income was ISK 954 million during the year (2015: ISK 500 million) and other expense was ISK 1,845 million (2015: ISK 1,192 million). Those amounts are not included in the table above.

Kaupthing hf. holds senior unsecured bonds, issued by Arion Bank in January 2016, for the amount of ISK 29,317 million at the end of the year. This amount is not included in the table above.

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RISK MANAGEMENT DISCLOSURES

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

The Board of Directors is ultimately responsible for the Group's risk management framework and ensuring that satisfactory risk policies and governance for controlling the Group's risk exposure are in place. The Board allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board sets risk appetite, which is translated into exposure limits and targets monitored by the Bank's Risk Management division.

The Chief Executive Officer (CEO) is responsible for sustaining an effective risk management framework, processes and control as well as maintaining a high level of risk awareness among the employees, making risk everyone's business.

The Bank operates several committees to manage risk. The Board Risk Committee (BRIC) is responsible for supervising the Bank's risk management framework, risk appetite and the internal capital and liquidty adequacy assessment processes (ICAAP/ILAAP). The Asset and Liability Committee (ALCO), is responsible for managing the asset-liability mismatch, liquidity risk, market risk, and interest rate risk and capital management. The Underwriting and Investment Committee (UIC) decides on underwriting and principal investments. The Bank operates four credit committees: The Board Credit Committee (BCC) which decides on all major credit risk exposures, the Arion Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's capital, and the Corporate Credit Committee (CCC) and Retail Branch Committees (RBC) which operate within tighter credit granting limits.

The Bank's Internal Audit conducts independent reviews of the Bank's and several subsidiaries' operations, risk management framework, processes and measurements. Internal Audit discusses its results with management and reports its findings and recommendations to the BRIC.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralized and reports directly to the CEO. The division is divided into four units: Credit Analysis, which supports and monitors the credit granting process; Credit Control, which monitors credit exposures on a customer-by-customer basis; Balance Sheet Risk, which oversees all risks related to asset and liability mismatch, including capital and is reponsible for the Bank's ICAAP and ILAAP; and Operational Risk which monitors risks associated with the daily operation of the Bank. The Bank's Data Officer is part of the Risk Management division.

The most significant risks the Group is exposed to are credit risk, including concentration risk, liquidity risk, currency risk, interest rate risk and legal risk. These risk factors are to the largest extent encountered within the Bank. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities.

The Bank has no large exposure at the end of the year. The total sum of large exposures is therefore 0% compared to 11% in the previous year. A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's eligible capital.

The Group is exposed to currency risk due to a net currency position on the balance sheet. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities.

Liquidity risk is a large risk factor in the Group's operation due to maturity mismatch between assets and liabilities. The maturity of loans exceeds the maturity of deposits, of which 75% is on-demand or with less than 30 day term.

Further information on risk management and capital adequacy is provided in the annual Financial Statements for 2016 and in the Pillar 3 Risk Disclosures for 2016. The Pillar 3 Risk Disclosures 2016 will be published in March 2017 and be available on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures will not be subject to external audit.

40. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off balance sheet items such as commitments and guarantees.

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

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

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

40. Credit risk, continued

Exposure to credit risk

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the year before the effect of mitigation due to collateral agreements or other credit enhancements. The Group uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard.

2016

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

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Cash and balances with Central Bank	-	-	-	-	-	87,634	-	-	-	-	-	87,634
Loans to credit institutions	-	-	-	-	-	80,116	-	-	-	-	-	80,116
Loans to customers	337,417	114,895	76,475	28,647	52,719	34,939	28,633	6,519	17,308	8,711	6,159	712,422
Financial instruments	307	1,106	261	-	7	18,865	10,942	3	557	59,253	-	91,301
Other assets with credit risk	443	779	14	19	22	6,708	10	7	540	72	3	8,617
Total on-balance sheet maximum exposure to credit risk	338,167	116,780	76,750	28,666	52,748	228,262	39,585	6,529	18,405	68,036	6,162	980,090

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

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	1,394	1,967	1,573	1,039	2,416	1,333	1,880	978	2,643	35	12	15,270
Unused overdrafts	27,609	2,226	640	574	5,951	1,546	2,363	381	2,845	1,895	349	46,379
Loan commitments	33	15,276	16,756	540	24,249	7,154	13,155	2,399	2,659	38	9	82,268
Total off-balance sheet maximum exposure to credit risk	29,036	19,469	18,969	2,153	32,616	10,033	17,398	3,758	8,147	1,968	370	143,917
Maximum exposure to credit risk	367,203	136,249	95,719	30,819	85,364	238,295	56,983	10,287	26,552	70,004	6,532	1,124,007

Amounts are in ISK millions

40. Credit risk, continued

2015

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

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Cash and balances with Central Bank	-	-	-	-	-	48,102	-	-	-	-	-	48,102
Loans to credit institutions	-	-	-	-	-	87,491	-	-	-	-	-	87,491
Loans to customers	324,629	102,624	75,850	30,802	51,784	33,460	21,384	6,001	19,864	8,193	5,759	680,350
Financial instruments	135	175	72	11	-	14,894	9,430	29	400	61,624	-	86,770
Other assets with credit risk	289	564	29	80	67	3,018	3	1	455	65	10	4,581
Total on-balance sheet maximum exposure to credit risk	325,053	103,363	75,951	30,893	51,851	186,965	30,817	6,031	20,719	69,882	5,769	907,294

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

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	1,352	3,032	1,253	1,225	4,145	729	3,299	2,244	1,855	22	6	19,162
Unused overdrafts	24,373	1,977	596	632	5,093	1,622	2,013	377	2,403	2,639	375	42,100
Loan commitments	188	39,196	27,711	11,463	14,083	3,544	14,017	10,618	2,183	3,000	65	126,068
Total off-balance sheet maximum exposure to credit risk	25,913	44,205	29,560	13,320	23,321	5,895	19,329	13,239	6,441	5,661	446	187,330
Maximum exposure to credit risk	350,966	147,568	105,511	44,213	75,172	192,860	50,146	19,270	27,160	75,543	6,215	1,094,624

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40. Credit risk, continued

Loans to customers specified by sectors	2016	2015
Individuals	47.4%	47.7%
Real estate activities and construction	16.1%	15.1%
Fishing industry	10.7%	11.1%
Information and communication technology	4.1%	4.7%
Wholesale and retail trade	7.4%	7.6%
Financial and insurance activities	4.9%	4.9%
Industry, energy and manufacturing	4.0%	3.1%
Transportation	0.9%	0.9%
Services	2.4%	2.9%
Public sector	1.2%	1.2%
Agriculture and forestry	0.9%	0.8%
	100.0%	100.0%

Collateral and other credit enhancements

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- Retail loans to individuals: Mortgages on residential properties.
- Corporate loans: Real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

The value of collateral is based on estimated market value. The valuation of real estate is built on market price, official valuation of the Icelandic Property Registry, or the opinion of internal or external specialists. The valuation of fishing vessels takes into account related fishing quotas.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses.

The collateral value in the table below is capped by the exposure amount.

Collateral held against different types of financial assets

2016	Cash and securities	Real estate	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	481	297,974	5	7,419	305,879
Real estate activities and construction	581	106,770	34	1,444	108,829
Fishing industry	564	8,100	57,092	8,041	73,797
Information and communication technology	27	2,598	-	18,363	20,988
Wholesale and retail trade	410	26,570	8	19,988	46,976
Financial and insurance activities	14,826	7,620	-	807	23,253
Industry, energy and manufacturing	3,287	15,332	-	6,875	25,494
Transportation	73	892	278	3,622	4,865
Services	20	7,221	71	3,650	10,962
Public sector	7	3,811	-	179	3,997
Agriculture and forestry	5	5,128	-	327	5,460
Financial instruments	5,953	-	-	-	5,953
Financial guarantees	1,038	3,871	1,249	2,375	8,533
Collateral held against different types of financial assets	27,272	485,887	58,737	73,090	644,986

Arion Bank Consolidated Financial Statements 2016 56 Amounts are in ISK millions

40. Credit risk, continued

2015	Cash and securities	Real estates	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	428	289,862	24	4,107	294,421
Real estate activities and construction	1,032	89,039	8	1,025	91,104
Fishing industry	53	7,956	57,945	7,037	72,991
Information and communication technology	76	2,369	-	18,630	21,075
Wholesale and retail trade	210	20,424	7	22,912	43,553
Financial and insurance activities	15,947	4,367	-	1,577	21,891
Industry, energy and manufacturing	461	12,792	3	4,416	17,672
Transportation	91	875	173	3,891	5,030
Services	13	4,847	40	2,623	7,523
Public sector	73	3,732	-	99	3,904
Agriculture and forestry	5	3,493	-	112	3,610
Financial instruments	7,474	-	-	-	7,474
Financial guarantees	885	4,232	623	1,445	7,185
Collateral held against different types of financial assets	26,748	443,988	58,823	67,874	597,433

Collateral repossessed

During the year the Group took possession of assets due to foreclosures. The total amount of real estates the Group took possession of during the year and still holds at year-end amount to ISK 1,817 million (31.12.2015: ISK 2,761 million) and other assets ISK 13 million (31.12.2015: ISK 7 million). The assets are held for sale, see Note 28.

Credit quality

Credit quality by class of financial assets

2016	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	87,634	-	-	87,634
Loans to credit institutions	80,116	-	-	80,116
Loans to customers				
Loans to corporates	358,709	14,251	2,046	375,006
Loans to individuals	312,259	21,854	3,303	337,416
Financial instruments	82,042	-	-	82,042
Other assets with credit risk	8,617	-	-	8,617
Credit quality by class of financial assets	929,377	36,105	5,349	970,831

2015	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	48,102	-	-	48,102
Loans to credit institutions	87,491	-	-	87,491
Loans to customers				
Loans to corporates	337,153	17,302	1,276	355,731
Loans to individuals	291,277	26,532	6,810	324,619
Financial instruments	82,714	-	-	82,714
Other assets with credit risk	4,581	-	-	4,581
Credit quality by class of financial assets	851,318	43,834	8,086	903,238

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40. Credit risk, continued

Neither past due nor impaired loans

The Bank uses internal credit rating models to monitor the development of credit risk and to estimate customers' probability of default (PD). The Bank rates customers with one of three models. For large corporates the Bank uses quantitative information based on financial statements as well as qualitative data. Credit ratings of individuals and SMEs are based on statistical models using historical information which has been found to be predictive. The models are updated annually and recalibrated with current data with the aim of improving their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement.

The table below shows loans to customers that are neither past due nor impaired, broken down by the Bank's classification scale, where 5 denotes the highest risk.

	Risk classification						
2016	1	2	3	4	5	Not rated	Total
Individuals	68,538	162,930	55,500	17,036	4,331	3,924	312,259
Real estate activities and construction	43,172	33,819	24,557	5,679	348	3,184	110,759
Fishing industry	24,480	36,143	9,700	2,579	604	79	73,585
Information and communication technology	18,372	3,207	966	5,476	-	12	28,033
Wholesale and retail trade	11,342	19,302	16,890	2,244	208	-	49,986
Financial and insurance activities	9,669	2,210	15,623	207	-	5,730	33,439
Industry, energy and manufacturing	7,908	7,854	10,101	719	635	351	27,568
Transportation	958	3,753	989	433	20	-	6,153
Services	2,303	5,312	7,263	847	28	3	15,756
Public sector	377	4,425	1,874	1,146	53	656	8,531
Agriculture and forestry	478	1,147	2,029	1,227	18	-	4,899
Neither past due nor impaired loans	187,597	280,102	145,492	37,593	6,245	13,939	670,968
2015							
Individuals	54,822	148,472	63,027	18,553	4,693	1,710	291,277
Real estate activities and construction	36,550	23,792	29,776	3,790	154	3,279	97,341
Fishing industry	21,807	33,232	7,657	5,415	1,249	1,341	70,701
Information and communication technology	17,346	4,252	8,949	126	-	-	30,673
Wholesale and retail trade	9,447	18,356	18,260	2,064	198	33	48,358
Financial and insurance activities	3,012	17,784	11,308	223	-	456	32,783
Industry, energy and manufacturing	3,088	14,256	2,930	324	135	-	20,733
Transportation	3,320	1,094	1,040	274	28	-	5,756
Services	2,326	4,805	9,918	539	19	-	17,607
Public sector	357	3,396	2,342	1,038	133	545	7,811
Agriculture and forestry	336	1,558	2,887	609	-	-	5,390
Neither past due nor impaired loans	152,411	270,997	158,094	32,955	6,609	7,364	628,430

Exposures that are 'Not rated' are typically due to newly formed entities and entities for which the Bank's rating models are not applicable.

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40. Credit risk, continued

Past due but not impaired loans by class of loans 2016	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	5,388	4,282	1,589	1,211	1,781	14,251
Loans to individuals	3,196	8,708	4,989	391	4,570	21,854
Past due but not impaired loans	8,584	12,990	6,578	1,602	6,351	36,105
2015						
Loans to corporates	9,638	3,779	1,681	662	1,542	17,302
Loans to individuals	3,706	9,437	5,237	554	7,598	26,532
Past due but not impaired loans	13,344	13,216	6,918	1,216	9,140	43,834

Loans past due up to three days are mainly overdrafts that were not renewed in time. The majority of the past due but not impaired loans are considered fully secured with collateral or have been acquired at discount. Loans aquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

	2016		2015	
Impaired loans to customers specified by sector	Impair-ment amount	Gross carrying amount	Impair-ment amount	Gross carrying amount
Individuals	7,069	10,372	10,593	17,403
Real estate activities and construction	770	1,056	1,515	1,867
Fishing industry	966	1,648	257	373
Information and communication technology	179	182	308	332
Wholesale and retail trade	540	868	681	893
Financial and insurance activities	261	298	5,953	6,011
Industry, energy and manufacturing	786	878	828	1,025
Transportation	4,301	4,307	4,433	4,440
Services	3,145	3,624	504	682
Public sector	89	113	143	215
Agriculture and forestry	175	284	126	186
Impaired loans to customers specified by sector	18,281	23,630	25,341	33,427

Arion Bank Consolidated Financial Statements 2016 59 Amounts are in ISK millions

40. Credit risk, continued

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's eligible capital according to Act. No. 161/2002 on Financial Undertakings and FME Rules No. 625/2013. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible collateral.

The Group had no large exposure at the end of the year before taking account of eligible collateral (31.12.2015: One large exposure of ISK 22 billion without eligible collateral).

	2016		2015	
No.	Gross	Net	Gross	Net
1	<10%	<10%	11%	11%
Sum of large exposure gross and net > 10%	0%	0%	11%	11%

41. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments.

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

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

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

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

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair value of financial instruments. The Group's operations are subject to interest rate risk associated with a mismatch between interest-bearing assets and interest-bearing liabilities. This mismatch is characterised by a gap between the interest fixing period of assets and liabilities, with a large amount of liabilities being demand deposits while the interest rates of assets are predominantly fixed to some extent, resulting in a repricing risk for the Group. The Group also faces interest basis risk between interest-bearing assets and interest bearing liabilities due to different types of floating-rate indices in different currencies.

The Group's strategy for managing its interest rate risk is to strive to contain interest rate mismatches within acceptable levels by maintaining partly matched funding for its loans to customers, offering deposit incentives and by targeted lending practices.

Arion Bank Consolidated Financial Statements 2016 60 Amounts are in ISK millions

41. Market risk, continued

Interest rate risk in the banking book

The following table shows the Group's interest-bearing assets and liabilities by interest fixing periods. The figures for loans to customers and borrowings are shown on a fair value basis, see Note 23, and are therefore different from the amounts shown in these Financial Statements. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category.

2016	Up to 3	3-12	1-5	5-10	Over 10	
Assets	months	months	years	years	years	Total
Balances with Central Bank	80,186	-	-	-	-	80,186
Loans to credit institutions	80,116	-	-	-	-	80,116
Loans to customers	382,928	63,694	138,540	4,457	127,601	717,220
Financial instruments	41,495	1,695	5,182	6,349	1,897	56,618
Assets	584,725	65,389	143,722	10,806	129,498	934,140
Liabilities						
Due to credit institutions and Central Bank	7,962	25	-	-	-	7,987
Deposits	376,424	21,111	12,450	1,263	816	412,064
Borrowings	62,830	8,653	126,836	20,670	129,423	348,412
Liabilities	447,216	29,789	139,286	21,933	130,239	768,463
Derivatives and other off-balance sheet items (net position)	(107,799)	(916)	111,083	(146)	-	2,222
Net interest gap	29,710	34,684	115,519	(11,273)	(741)	167,899

2015						
Assets						
Balances with Central Bank	43,181	-	-	-	-	43,181
Loans to credit institutions	87,491	-	-	-	-	87,491
Loans to customers	347,571	64,594	127,907	5,255	142,869	688,196
Financial instruments	43,925	10,002	8,556	7,786	242	70,511
Assets	522,168	74,596	136,463	13,041	143,111	889,379
Liabilities						
Due to credit institutions and Central Bank	11,387	-	-	-	-	11,387
Deposits	464,998	3,501	848	-	-	469,347
Borrowings	72,010	4,509	48,705	12,982	126,633	264,839
Subordinated liabilities	10,365	-	-	-	-	10,365
Liabilities	558,760	8,010	49,553	12,982	126,633	755,938
Derivatives and other off-balance sheet items (net position)	(46,330)	(1,802)	49,346	-	-	1,214
Net interest gap	(82,922)	64,784	136,256	59	16,478	134,655

Arion Bank Consolidated Financial Statements 2016 61 Amounts are in ISK millions

41. Market risk, continued

Sensitivity analysis of interest rate risk in the banking book

The following table shows the sensitivity of the Group's net present value of interest-bearing assets and liabilities to changes in interest rates by currencies. Sensitivity is quantified as the net change in value of interest-bearing assets and liabilities when assuming a simultaneous parallel shift upwards and downwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income and is not an estimate of risk. The calculations are based on contractual interest fixing periods, not taking into account the expected behavior of non-maturing deposits.

	2016		2015	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	414	(63)	1,850	(1,763)
ISK, Non index-linked	348	(508)	751	(735)
EUR	87	(147)	185	(178)
Other	162	(148)	522	(494)

Interest rate risk in the trading book

The following table shows the total basis point value (BPV) of the Group's bonds and derivatives in the trading book at market value (MV). BPV denotes the change in value given a basis point (0.01%) yield change.

	2016			2015		
Trading financial instruments, long positions	MV	Duration	BPV	MV	Duration	BPV
ISK, CPI index-linked	8,084	2.2	(1.8)	4,544	3.6	(1.6)
ISK, Non index-linked	10,992	1.0	(1.1)	5,849	(1.8)	1.1
FX	37,399	(0.5)	2.0	64,226	(0.6)	3.9
Total	56,475	0.2	(0.9)	74,619	(0.5)	3.4
Trading financial instruments, short positions						
ISK, CPI index-linked	518	4.7	(0.2)	393	9.7	(0.4)
ISK, Non index-linked	15,680	0.3	(0.4)	7,953	0.3	(0.3)
FX	29,847	(0.8)	2.4	64,172	(0.5)	2.9
Total	46,045	(0.4)	1.8	72,518	(0.3)	2.3

Sensitivity analysis of interest rate risk in the trading book

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

	2016		2015	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	156	(152)	126	(121)
ISK, Non index-linked	127	(64)	(142)	130
EUR	2	(20)	19	(20)
Other	-	(13)	(122)	115

Arion Bank Consolidated Financial Statements 2016 62 Amounts are in ISK millions

41. Market risk, continued

Indexation risk

The Group is exposed to indexation risk when there is a mismatch between index-linked assets and liabilities.

Transaction maturity profile of indexed assets and liabilities

2016	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	12,911	97,225	218,981	329,117
Financial instruments	7,100	-	-	7,100
Off-balance sheet position	851	6,619	-	7,470
Assets, CPI index-linked	20,862	103,844	218,981	343,687
Liabilities, CPI index-linked				
Deposits	69,621	12,121	2,050	83,792
Borrowings	2,253	24,437	114,747	141,437
Off-balance sheet position	-	518	-	518
Other	395	692	893	1,980
Liabilities, CPI index-linked	72,269	37,768	117,690	227,727
Net on-balance sheet position	(52,258)	59,975	101,291	109,008
Net off-balance sheet position	851	6,101	-	6,952
CPI Balance	(51,407)	66,076	101,291	115,960

2015	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	13,629	76,393	209,485	299,507
Financial instruments	3,412	-	-	3,412
Off-balance sheet position	749	7,940	-	8,689
Assets, CPI index-linked	17,790	84,333	209,485	311,608
Liabilities, CPI index-linked				
Deposits	72,352	12,899	1,916	87,167
Borrowings	2,128	14,164	112,350	128,642
Other	-	-	782	782
Liabilities, CPI indexed linked	74,480	27,063	115,048	216,591
Net on-balance sheet position	(57,439)	49,330	94,437	86,328
Net off-balance sheet position	749	7,940	-	8,689
CPI Balance	(56,690)	57,270	94,437	95,017

Arion Bank Consolidated Financial Statements 2016 63 Amounts are in ISK millions

41. Market risk, continued

Currency risk

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

Breakdown of assets and liabilities by currency

2016

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	85,052	775	627	364	197	108	511	87,634
Loans to credit institutions	18,946	16,963	17,444	8,522	1,826	10,064	6,351	80,116
Loans to customers	593,185	66,242	34,012	2,857	7,378	7	8,741	712,422
Financial instruments	91,566	13,403	9,572	311	244	2,245	115	117,456
Investment property	5,358	-	-	-	-	-	-	5,358
Investments in associates	831	8	-	-	-	-	-	839
Intangible assets	6,978	-	-	-	4,079	-	-	11,057
Tax assets	272	-	-	-	16	-	-	288
Other assets	19,356	650	556	142	135	13	2	20,854
Assets	821,544	98,041	62,211	12,196	13,875	12,437	15,720	1,036,024
Liabilities and equity								
Due to credit inst. and Central Bank ..	6,857	978	84	3	-	1	64	7,987
Deposits	377,195	15,762	12,038	4,186	844	1,301	738	412,064
Financial liabilities at fair value	3,020	408	272	-	-	16	10	3,726
Tax liabilities	7,075	-	-	-	218	-	-	7,293
Other liabilities	44,625	2,660	1,160	4,255	756	229	409	54,094
Borrowings	176,530	109,217	32,723	-	-	13,520	7,486	339,476
Subordinated liabilities	-	-	-	-	-	-	-	-
Shareholders' equity	211,212	-	-	-	-	-	-	211,212
Non-controlling interest	172	-	-	-	-	-	-	172
Liabilities and equity	826,686	129,025	46,277	8,444	1,818	15,067	8,707	1,036,024
Net on-balance sheet position	(5,142)	(30,984)	15,934	3,752	12,057	(2,630)	7,013	
Net off-balance sheet position	279	31,775	(15,315)	(3,232)	(8,579)	2,335	(7,263)	
Net position	(4,863)	791	619	520	3,478	(295)	(250)	

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41. Market risk, continued

2015

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	47,357	252	167	37	96	37	156	48,102
Loans to credit institutions	20,923	24,741	19,478	7,260	3,182	4,125	7,782	87,491
Loans to customers	568,196	44,532	37,395	6,487	11,357	9	12,374	680,350
Financial instruments	84,752	24,852	13,227	6,145	63	3,248	904	133,191
Investment property	7,542	-	-	-	-	-	-	7,542
Investments in associates	1,043	-	-	26,256	-	-	-	27,299
Intangible assets	5,575	-	-	-	3,710	-	-	9,285
Tax assets	205	-	-	-	-	-	-	205
Other assets	16,711	482	170	177	22	14	2	17,578
Assets	752,304	94,859	70,437	46,362	18,430	7,433	21,218	1,011,043
Liabilities and equity								
Due to credit inst. and Central Bank ..	9,471	381	74	6	1	-	1,454	11,387
Deposits	388,228	18,041	50,913	6,865	1,523	2,156	1,621	469,347
Financial liabilities at fair value	6,791	584	104	10	4	-	116	7,609
Tax liabilities	4,500	-	-	-	422	-	-	4,922
Other liabilities	41,098	2,648	1,484	1,432	832	347	1,620	49,461
Borrowings	142,060	44,526	33,442	8,511	-	13,447	14,072	256,058
Subordinated liabilities	-	3,942	2,603	3,820	-	-	-	10,365
Shareholders' equity	192,786	-	-	-	-	-	-	192,786
Non-controlling interest	9,108	-	-	-	-	-	-	9,108
Liabilities and equity	794,042	70,122	88,620	20,644	2,782	15,950	18,883	1,011,043
Net on-balance sheet position	(41,738)	24,737	(18,183)	25,718	15,648	(8,517)	2,335	
Net off-balance sheet position	9,619	(13,684)	20,273	(1,470)	(17,856)	5,481	(2,363)	
Net position	(32,119)	11,053	2,090	24,248	(2,208)	(3,036)	(28)	

Sensitivity analysis on currency risk

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

	2016		2015	
Currency	-10%	+10%	-10%	+10%
EUR	(79)	79	(1,105)	1,105
USD	(62)	62	(209)	209
GBP	(52)	52	(2,425)	2,425
DKK	(348)	348	221	(221)
NOK	30	(30)	304	(304)
Other	25	(25)	3	(3)

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41. Market risk, continued

Equity risk

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. For information on assets seized and held for sale and equity exposures, see Notes 28 and 22 respectively.

Sensitivity analysis of equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices on the Statement of Comprehensive Income. A negative amount in the table reflects a potential net reduction in the Statement of Comprehensive income or equity, while a positive amount reflects a potential net increase. Investments in associates are excluded.

	2016		2015	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(295)	295	(214)	214
Banking book - listed	(913)	913	(1,387)	1,387
Banking book - unlisted	(1,193)	1,193	(1,819)	1,819

Derivatives

Customers can enter into derivatives contracts with the Bank. The types of derivatives currently offered by the Group are forward contracts for foreign exchange, securities and commodities, foreign exchange and interest rate swaps and options for foreign exchange, securities and commodities. Eligible underlying instruments, limits on exposures and required collateral are determined in accordance with the Group's risk appetite. The Group also uses derivatives to reduce market risk on its balance sheet. Note 23 shows a breakdown of the Group's derivative positions by type.

Prepayment risk

Prepayment risk is the risk that the Group will incur a financial loss because its customers and counterparties repay or request repayment earlier or later than expected, such as fixed rate mortgages when interest rates fall. The Group is not materially exposed to prepayment risk at year-end 2016.

42. Liquidity and Funding risk

Liquidity risk is defined as the risk that the Group, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

The Group's primary source of funding is deposits from individuals, businesses and Financial Undertakings. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 70% is on-demand.

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

The Group's strategy is to always maintain sufficient liquidity by maintaining a high ratio of liquid assets and available funding to near term liabilities and possible payment outflows. Uncertainties in relation to the capital controls have been significantly reduced and in January 2016 Kaupthing's deposits in foreign currency with the Group were termed out into EMTN funding. As a result, liquidity risk due to entities in winding-up has been reduced.

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42. Liquidity and Funding risk, continued

Maturity gap analysis

Group's assets and liabilities at carrying amount by residual maturity

2016 *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	87,634	78,302	-	9,332	-	-	-
Loans to credit institutions	80,116	54,104	26,012	-	-	-	-
Loans to customers	712,422	9,051	54,203	79,205	253,938	316,025	-
Financial instruments	117,456	12,715	2,100	3,670	51,729	11,828	35,414
Derivatives - assets leg	*75,527*	-	*28,038*	*19,179*	*27,825*	*485*	-
Derivatives - liabilities leg	*(70,368)*	-	*(27,300)*	*(17,927)*	*(24,886)*	*(255)*	-
Investment property	5,358	-	-	-	-	-	5,358
Investments in associates	839	-	-	-	-	-	839
Intangible assets	11,057	-	-	-	-	-	11,057
Tax assets	288	-	-	-	288	-	-
Other assets	20,854	2,687	3,883	1,303	745	-	12,236
Assets	1,036,024	156,859	86,198	93,510	306,700	327,853	64,904
Liabilities							
Due to credit institutions and Central Bank	7,987	7,636	-	326	25	-	-
Deposits	412,064	288,390	74,202	37,769	10,088	1,615	-
Financial liabilities at fair value	3,726	-	2,400	127	895	304	-
Derivatives - assets leg	*(57,923)*	-	*(13,857)*	*(3,960)*	*(39,388)*	*(718)*	-
Derivatives - liabilities leg	*59,766*	-	*14,374*	*4,087*	*40,283*	*1,022*	-
Short position securities used for hedging	*1,884*	-	*1,884*	-	-	-	-
Tax liabilities	7,293	-	-	6,626	667	-	-
Other liabilities	54,094	21,837	7,414	3,446	3,660	6	17,731
Borrowings	339,476	-	10,293	13,371	153,607	162,205	-
Liabilities	824,640	317,863	94,309	61,665	168,942	164,130	17,731
Off-balance sheet items							
Financial guarantees	15,270	2,893	4,032	4,136	2,538	1,671	-
Unused overdraft	46,379	1,460	9,098	18,305	17,516	-	-
Loan commitments	82,268	1,348	38,757	17,075	21,088	4,000	-
Off-balance sheet items	143,917	5,701	51,887	39,516	41,142	5,671	-
Net assets (liabilities)	67,467	(166,705)	(59,998)	(7,671)	96,616	158,052	47,173

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42. Liquidity and Funding risk, continued

2015 *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	48,102	35,467	-	12,635	-	-	-
Loans to credit institutions	87,491	50,151	37,340	-	-	-	-
Loans to customers	680,350	3,984	42,429	90,014	234,035	309,888	-
Financial instruments	133,191	4,765	1,711	10,861	54,392	10,985	50,477
Derivatives - assets leg	*56,171*	-	*24,671*	*1,478*	*29,509*	*513*	-
Derivatives - liabilities leg	*(53,770)*	-	*(24,262)*	*(1,421)*	*(27,688)*	*(399)*	-
Investment property	7,542	-	-	-	-	-	7,542
Investments in associates	27,299	-	-	-	-	-	27,299
Intangible assets	9,285	-	-	-	-	-	9,285
Tax assets	205	-	-	-	205	-	-
Other assets	17,578	1,017	2,592	174	793	-	13,002
Assets	1,011,043	95,384	84,072	113,684	289,425	320,873	107,605
Liabilities							
Due to credit institutions and Central Bank	11,387	9,881	-	1,481	25	-	-
Deposits	469,347	268,727	95,191	89,937	13,575	1,917	-
Financial liabilities at fair value	7,609	-	6,346	536	631	96	-
Derivatives - assets leg	*(49,199)*	-	*(36,552)*	*(5,662)*	*(6,518)*	*(467)*	-
Derivatives - liabilities leg	*52,192*	-	*38,282*	*6,198*	*7,149*	*563*	-
Short position bonds and derivatives	*1,309*	-	*1,309*	-	-	-	-
Short position bonds used for hedging	*3,307*	-	*3,307*	-	-	-	-
Tax liabilities	4,922	-	-	3,274	1,648	-	-
Other liabilities	49,461	17,002	14,724	5,192	3,529	6	9,008
Borrowings	256,058	-	7,081	4,308	69,933	174,736	-
Subordinated liabilities	10,365	-	-	-	3,942	6,423	-
Liabilities	809,149	295,610	123,342	104,728	93,283	183,178	9,008
Off-balance sheet items							
Financial guarantees	19,162	3,402	2,371	7,589	3,954	1,846	-
Unused overdraft	42,100	842	10,071	14,984	15,768	435	-
Loan commitments	126,068	-	50,628	35,542	34,506	5,392	-
Off-balance sheet items	187,330	4,244	63,070	58,115	54,228	7,673	-
Net assets (liabilities)	14,564	(204,470)	(102,340)	(49,159)	141,914	130,022	98,597

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42. Liquidity and Funding risk, continued

Net Stable Funding Ratio

The net stable funding ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per the definition of the Central Bank of Iceland rules No. 1032. In general, RSF is determined by applying different weights to different asset classes depending on the level of liquidity. ASF however is calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness. In 2016, the ratio for foreign currency shall be at least 90% and from 2017 the ratio shall exceed 100%.

Calculations of the NSFR are based on consolidated figures for the Bank and Arion Bank Mortgages Institutional Investor Fund. When calculating the FX ratio, a negative FX imbalance is subtracted from the numerator and a positive FX imbalance is subtracted from the denominator. The FX imbalance discrepancy between the Group's official FX imbalance and the imbalance reported in the NSFR is due to the fact that the Bank's subsidiaries have a substantial positive FX imbalance but are settled in ISK.

2016	ISK	FX	Total
Available stable funding	612,964	169,821	782,785
Required stable funding	544,854	87,010	631,864
FX imbalance		(4,019)	
Net stable funding ratio	113%	191%	124%

2015			
Available stable funding	540,864	129,273	670,137
Required stable funding	539,841	95,511	635,352
FX imbalance		(11,363)	
Net stable funding ratio	100%	123%	105%

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42. Liquidity and Funding risk, continued

Liquidity coverage ratio

The liquidity coverage ratio (LCR) is part of the standards introduced in the Basel III Accord. The LCR is the result of a stress test that is designed to ensure that banks have the necessary assets on hand to withstand short-term liquidity disruptions. More accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, assets must be non-pledged, liquid and easily priced on the market, repoable at the Central Bank and not issued by the Group or related entities.

The Central Bank has set rules for minimum LCR. In 2016 the LCR requirement is 100% in foreign currency and 90% in total (ISK and foreign currency). The latter requirement will be 100% from 2017.

The following table shows the breakdown for the Group's LCR calculations broken down on currencies; ISK, FX and total. All amounts are weighted by their respective LCR weights as defined by the Central Bank.

2016	ISK	FX	Total
Liquid assets level 1 *	112,770	13,026	125,796
Liquid assets level 2 **	-	2,932	2,932
Liquid Assets	112,770	15,958	128,728
Deposits	93,584	16,885	110,469
Market Borrowing	3,192	371	3,563
Other Cash outflows	12,426	7,013	19,439
Cash outflows	109,202	24,269	133,471
Short-term deposits with other banks ***	1,688	51,779	53,467
Other Cash inflows	3,843	1,011	4,854
Cash inflows	5,531	52,790	58,321
Liquidity coverage ratio (LCR) ****	109%	263%	171%

2015	ISK	FX	Total
Liquid assets level 1 *	99,483	24,088	123,571
Liquid assets level 2 **	-	5,869	5,869
Liquid Assets	99,483	29,957	129,440
Deposits	122,275	21,640	143,915
Market Borrowing	1,502	122	1,624
Other Cash outflows	16,296	34,749	51,045
Cash outflows	140,073	56,511	196,584
Short-term deposits with other banks ***	3,768	57,881	61,649
Other Cash inflows	9,193	29,457	38,650
Cash inflows	12,961	87,338	100,299
Liquidity coverage ratio (LCR) ****	78%	212%	134%

* Level 1 assets receive a 100% weight in LCR calculations and include the Group's Cash and balances with Central Bank, domestic bonds eligible as collateral at the Central Bank and foreign government bonds.

** Level 2 assets include the Group's covered bonds with a minimum rating of AA- and receive a 85% weight in LCR calculations.

*** Short-term deposits in other banks are defined as cash inflows in LCR calculations.

**** LCR is defined as: LCR = Weighted liquid assets / (weighted cash outflows - weighted cash inflows) where weighted cash inflows are capped at 75% of weighted cash outflows.

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42. Liquidity and Funding risk, continued

Composition of liquid assets

The following table shows the composition of the Bank's liquidity buffer. At 1 January 2017 the Bank's liquidity facility with the Icelandic government expired, and is not included in the composition of liquid assets for 31 December 2016.

2016	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	85,053	627	775	1,179	87,634
Short-term deposits in other banks	1,688	16,018	14,090	21,671	53,467
Domestic bonds eligible as collateral at the Central Bank	27,718	-	-	-	27,718
Foreign government bonds	-	5,536	4,908	-	10,444
Covered bonds with a minimum rating of AA-	-	-	1,202	2,247	3,449
Liquidity reserve	114,459	22,181	20,975	25,097	182,712

2015	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	47,357	167	252	326	48,102
Short-term deposits in other banks	3,768	16,741	20,824	20,316	61,649
Domestic bonds eligible as collateral at the Central Bank	22,614	-	-	-	22,614
Foreign government bonds	-	10,658	8,700	3,984	23,342
Government liquidity facility	29,513	-	-	-	29,513
Covered bonds with a minimum rating of AA-	-	-	2,122	4,783	6,905
Liquidity reserve	103,252	27,566	31,898	29,409	192,125

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42. Liquidity and Funding risk, continued

LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. Some similar categories are grouped together. The table contains deposits at the Bank and at banking subsidiaries. Thus, amounts due to Central Bank and amounts due to credit institutions at non-banking subsidiaries are excluded.

LCR categorization - amounts and LCR outflow weights	Deposits maturing within 30 days					
2016	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Individuals	97,232	10%	40,376	5%	59,344	196,952
SME	39,823	10%	3,955	5%	3,762	47,540
Corporations	55,094	40%	921	20%	5,850	61,865
Sovereigns, central banks and PSE	11,653	40%	-	-	1,379	13,032
Pension funds	31,157	100%	-	-	15,959	47,116
Domestic financial entities	24,310	100%	-	-	16,730	41,040
Foreign financial entities	2,150	100%	-	-	-	2,150
Other foreign parties	4,466	100%	3,276	25%	2,288	10,030
Total	265,885		48,528		105,312	419,725
2015						
Individuals	86,095	10%	39,598	5%	53,599	179,292
SME	37,884	10%	3,928	5%	4,327	46,139
Corporations	36,300	40%	823	20%	4,945	42,068
Sovereigns, central banks and PSE	11,900	40%	-	-	1,304	13,204
Financial entities being wound up	16,948	100%	-	-	47,062	64,010
Pension funds	41,609	100%	-	-	35,104	76,713
Domestic financial entities	32,727	100%	-	-	11,016	43,743
Foreign financial entities	5,193	100%	-	-	-	5,193
Other foreign parties	3,707	100%	3,260	25%	1,923	8,890
Total	272,363		47,609		159,280	479,252

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

43. Operational risk

Operational risk is the risk of direct or indirect loss, or damage to the Group's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Group's image and operational earnings.

Each business unit within the Group is primarily responsible for taking and managing their own operational risk. Operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Group's operational risk.

The Group uses the standardized approach to the calculation of capital requirements for operational risk.

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44. Capital management

Capital ratio

The focus of capital management at the Group is to optimize the capital structure in the medium term and consequently maintain the Group's capitalization comfortably above the regulatory minimum, including capital buffers and Pillar 2 requirements.

The Group's capital ratios are calculated in accordance with Act No. 161/2002 on Financial Undertakings. In September 2016, amendments were made to the Act, effectively adopting parts of CRR into law. The regulation had not been fully implemented at 31 December 2016 and as a result, the legal framework is not entirely aligned with CRR. The Group however assumes a full adoption of CRR in the capital calculations for 31 December 2016. Capital ratios for 31 December 2015 are based on the the preceding Basel II definitions. The Group uses the standardized approach to calculate the capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

Capital Base	2016	2015
Total equity	211,384	201,894
Non-controlling interest not eligible for inclusion in CET1 capital	(172)	(9,108)
Intangible assets	(11,057)	(9,285)
Tax assets	(288)	(205)
Cash flow hedges	(22)	-
Additional value adjustments	(127)	-
Equity holdings in financial sector entities *	-	(3,151)
Common equity Tier 1 capital	199,718	180,145
Non-controlling interest not eligible for inclusion in CET1 capital	172	9,108
Tier 1 capital	199,890	189,253
Subordinated liabilities	-	10,365
Regulatory adjustments to Tier 2 capital **	-	(771)
Equity holdings in financial sector entities *	-	(3,118)
General credit risk adjustments	4,557	-
Tier 2 capital	4,557	6,476
Total capital base	204,447	195,729

Risk-weighted assets	2016	2015
Credit risk, loans	577,661	567,242
Credit risk, securities and other	68,074	113,791
Market risk due to currency imbalance	5,449	38,401
Market risk other	12,966	7,035
Credit valuation adjustment	2,678	-
Operational risk	86,490	81,441
Total risk-weighted assets	753,318	807,910
Of which domestic	687,921	694,803

Capital ratios	2016	2015
CET1 ratio	26.5%	22.3%
Tier 1 ratio	26.5%	23.4%
Capital adequacy ratio	27.1%	24.2%

* In CRR (Basel III), a 10% threshold criteria applies to deduction of such holdings. At 31 December 2015 such deductions were split between Tier 1 and Tier 2 capital without any threshold criteria.

** Straight-line amortization for maturities within five years.

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44. Capital management, continued

The following table outlines the implementation of the capital buffer requirements in accordance with the Financial Undertakings Act, as prescribed by the Financial Stability Council and approved by the FME.

Capital buffer requirement, % of RWA	1.6.2016	1.1.2017	1.3.2017	1.11.2017
Capital conservation buffer	1.75%	2.50%	2.50%	2.50%
Capital buffer for systematically important institutions	2.00%	2.00%	2.00%	2.00%
Systemic risk buffer *	3.00%	3.00%	3.00%	3.00%
Countercyclical capital buffer *	-	-	1.00%	1.25%
Combined capital buffer requirement	6.75%	7.50%	8.50%	8.75%

The Bank carries out an ongoing process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Group has in place sufficient risk management processes and systems to identify, manage and measure the Group's total risk exposure. The ICAAP is aimed at identifying and measuring the Group's risk across all risk types and ensure that the Group has sufficient capital in accordance with its risk profile. The FME supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole following the Supervisory Review and Evaluation Process (SREP). The Group's capital base exceeds the FME's SREP requirements.

The Bank's Pillar 2R capital add-on, which is the result of the ICAAP/SREP, may comprise 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. With the current capital structure, the Pillar 2R requirement is solely met with CET1 capital.

2016		Fully implemented
Total capital requirement, % of RWA	Current	1.11.2017
Pillar 1 capital requirement	8.0%	8.0%
Pillar 2R capital requirement **	4.3%	4.3%
Combined buffer requirement	6.5%	8.4%
Total regulatory capital requirement	18.8%	20.7%
Available capital	27.1%	27.1%
CET1 requirement, % of RWA		
Pillar 1 CET1 requirement	4.5%	4.5%
Pillar 2R CET1 requirement **	2.4%	2.4%
Combined buffer requirement	6.5%	8.4%
CET1 regulatory capital requirement	13.4%	15.3%
Available CET1 capital	26.5%	26.5%

*The capital buffers for systemic risk and countercyclical effects only apply to the part of RWA that is calculated on domestic exposures. The precise meaning of what constitutes the domestic part has not been defined. Here, the domestic part of RWA is assumed to be the portion of credit risk and market risk RWA that is calculated on domestic exposures, in addition to 100% of operational risk RWA. With the FME's expected recognition of countercyclical buffers in foreign countries, these will apply to the portion of RWA that is calculated on exposures from the corresponding countries.

** The SREP result based on the Group's financial statement of 31.12.2015.

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44. Capital management, continued

Leverage ratio

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The minimum leverage ratio requirement is 3% as stated in Act No. 161/2002 on Financial Undertakings.

	2016	2015
On-balance sheet exposures	1,011,735	982,348
Derivative exposures	8,226	3,789
Securities financing transaction exposures	9,330	16,287
Off-balance sheet exposures	83,156	127,675
Total exposure	1,112,447	1,130,099
Tier 1 capital	199,890	189,253
Leverage ratio	18.0%	16.7%

Solvency II

At the end of the year the Group held the insurance companies Vörður and Okkar.

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vörður was ISK 2,489 million at the end of the year and Okkar ISK574 million and calculated solvency of Vörður ISK 3,609 million and Okkar ISK 1,236 million. The solvency ratio, which is the ratio of calculated solvency to the solvency requirements, of Vörður was 145.0% and Okkar 215,0% at the end of the year.

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Notes to the Consolidated Financial Statements

SIGNIFICANT ACCOUNTING POLICIES

The accounting policies adopted in the preparation of these Consolidated Financial Statements are consistent with those followed in the preparation of the Group's Consolidated Financial Statements for the year ended 31 December 2015 except for new and amended IFRS adopted by the European Union, that became effective as of 1 January 2016, see Note 70, and amendments to Icelandic Annual Accounts Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

45. Going concern assumption

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

46. Principles underlying the consolidation

Subsidiaries

Subsidiaries are entities controlled by the Group. The Financial Statements of subsidiaries are included in the Financial Statements from the date that control commences until the date that control ceases. The Financial Statements of the subsidiaries are prepared for the same reporting period as the parent entity, using consistent accounting policies.

Business combinations

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if, and only if, the Group has:

- power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee);
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect its returns.

Generally, there is a presumption that a majority of voting rights result in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an investee, the Group considers all relevant facts and circumstances in assessing whether it has power over an investee, including (i) the contractual arrangement with the other vote holders of the investee, (ii) rights arising from other contractual arrangements and (iii) the Group's voting rights and potential voting rights. The Group re-assesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

The Group measures goodwill at the acquisition date as:

- the fair value of the consideration transferred; plus
- the recognized amount of any non-controlling interests in the acquiree; less
- if the business combination is achieved in stages, the fair value of the pre-existing equity interest in the acquiree; less
- the net recognized amount (generally fair value) of the identifiable assets acquired and liabilities assumed.

When the excess is negative, a bargain purchase gain is recognized immediately in profit or loss.

Transaction costs incurred are expensed and included in administration expense.

Non-controlling interests

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Group; such interests are presented separately in the Statement of Comprehensive Income and are included in equity in the Statement of Financial Position, separately from equity attributable to owners of the Group.

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:

- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

Changes in the Group's interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

46. Principles underlying the consolidation, continued

Loss of control

On the loss of control, the Group derecognizes the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognized in profit or loss.

Transactions eliminated on consolidation

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Financial Statements.

If an investment in a subsidiary is classified as held for sale the investment is accounted for as non-current asset and disposal groups held for sale from the date of classification.

Funds management

The Group manages and administers assets held in unit trusts and investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Financial Statements except when the Group controls the entity.

When assessing whether to consolidate investment funds, the Group reviews all facts and circumstances to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal, and hence controls and consolidates a fund, when the Group acts as fund manager and cannot be removed without cause, has variable returns through significant holdings, and is able to influence the returns of the funds by exercising its power. The Group is defined as agent in all instances.

47. Associates

Associates are those entities over which the Group has a significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Group holds 20% or more of the voting power, including potential voting rights, unless it can be clearly demonstrated that this is not the case. Investments in associates are initially recognized at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The considerations made in determining significant influence are similar to those necessary to determine control over subsidiaries.

The Group's investments in its associate are accounted for using the equity method.

The Financial Statements include the Group's share of the total recognized income and expenses of associates from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its carrying value of associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognizing its share of those profits only after its share of the profits equals the share of losses not recognized.

Upon loss of significant influence over the associate, the Group measures and recognizes any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognized in profit or loss.

Impairment on investments in associates

After applying the equity method to account for investments in associates, the Group determines whether it is necessary to recognize any impairment loss with respect to its investments in associates. The Group first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Group then tests the entire carrying amount of the investment for impairment, by comparing its recoverable amount, which is the higher of value in use and fair value less costs to sell, with its carrying amount. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the Group. The excess of the carrying amount over the recoverable amount is recognized in the Statement of Comprehensive Income as an impairment loss. Impairment losses are subsequently reversed through the Statement of Comprehensive Income if the reasons for the impairment loss no longer apply.

48. Foreign currency

Items included in the Financial Statements of each of the Group's subsidiaries are measured using the functional currency of the respective entity.

Foreign currency transactions

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. All differences arising on settlement or translation of monetary items are taken to the Statement of Comprehensive Income. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

49. Interest

Interest income and expense are recognized in the Statement of Comprehensive Income using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and financial liability and is not revised subsequently.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the Statement of Comprehensive Income include:

- interest on financial assets and liabilities at amortized cost on an effective interest rate basis;
- interest on financial assets and liabilities held for trading; and
- interest on financial assets designated at fair value through profit or loss.

50. Fee and commission

The Group provides various services to its clients and earns income therefrom, such as income from Corporate Banking, Retail Banking, Capital Markets, Corporate Finance, Asset Management and Private Banking. Fees earned from services that are provided over a certain period of time are recognized as the services are provided. Fees earned from transaction type services are recognized when the service has been completed. Fees that are performance linked are recognized when the performance criteria are fulfilled.

Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

51. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and financial liabilities classified as held for trading, Net gain on financial assets and liabilities at fair value, Net foreign exchange gain.

i) Dividend income is recognized when the right to receive dividend is established. Usually this is the ex-dividend date for equity securities.

ii) Net gain on financial assets and liabilities at fair value comprises all realized and unrealized fair value changes in trading portfolio and assets and liabilities designated at fair value through profit or loss, except for interest (which is included in Interest income and Interest expense) and foreign exchange gain and losses (which are included in Net foreign exchange gains as described below).

iii) Net foreign exchange gain comprise all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous Financial Statements.

Net foreign exchange gain also include foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognized in profit or loss.

52. Income tax expense

Tax expense comprises current and deferred tax. Income tax for the year has been calculated and recognized in the Financial Statements.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities and the realization of foreign exchange gain or loss, for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantively enacted at the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realized.

53. Financial assets and financial liabilities

Recognition

The Group initially recognizes loans, deposits, debt securities issued and subordinated liabilities on the date that they are originated. Regular way purchases and sales of financial assets are recognized on the trade date at which the Group commits to purchase or sell the asset. All other financial assets and liabilities are recognized on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

Classification

The Group classifies its financial assets in one of the following categories:

- amortized cost;
- at fair value through profit or loss and within the category as:
  - held for trading; or
  - designated at fair value through profit or loss; or
- AFS financial assets at fair value through other comprehensive income.

The Group classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortized cost or held for trading.

Designation at fair value through profit or loss

The Group has designated financial assets and liabilities at fair value through profit or loss in either of the following circumstances:

- the assets or liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

53. Financial assets and financial liabilities, continued

Derecognition

Financial assets are derecognized when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

Financial liabilities are derecognized when the obligation of the Group specified in the contract is discharged or cancelled or expires.

Offsetting

Financial assets and liabilities are set off and the net amount reported in the Statement of Financial Position when, and only when, the Group has a legal right to offset the recognized amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains or losses arising from a group of similar transactions such as in the Group's trading activity.

Amortized cost measurement

The amortized cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount recognized and the maturity amount, minus any reduction for impairment.

All consumer price indexed assets and liabilities are revalued based on the index rate at the end of the year.

Fair value measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Group measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses, and option pricing models. The Group uses widely recognized valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the Statement of Financial Position.

Identification and measurement of impairment

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

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

53. Financial assets and financial liabilities, continued

The Group considers evidence of impairment for loans at both a borrower-specific and a collective level. Borrowers for specific assessment are sampled based on a combination of the borrowers' exposure, days in default and an internal classification where customers are classified according to financial position, defaults and credit rating. In determining specific provisions for impairment on individually assessed borrowers, the following factors are considered:

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

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow.

Collective provisions are taken for all loans other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default, but have been determined not to require specific impairment.

In assessing collective impairment, two deciding, quantitative components need to be addressed in order to perform the calculation i.e. probability of default (PD) and loss given default (LGD). The Group uses internally developed probability-of-default models, which are regularly benchmarked against actual outcomes to ensure the predictive power of the models. For loss given default the Group uses internally developed models as well.

Impairment losses are recognized in profit or loss and reflected in an allowance account against loans. When an event occurring after the impairment was recognized causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognized as an increase in value of loans in profit or loss when recalculation results in an increase in carrying amount and impairment when there is a decrease in carrying amount.

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

54. Cash and cash equivalents

Cash and cash equivalents in the Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition. Cash and cash equivalents are carried at amortized cost in the Statement of Financial position.

55. Loans

Loans are financial instruments with fixed or determinable payments that are not quoted in an active market and that the Group does not intend to sell immediately or in the near term. Loans include loans provided by the Group to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

Loans are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortized cost using the effective interest method.

When the Group is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, the arrangement is classified as a capital lease and a receivable equal to the net investment in the lease is recognized and presented within loans.

When the Group purchases an asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date reverse repo or stock borrowing, the arrangement is accounted for as a loan, and the underlying asset is not recognized in the Group's Financial Statements.

56. Financial instruments

Trading assets and liabilities

Trading assets and liabilities are financial instruments acquired principally for the purpose of generating profits from short term price fluctuations or from a dealer's margin, and derivative financial instruments.

Securities used for hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts. Those assets are not subject to hedge accounting.

Financial assets designated at fair value through profit or loss

Assets classified designated at fair value through profit or loss consist of equity and debt instruments which are acquired by the Group with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial instruments and trading liabilities are initially and subsequently measured at fair value in the Statement of Financial position, with transaction costs recognized in profit or loss. All changes in fair value are recognized as part of net financial income in profit or loss.

Interest and dividend income that arises from these assets are included in Interest income and Net financial income, respectively.

Available-for-sale financial assets designated at fair value through Other comprehensive income

AFS financial assets include equity investments. Equity investments classified as AFS are those that are neither classified as held for trading nor designated at fair value through profit or loss. After initial measurement, AFS financial assets are subsequently measured at fair value with unrealized gains or losses recognized in OCI and credited in the AFS reserve until the investment is derecognized, at which time, the cumulative gain or loss is recognized in other operating income, or the investment is determined to be impaired, when the cumulative loss is reclassified from the AFS reserve to the statement of profit or loss in finance costs.

57. Derivatives

A derivative is a financial instrument or other contract, the value of which changes in response to a change in an underlying variable, such as share, commodity or bond prices, an index value or an exchange or interest rate, which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

Derivatives are recognized at fair value. Fair value changes are recognized in the Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and net financial gain or loss. Interest income is recognized on an accrual basis. Derivatives with positive fair values are recognized as Financial instruments and derivatives with negative fair values are recognized as Financial liabilities at fair value.

58. Intangible assets

Goodwill

Goodwill that arises on the acquisition of subsidiaries is presented with intangible assets. Subsequent to initial recognition goodwill is measured at cost less accumulated impairment losses.

Infrastucture and customer relationship

Infrastructure and customer relationship and related agreements are measured at cost less any accumulated impairment losses.

Software

Software acquired by the Group is measured at cost less accumulated amortization and any accumulated impairment losses.

Subsequent expenditure on software is capitalized only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Amortization of intangible assets

Amortization of intangible assets is recognized in the Statement of Comprehensive Income on a straight-line basis over the estimated useful life, from the date that it is available for use. The estimated useful life of intangible assets for the current and comparative periods is three to ten years.

59. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both.

Investment property is initially measured at cost and subsequently at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the statement of comprehensive income.

60. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than non-current assets held for resale, investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The recoverable amount of intangible assets is assessed annually.

An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in profit or loss.

The recoverable amount of an asset is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss in respect of other assets, where impairment losses have been recognized in prior periods, are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

61. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortized cost using the effective interest method.

62. Borrowings

Some of the borrowings of the Group are classified as other financial liabilities and are initially recognized at fair value less attributable transaction costs. Subsequent to initial recognition, borrowings are measured at amortized cost with any difference between cost and redemption amount being recognized in the Statement of Comprehensive Income over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

63. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within Tier II, as shown in Note 44. The Group may only retire subordinated liabilities with the permission of the Icelandic Financial Supervisory Authority.

Subordinated liabilities are recognized initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at principal amount due plus accrued interest, which is recognized in the Statement of Comprehensive Income based on the contractual terms of the borrowing.

64. Other assets and other liabilities

Property and equipment

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses. When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

Subsequent expenditure is capitalized only when it is probable that the future economic benefits of the expenditure will flow to the Group. Ongoing repairs and maintenance are expensed as incurred.

The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives are as follows:

Buildings	33-50 years
Equipment	3-7 years

The depreciation methods, useful lives and residual values are reassessed annually.

Non-current assets and disposal groups held for sale

The Group classifies a non-current asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset or disposal group and the sale must be highly probable.

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognized at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement. Revaluation through the reversal of impairment in subsequent periods is limited so that the carrying amount of the held for sale, non-current assets or disposal group does not exceed the carrying amount that would have been determined had no impairment loss been recognized in prior years.

Other assets and other liabilities

Other assets and other liabilities are stated at cost less impairment.

Insurance claim

Estimate is made in accordance with Solvency II rules. Data from the company's claim system are extrapolated to predict the final amount of the claims that will be paid at the end of the reporting period with corresponding expected payments from reporting date until the settlement of claims that occurred prior to the reporting date. In addition, estimation of settlement cost, risk and other factors is made in accordance with the instructions in Solvency II rules. This approach is consistent with the valuation of insurance liabilities in IFRS 4.

65. Equity

Dividends

Dividends on shares are recognized in equity in the period in which they are approved by Arion Bank's shareholders.

Statutory reserve

According to the Icelandic Companies Act No. 2/1995 at least 10% of the profit of the Group which is not devoted to meeting losses from previous years and is not contributed to other legal reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital. When that limit has been reached the contribution must be at least 5% of the profit until the statutory reserve amounts to 25% of the share capital of the Bank.

65. Equity, continued

Reserve for investments in subsidiaries and associates

According to the Financial Statements Act No. 3/2006 the difference between share of profit of subsidiary or associate in excess of dividend payment or dividend payment pending, shall be transferred to a restricted shareholding equity reserve, net of tax, which is not subject to dividend payments. When shareholding in subsidiary or associate is sold or written off the shareholding equity reserve shall be released and the amount transferred to retained earnings.

Reserve for investments in securities

According to the Financial Statements Act No. 3/2006 fair value changes of financial assets from the initial reporting, shall be transferred from retained earnings to a fair value equity reserve, net of tax. The fair value equity reserve is not subject to dividend payments. The fair value equity reserve shall be released in accordance with fair value changes recognized when financial asset is sold or redeemed or the assumptions for the fair value change is no longer in force.

Available-for-sale reserve

AFS reserve comprises all unrealized gain or losses related to fair value measurements of AFS financial assets.

Foreign currency translation reserve

The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the Financial Statements of foreign operations.

66. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to the shareholders of Arion Bank hf. by the weighted average number of ordinary shares outstanding during the year.

67. Financial guarantees

In the ordinary course of business, the Group gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognized in the Financial Statements at fair value, being the premium received. Subsequent to initial recognition, the Group's liability under each guarantee is measured at the higher of the amount initially recognized less, when appropriate, cumulative amortization recognized in the Statement of Comprehensive Income, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is recorded in the Statement of Comprehensive Income. The premium received is recognized in the Statement of Comprehensive Income in Net fees and commission income on a straight line basis over the life of the guarantee.

68. Fiduciary activities

The Group provides asset custody, asset management, investment management and advisory services to its clients. These services require the Group to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Group's custody are not reported in its Statement of Financial Position.

69. Employee benefits

All entities with employees within the Group have defined contribution plans. The entities pay fixed contributions to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid. The contributions are recognized as an expense in the Statement of Comprehensive Income when they become due. The Group does not operate any pension fund which confers pension rights.

70. New standards and amendments to standards

The Consolidated Financial Statements are presented in accordance with the new and revised IFRS standards and new interpretations (IFRIC), applicable in the year 2016. These new and revised IFRSs did not have material effect on amounts nor information reported in the Consolidated Financial Statements.

Amendments to IAS 27 Equity Method in Separate Financial Statements allows entities to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate Financial Statements. Entities already applying IFRS and electing to change to the equity method in their separate financial statements have to apply that change retrospectively. These amendments do not have any impact on the Bank's Consolidated Financial Statements. The amendment is effective from 1 January 2017 but will not have any impact on the Bank's Consolidated Financial Statements.

A number of new standards, amendments to standards and interpretations have been issued but are not yet effective for the year ended 31 December 2016, and have not been applied in preparing these Financial Statements. Relevant to the Group's reporting are:

IFRS 9 Financial Instruments

In July 2014, the IASB issued IFRS 9 Financial Instruments, the standard that will replace IAS 39 for annual periods on or after 1 January 2018, with early adoption permitted. The Group has set up a multidisciplinary implementation team ('the Team') with members from Risk, Finance and other relevant divisions to prepare for IFRS 9 implementation ('the Project'). IFRS 9 steering committee consists of Chief Risk and Finance officers as well as senior managers from Corporate banking and Retail banking, who regularly report to the Bank's Audit committee (BAC). The Project has six key phases: the initial assessment and analysis, design, build and test the system, parallel running in the second half of 2017, and go live in 2018. At year-end 2016 the Project is on time and the Group will be able to meet the set timeline in this project. The Group is currently evaluating the impats of IFRS 9 on the Financial Statements.

Classification and measurement

From a classification and measurement perspective, the new standard will require all financial assets, except equity instruments and derivatives, to be assessed based on a combination of the entity’s business model for managing the assets and the instruments’ contractual cash flow characteristics. The IAS 39 measurement categories will be replaced by: fair value through profit or loss (FVPL), fair value through other comprehensive income (FVOCI), and amortised cost. IFRS 9 will also allow entities to continue to irrevocably designate instruments that qualify for amortised cost or fair value through OCI instruments as FVPL, if doing so eliminates or significantly reduces a measurement or recognition inconsistency. Equity instruments that are not held for trading may be irrevocably designated as FVOCI, with no subsequent reclassification of gains or losses to the Statement of Comprehensive Income.

The accounting for financial liabilities will largely be the same as the requirements of IAS 39, except for the treatment of gains or losses arising from an entity’s own credit risk relating to liabilities designated at FVPL. Such movements will be presented in OCI with no subsequent reclassification to the Statement of Comprehensive income , unless an accounting mismatch in profit or loss would arise.

Having completed its initial assessment, the Group has concluded that:

• The majority of loans to credit institutions and loans to customers that are classified as loans and receivables under IAS 39 are expected to be measured at amortised cost under IFRS 9.

• Financial assets and liabilities held for trading and financial assets and liabilities designated at FVPL are expected to be continue to be measured at FVPL.

Arion Bank has finalised majority of the work on business models setup for each division and each classes of assets. The estimated outcome will not change the setup of the Balance Sheet significantly from IAS 39 classification.

Impairment of financial assets

IFRS 9 will also fundamentally change the loan loss impairment methodology. The standard will replace IAS 39’s incurred loss approach with a forward-looking expected loss (ECL) approach. The Group will be required to record an allowance for expected losses for all loans and other debt financial assets not held at FVPL, together with loan commitments and financial guarantee contracts. The allowance is based on the expected credit losses associated with the probability of default in the next twelve months unless there has been a significant increase in credit risk since origination, in which case, the allowance is based on the expected loss over the life of the asset - lifetime expected credit loss (LECL).

70. New standards and amendments to standards, continued

The Group has established a policy to perform an assessment at the end of each reporting period of whether credit risk has increased significantly since initial recognition by considering the change in the risk of default occurring over the remaining life of the financial instrument.

• To calculate ECL, the Group will estimates the risk of a default occurring on the financial instrument during its expected life. ECLs are estimated based on the present value of all cash shortfalls over the remaining expected life of the financial asset, i.e., the difference between: the contractual cash flows that are due to the Group under the contract, and

• The cash flows that the Group expects to receive,

• discounted at the effective interest rate of the loan.

In comparison to IAS 39, the Group expects the impairment charge under IFRS 9 to be more volatile than under IAS 39 and to result in an increase in the total level of current impairment allowances.

The Group will group its loans into Stage 1, Stage 2 and Stage 3, based on the applied impairment methodology, as described below:

• Stage 1 – Performing loans: when loans are first recognised, the Group recognises an allowance based on 12-month expected credit losses.

• Stage 2 – Underperforming loans: when a loan shows a significant increase in credit risk, the Group records an allowance for the lifetime expected credit loss.

• Stage 3 – Impaired loans: the Group recognises the lifetime expected credit losses for these loans. In addition, in Stage 3 the Group accrues interest income on the amortised cost of the loan net of allowances.

The Group will record impairment for FVOCI debt securities, depending on whether they are classified as Stage 1, 2, or 3, as explained above. However, the expected credit losses will not reduce the carrying amount of these financial assets in the statement of financial position, which will remain at fair value. Instead, an amount equal to the allowance that would arise if the asset were measured at amortised cost will be recognised in OCI as an accumulated impairment amount, with a corresponding charge to profit or loss.

For 'low risk' FVOCI debt securities, the Group intends to apply a policy which assumes that the credit risk on the instrument has not increased significantly since initial recognition and will calculate ECL as explained in Stage 1. Such instruments will generally include traded, investment grade securities where the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. The Group will not consider instruments to have low credit risk simply because of the value of collateral. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the Group's other financial instruments.

Forward looking information

The Group will incorporate forward-looking information in both the assessment of significant increase in credit risk and the measurement of ECLs.

The Group considers forward-looking information such as macroeconomic factors and economic forecasts. To evaluate a range of possible outcomes, the Group intends to formulate three scenarios: a base case, a worse case and a better case. The base case scenario represents the more likely outcome resulting from the Group's normal financial planning and budgeting process, while the better and worse case scenarios represent more optimistic or pessimistic outcomes. For each scenario, the Group will derive an ECL and apply a probability weighted approach to determine the impairment allowance.

The Group will use internal information coming from internal economic experts, combined with published external information from government and private economic forecasting services. Both the Risk and Finance management teams will need to approve the forward-looking assumptions before they are applied for different scenarios.

70. New standards and amendments to standards, continued

Limitation of estimation techniques

The models applied by the Group may not always capture all characteristics of the market at a point in time as they cannot be recalibrated at the same pace as changes in market conditions. Interim adjustments are expected to need to be made until the base models are updated. Although the Group will use data that is as current as possible, models used to calculate ECLs will be based on data that is one month in arrears and adjustments will be made for significant events occurring prior to the reporting date. The governance over such adjustments is still in development.

Capital management

The impact on capital adequacy is not possible to determine as it is expected the Basel committee will issue new rules for the transition to IFRS 9, but these are not yet final.

Presentation of the operating model

The steering committee will present the proposed operating model to BAC in second quarter of 2017.

IFRS 15 Revenue from Contracts with Customers

The standard was issued in 2014 and defines principles for recognizing revenue and will be applicable to all contracts with customers. However, interest and fee income integral to financial instruments and leases will continue to fall outside the scope of IFRS 15 and will be regulated by the other applicable standards. Revenue under IFRS 15 will need to be recognized as goods and services are transferred, to the extent that the transfer anticipates entitlement to goods and services. The standard specifies a comprehensive set of disclosure requirements. The standard will be effective for periods beginning on 1 January 2018 with early adoption permitted. The Group does not expect IFRS 15 to be adopted early and is currently evaluating its impacts.

IFRS 16 Leases

The standard issued in January 2016 does not significantly change the accounting for leases for lessors. However, it does require lessees to recognize most leases on their balance sheet as lease liabilities, with the corresponding right-to-use assets. Lessees must apply a single model for all recognized leases, but will have the option not to recognize short-term leases and leases of low-value assets. The standard is effective for annual periods beginning 1 January 2019. The Group is currently assessing the impact of the new standard.

Amendments to IAS 12 Income Taxes

The amendments clarify the accounting treatment of deferred tax assets of debt instruments measured at fair value for accounting, but measured at cost for tax purposes. The amendment is effective from 1 January 2017. The Group is currently evaluating the impact, but does not anticipate that adopting the amendments would have a material impact on its Financial Statements.

Amendments to IAS 7 Statement of Cash Flows

The amendments to the standard, issued in January 2016, are intended to improve disclosures of financing activities and help users to better understand the reporting entities' liquidity positions. Under the new requirements, entities will need to disclose changes in their financial liabilities as a result of financing activities such as changes from cash flows and non-cash items (e.g., gains and losses due to foreign currency movements). The amendment is effective from 1 January 2017. The Group is currently evaluating the impact.

Consolidated Financial Statements

– for the year 2015

Arion Bank

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The Financial Statements of Arion Bank for the year ended 31 December 2015 include the Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Outlook

The Icelandic economy performed strongly in 2015. GDP growth was 4.5% during the first nine months of the year and both investment and private consumption gained momentum. Unemployment measured 1.9% at the end of the year, compared with 4.3% the previous year. Inflation crept up slightly, with annual inflation measuring 2% in December, which was nevertheless below the Central Bank’s targets. The outlook for the Icelandic economy is reasonably bright. The most recent forecast from Arion Bank Research, from October 2015, projects GDP growth of 4.1% in 2016 and 3.1% in 2017. The average rate of unemployment can be expected to drop slightly and will be around 4% in 2016 and 3.7% in 2017. The increasd demand for labour will mainly be in the travel and construction industries. In January Arion Bank Research revised its inflation forecast downwards and now projects average inflation for 2016 of 2.3%, but this is expected to rise to 3.5% in 2017. The government's plan to lift the capital controls has gone mostly as scheduled. The Icelandic courts have approved stability contributions from the failed banks' estates and the government has already received part of these contributions from the estates, which are to be used exclusively towards the reduction of government debt. An auction releasing offshore ISK will likely be held this spring, after which capital controls will be lifted on the domestic economy. Standard & Poor’s recently upgraded Iceland’s sovereign credit rating to BBB+ with a stable outlook. At the same time it changed the outlook on Arion Bank's BBB- credit rating from stable to positive. Further ratings upgrades are expected for both Iceland and Arion Bank as the government's plan to lift capital controls materializes and as debt continues to be reduced.

Arion Bank is a leading relationship bank on the Icelandic financial market. The Bank enjoys a strong position in all its business segments: Retail Banking, Corporate Banking, Asset Management and Investment Banking. The Bank's subsidiaries further supplement its service offering and form an integral part of the Group. The main subsidiaries include Valitor hf., which is a market leader in Iceland for acquiring and payment solutions and is also with operation in Scandinavia and the United Kingdom. The Bank also owns Stefnir hf., Iceland's largest fund management company, and OKKAR Líftryggingar hf., Iceland's second largest life insurance company.

A milestone in Arion Bank's operations was reached in 2015 when the Bank largely completed the sale of direct and indirect ownership which had been acquired during the process of restructuring its clients’ debts. Arion Bank sold shares in three companies, Reitir fasteignafélag hf., Eik fasteignafélag hf. and Síminn hf., when they were listed on Nasdaq Iceland during the year. Arion Bank arranged the listing of these companies on the Icelandic stock market and they were all the IPOs in Iceland during the year. In addition a sizeable indirect holding in Refresco Gerber was sold during the year as the company was listed on the Euronext market in Amsterdam. At the end of the year the Bank also sold its interest in Klakki ehf. In January 2016 the Bank announced the sale by its subsidiary BG12 slhf. of a 46% shareholding in Bakkavor Group Ltd.

Arion Bank has not been unaffected by the prevailing situation on the global oil market as it has made loans to service companies in the industry. These loans are less than 1% of total loans to customers and have been adequately provisioned for in the Bank's accounts.

One of the proposals made by a group of restricted holders of Kaupthing claims and their advisors to the government leading up to a composition was that Kaupthing's foreign exchange exposure to Arion Bank would be termed out in an EMTN format and that Kaupthing would purchase at par the long-term FX financing provided by the Central Bank to Arion Bank, also to be changed into an EMTN format. In January 2016 the Bank reached an agreement with Kaupthing under which Arion Bank will issue a bond under its EMTN Programme in the amount of USD 747 million (ISK 97 billion). The bond is a 7-year instrument, callable on interest payment dates during the first two years. The bond bears floating LIBOR plus 2.6% for the first two years and will then, if it has not been called, be re-priced at market terms. This bond issue secures the long-term funding of Arion Bank in foreign currency.

On 22 January 2016 the Financial Stability Council published its recommendation for capital buffers which, if ratified by the FME, will impose 8.5% buffer requirements on Arion Bank when fully loaded as early as Q1 2017. Arion Bank already meets the combined Pillar 2 and fully loaded buffer requirements and does not expect to be required to increase its capital base in the coming years.

Arion Bank is financially robust as demonstrated by leverage ratio of 16.7% (see Note 45). Its liquidity position is strong, with LCR at 134%. All the ingredients are in place to enable Arion Bank to continue to offer its customers quality services in the areas which are important to them, whether in Retail Banking, Corporate Banking, Asset Management or Investment Banking.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Operations during the year

Net earnings amounted to ISK 49,679 million in 2015 and the Group's equity amounted to ISK 201,894 million at year end. The capital ratio of the Group, according to the Financial Undertakings Act No. 161/2002 was 24.2% and the Tier 1 ratio was 23.4%, which comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also strong at year end and well above the regulatory minimum.

One of Arion Bank's main tasks in recent years has been to improve the quality of its loan portfolio and to reduce the amount of problem loans. The Bank has succeded in this as the distribution of loans between individuals and companies is satisfactory and the ratio of problem loans has decreased to 2.4%.

Operations in 2015 were significantly affected by one-off events, where the sale of shareholdings in Reitir fasteignafélag hf., Eik fasteignafélag hf., Síminn hf. and Refresco Gerber had a substantial impact. Additionally, valuation changes related to the shareholding in Bakkavor Group Ltd. affected the earnings positively in 2015 after the shareholding was sold at the beginning of 2016. Core operations were strong and the Bank is well funded. Net interest income increased by 11.4% compared with 2014. Net commission income increased between years, or by 8.8%, and the increase was generated across the Bank. Net financial income totalled ISK 12,844 million, a significant proportion of this relating to profit from sale and valuation change from the holding in Refresco Gerber and valuation changes relating to holdings in Reitir fasteignafélag hf. and Síminn hf. following the company's listing on Nasdaq Iceland. The Bank's equities and bond portfolios also performed well during the year.

The Board proposes that net earnings will be added to equity and that no dividend will be paid in 2016 for the fiscal year 2015.

In November Visa Inc. and Visa Europe Ltd. announced a definitive agreement for Visa Inc. to acquire Visa Europe Ltd. Arion Bank is member of Visa Europe Ltd. through its subsidiary Valitor Holding hf. The transaction is subject to appeal and regulatory approvals and is expected to be completed in the second quarter of 2016. The expected share of profit from the sale of Visa Europe Ltd. is estimated to be ISK 2,903 million after taking into account estimated tax effects and the conditional payment to Landsbankinn hf., which was part of the agreement when Arion Bank acquired a 38% shareholding in Valitor Holding hf. from Landsbankinn hf. in 2014 (see Note 34).

The merger of the savings bank AFL - sparisjóður with Arion Bank was approved by the FME on 15 October and was effective from that day. Arion Bank will offer quality services to the former customers of the savings bank and intends to be an active participant in the savings bank's home market.

The main change on the Balance Sheet from year end 2014 is related to the funding of the Bank, i.e. the issue of bonds and an increase in the deposit base after a slight reduction at the end of 2014. This increase is reflected on the asset side by an increase in liquid assets and Loans to customers. Loans to customers increased by ISK 32,842 million during the year. The increase is partly related to new lending to businesses in the real estate sector. In April Arion Bank paid a dividend to its shareholders of ISK 12,809 million.

In March Arion Bank launched its inaugural euro senior unsecured benchmark issue, when the Bank sold EUR 300 million, or ISK 45 billion, of 3-year fixed rate bonds to around 100 international investors. It was the Bank's first public transaction in euros and the single largest transaction by an Icelandic bank in recent years, and the most important step taken by an Icelandic bank to re-enter the international capital markets since 2008.

At the end of June Arion Bank completed a 5-year bond issue of 500 million Norwegian kroner, approximately ISK 8 billion. The Bank tapped this bond issue for an additional NOK 300 million in November, taking the overall issue size to NOK 800 million. The bonds bear floating NIBOR +2.95%. In relation to these bond issues Arion Bank has repurchased NOK 394 million of a NOK 500 million issue from 2013.

During the year Arion Bank prepaid ISK 20 billion of the approximately ISK 30 billion subordinated loan from the Icelandic treasury. The loan was granted at the beginning of 2010 in connection with the recapitalization of the Bank.

Arion Bank continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. The Bank issued a total of ISK 23.6 billion of covered bonds in 2015 in the domestic market, of which ISK 15 billion were inflation-linked bonds and ISK 8.6 billion were fixed rate bonds. Arion Bank will continue to issue covered bonds on a regular basis on the domestic market in 2016.

The Group had 1,147 full-time equivalent positions at the end of the year compared with 1,120 at the end of 2014; 876 of these positions were at Arion Bank, compared with 865 at the end of 2014.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Group ownership

On behalf of its creditors Kaupthing ehf., through its subsidiary Kaupskil ehf., holds 87% of the shares in Arion Bank hf. The remaining shareholding of 13% is held by Icelandic State Financial Investments on behalf of the Icelandic government.

The Board of Directors has seven members, four women and three men. The ratio of men to women is therefore in compliance with the law which states that companies with more than 50 people should ensure that the ratio of either sex on the board of directors should not be less than 40%. Six Directors are appointed by Kaupskil ehf. and one by Icelandic State Financial Investments.

Risk management

The Group faces various risks arising from its day-to-day operations as a financial institution. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels. The Group's risk management, its structure and main risk factors are described in the notes, starting at Note 41.

Corporate governance

The Board of Directors of Arion Bank hf. is committed to good corporate governance and endeavors to promote responsible behavior and corporate culture within the Bank for the benefit of all stakeholders. Arion Bank has to this end devised a corporate governance statement which is designed to help foster open and honest communication between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. In December 2015 Arion Bank was recognized as a company which had achieved excellence in corporate governance.

The Board of Directors is the supreme authority in the affairs of the Bank between shareholders' meetings. The Board tends to those operations of the Bank which are not considered part of the Bank´s day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. One of the main duties of the Board of Directors is to appoint a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The CEO hires the Executive Management. There are three Board subcommittees: the Board Audit and Risk Committee, the Board Credit Committee and the Board Remuneration Committee. The committee members are all Directors and there is furthermore one external expert member of the Board Audit and Risk Committee.

The main roles of the Board, as further specified in the rules of procedure of the Board, include approving the Bank's strategy, supervising the financial affairs and accounting and ensuring that appropriate internal controls are in place. The Board ensures that the Bank has active Internal Audit, Compliance and Risk Management departments. The Internal Auditor is appointed by the Board of Directors and works independently of other departments of the Bank in accordance with a charter from the Board. The Internal Auditor provides independent and objective assurance and advice designed to add value and improve the Bank's operations. The Compliance Officer, who reports directly to the CEO, works independently within the Bank in accordance with a charter from the Board. The chief role of the Compliance Officer is to ensure that the Bank and its employees fulfil their obligations under the Securities Transactions Act and the Act on Measures against Money Laundering and Terrorist Financing.

Corporate governance at Arion Bank is described in more detail in the Bank's Corporate Governance Statement which is contained in the unaudited appendix to the Financial Statement and on the website www.arionbanki.is. The Corporate Governance Statement is based on the legislation, regulations and recognized guidelines in force when the Bank's annual financial statement are adopted by the Board of Directors. This statement is prepared in accordance with the Financial Undertakings Act No. 161/2002 and Guidelines on Corporate Governance, 5th edition, issued by the Icelandic Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland in May 2015. Corporate governance at Arion Bank complies with the guidelines with a few exceptions, which are explained in more detail in the Corporate Governance Statement.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Endorsement of the Board of Directors and the Chief Executive Officer

The Financial Statements of Arion Bank for the year ended 31 December 2015 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions.

It is our opinion that the Financial Statements give a true and fair view of the financial performance of the Group for the year 2015 and its financial position as at 31 December 2015.

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

The Board of Directors and the CEO have today discussed the Financial Statements of Arion Bank for the year 2015 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 24 February 2016

Board of Directors

Monica Caneman
Chairman

Benedikt Olgeirsson

Guðrún Johnsen

Måns Höglund

Brynjólfur Bjarnason

Kirstín Þ. Flygenring

Þóra Hallgrímsdóttir

Chief Executive Officer

Höskuldur H. Ólafsson

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Shareholders of Arion Bank.

We have audited the accompanying Consolidated Financial Statements of Arion banki hf., which comprise the Consolidated Statement of Comprehensive Income for the year 2015, Consolidated Statement of Financial Position as at 31 December 2015, Consolidated Statement of Changes in Equity and Consolidated Statement of Cash Flow for the year 2015, and a summary of significant accounting policies and other explanatory information.

The Board of Directors and Management's Resposibility for the Consolidated Financial Statements

Management and the board of directors are responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these Consolidated Financial Statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Consolidated Financial Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Consolidated Financial Statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the Consolidated Financial Statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the Consolidated Financial Statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Consolidated Financial Statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the Consolidated Financial Statements give a true and fair view, of the consolidated financial position of Arion banki hf. as of December 31, 2015, and its consolidated financial performance and its consolidated cash flows for the period then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Confirmation of Endorsement and Statement by the Board of Directors and the CEO

Pursuant to the requirements of Article 104 of the Icelandic Financial Statements Act No. 3/2006, we confirm to the best of our knowledge that the accompanying Endorsement and Statement by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statements Act.

Kópavogur, 24 February 2016

Deloitte ehf.

Páll Grétar Steingrímsson
State Autorised Public Accountant

Gunnar Þorvarðarson
State Autorised Public Accountant

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR 2015

	Notes	2015	2014
Interest income		54,546	50,872
Interest expense		(27,554)	(26,652)
Net interest income	6	26,992	24,220
Fee and commission income		21,234	18,447
Fee and commission expense		(6,750)	(5,138)
Net fee and commission income	7	14,484	13,309
Net financial income	8	12,844	7,290
Share of profit of associates	24	29,466	3,498
Other operating income	9	2,769	5,673
Operating income		86,555	53,990
Salaries and related expense	10	(14,892)	(13,979)
Other operating expense	11	(13,304)	(13,063)
Bank levy	12	(2,818)	(2,643)
Net impairment	13	(3,087)	2,135
Earnings before tax		52,454	26,440
Income tax expense	14	(3,135)	(4,679)
Net earnings from continuing operations		49,319	21,761
Net gain from discontinued operations, net of tax	15	360	6,833
Net earnings		49,679	28,594
Other comprehensive income			
Net gain on AFS financial assets, net of tax		2,903	-
Exchange difference on translating foreign subsidiaries	32	13	(5)
Net other comprehensive income to be reclassified to profit or loss in subsequent periods		2,916	(5)
Total comprehensive income		52,595	28,589
Attributable to			
Shareholders of Arion Bank		44,884	28,465
Non-controlling interest		7,711	129
Total comprehensive income		52,595	28,594
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	16	22.26	10.82

The notes on pages 13 to 78 are an integral part of these Financial Statements.

Arion Bank Consolidated Financial Statements 2015 8 Amounts are in ISK millions

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DESEMBER 2015

Assets	Notes	2015	2014
Cash and balances with Central Bank	17	48,102	21,063
Loans to credit institutions	18	87,491	108,792
Loans to customers	19	680,350	647,508
Financial instruments	20-22	133,191	101,828
Investment property	22	7,542	6,842
Investments in associates	24	27,299	21,966
Intangible assets	25	9,285	9,596
Tax assets	26	205	655
Other assets	27	17,578	15,486
Total Assets		1,011,043	933,736
Liabilities			
Due to credit institutions and Central Bank	21	11,387	22,876
Deposits	21	469,347	454,973
Financial liabilities at fair value	21	7,609	9,143
Tax liabilities	26	4,922	5,123
Other liabilities	28	49,461	47,190
Borrowings	21,29	256,058	200,580
Subordinated liabilities	21,30	10,365	31,639
Total Liabilities		809,149	771,524
Equity			
Share capital and share premium	32	75,861	75,861
Other reserves	32	4,548	1,632
Retained earnings		112,377	83,218
Total Shareholders' Equity		192,786	160,711
Non-controlling interest		9,108	1,501
Total Equity		201,894	162,212
Total Liabilities and Equity		1,011,043	933,736

The notes on pages 13 to 78 are an integral part of these Financial Statements.

Arion Bank Consolidated Financial Statements 2015 9 Amounts are in ISK millions

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR 2015

	Share capital and share premium	Other reserves	Retained earnings	**Total share-holders' equity**	Non-controlling interest	**Total equity**
Equity 1 January 2015	75,861	1,632	83,218	160,711	1,501	162,212
Net earnings	-	-	41,968	41,968	7,711	49,679
Other comprehensive income	-	2,916	-	2,916	-	2,916
Total comprehensive income	-	2,916	41,968	44,884	7,711	52,595
Dividend paid	-	-	(12,809)	(12,809)	-	(12,809)
Decrease due to purchase of non-controlling interest	-	-	-	-	(104)	(104)
Equity 31 December 2015	75,861	4,548	112,377	192,786	9,108	201,894
Equity 1 January 2014	75,861	1,637	62,591	140,089	4,858	144,947
Net earnings	-	-	28,465	28,465	129	28,594
Other comprehensive income	-	(5)	-	(5)	-	(5)
Total comprehensive income	-	(5)	28,465	28,460	129	28,589
Dividend paid	-	-	(7,811)	(7,811)	-	(7,811)
Increase in non-controlling interests due to purchase of subsidiary	-	-	-	-	10	10
Decrease due to purchase of non-controlling interest	-	-	(27)	(27)	(3,496)	(3,523)
Equity 31 December 2014	75,861	1,632	83,218	160,711	1,501	162,212

The notes on pages 13 to 78 are an integral part of these Financial Statements.

Arion Bank Consolidated Financial Statements 2015 10 Amounts are in ISK millions

CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR 2015

	2015	2014
Operating activities		
Net earnings	49,679	28,594
Non-cash items included in net earnings and other adjustments	(51,720)	(36,549)
Changes in operating assets and liabilities	16,109	(4,608)
Interest received	41,178	45,020
Interest paid*	(22,108)	(23,403)
Dividend received	7,954	875
Income tax paid	(4,499)	(6,545)
Net cash from operating activities	36,593	3,384
Investing activities		
Acqusition of associates	(262)	(123)
Proceeds from sale of associates	17,148	4,603
Dividend from associates	611	16
Acqusition of subsidiary	-	(3,100)
Acqusition of intangible assets	(790)	(603)
Acqusition of property and equipment	(711)	(1,866)
Proceeds from sale of property and equipment	30	563
Net cash from (used in) investing activities	16,026	(510)
Financing activities		
Payment of subordinated liabilities	(19,883)	-
Dividend paid to shareholders of Arion Bank	(12,809)	(7,811)
Acquisition of non-controlling interest	(118)	(3,516)
Net cash used in financing activities	(32,810)	(11,327)
Net increase (decrease) in cash and cash equivalents	19,809	(8,453)
Cash and cash equivalents at beginning of the year	91,715	99,683
Cash and cash equivalents acquired through business combinations	-	9
Effect of exchange rate changes on cash and cash equivalents	(1,524)	476
Cash and cash equivalents at the end of the year	110,000	91,715
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	2,768	1,617
Settlement of loans through foreclosure on collateral from customers with view to resale	(2,768)	(1,617)
Changes due to the sale of Landfestar		
Changes in investment property	-	(23,131)
Changes in investment in asscociates	-	7,242
Changes in borrowings	-	14,769
Changes in tax liabilities	-	1,120

* Interest paid includes interest credited to deposit accounts at the end of the year.

The notes on pages 13 to 78 are an integral part of these Financial Statements.

Arion Bank Consolidated Financial Statements 2015 11 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR 2015

	2015	2014
Non-cash items included in net earnings and other adjustments		
Net interest income	(26,992)	(24,220)
Net impairment	3,087	(2,135)
Income tax expense	3,135	4,679
Bank levy	2,818	2,643
Net foreign exchange loss (gain)	182	(813)
Net gain on financial instruments	(5,072)	(5,602)
Depreciation and amortisation	1,656	2,034
Share of profit of associates and fair value change	(29,466)	(3,498)
Investment property, fair value change	(422)	(2,026)
Net gain from discontinued operations, net of tax	(360)	(6,833)
Other changes	(286)	(778)
Non-cash items included in net earnings and other adjustments	(51,720)	(36,549)
Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	(3,700)	52
Loans to credit institutions, excluding bank accounts	13,637	1,251
Loans to customers	(29,588)	(7,488)
Financial instruments and financial liabilities at fair value	(23,655)	(4,626)
Investment property	54	3,425
Other assets	2,660	14,013
Due to credit institutions and Central Bank	(11,266)	(5,094)
Deposits	19,704	(16,361)
Borrowings	53,070	6,785
Other liabilities	(4,807)	3,435
Changes in operating assets and liabilities	16,109	(4,608)
Cash and cash equivalents		
Cash in hand and demand deposits	48,102	21,063
Due from credit institutions	74,533	79,587
Mandatory reserve with Central Bank	(12,635)	(8,935)
Cash and cash equivalents	110,000	91,715

The notes on pages 13 to 78 are an integral part of these Financial Statements.

Arion Bank Consolidated Financial Statements 2015 12 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
CONTENTS

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

GENERAL INFORMATION

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Financial Statements for the year ended 31 December 2015 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions.

The Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 24 February 2016.

Basis of measurement

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

- financial assets and financial liabilities held for trading are measured at fair value;
- financial assets and financial liabilities at fair value are measured at fair value;
- financial assets classified as available-for-sale are measured at fair value;
- investment properties are measured at fair value; and
- non-current assets and disposal groups classified as held for sale are stated at the lower of their carrying amount and fair value, less costs to sell.

Functional and presentation currency

The Financial Statements are presented in Icelandic Krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the year the exchange rate of the ISK against the USD was 130.08 and 141.28 for the EUR (31.12.2014: USD 127.46 and EUR 154.28).

2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Financial Statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

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

The key sources of estimation uncertainty are within impairment losses and reversal of impairment losses on loans.

3. The Group

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

	Operating activity	Currency	Equity interest 2015	2014
AFL - sparisjóður, Aðalgata 34, Siglufjörður, Iceland	Retail banking	ISK	-	99.3%
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland	Retail banking	ISK	100.0%	100.0%
BG12 slhf., Katrínartún 2, Reykjavík, Iceland	Holding company	ISK	62.0%	62.0%
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Eignabjarg ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	-	100.0%
Eignarhaldsfélagið Landey ehf., Grófin 1, Reykjavík, Iceland	Real estate	ISK	100.0%	100.0%
Kolufell ehf., Borgartún 19, Reykjavík, Iceland	Real estate	ISK	68.9%	68.9%
Okkar líftryggingar hf., Laugavegur 182, Reykjavík, Iceland	Life insurance	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjörður, Iceland	Payment solutions	ISK	100.0%	98.8%

In September Arion Bank had acquired 100% shareholding in AFL - sparisjóður and in October the two entities were merged.

Eignabjarg ehf. was liquidated at year end after having sold its shareholding in the associated company Reitir fasteignafélag hf. in 2015, see note 24.

In 2015 the Bank increased its shareholding in Valitor Holding hf. and holds 100% shareholding at year end.

Arion Bank Consolidated Financial Statements 2015 15 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

OPERATING SEGMENT REPORTING

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. In presenting the geographic information, segment revenue has been based on the geographic location of customers.

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

Operating segments

The Group comprises six main operating segments:

Asset Management comprises Institutional Asset Management, Private Banking, Investment Services and Pension Fund Administration. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Asset Management also administers pension funds. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

Corporate Banking provides comprehensive financial services and customized solutions to larger corporate clients in Iceland. Corporate Banking provides a full range of conventional lending products, deposit accounts as well as value added electronic corporate solutions to meet the needs of each customer.

Investment Banking is divided into Corporate Advisory, Capital Markets and Research. Corporate Advisory advises customers on securities offerings and the admission of securities for trading on regulated securities markets and also provides M&A advisory services. Capital Markets handles securities brokerage and foreign exchange trading for the Bank's customers. Research publishes regular analyses of listed securities, the major business sectors, markets and the Icelandic economy and also produces economic forecasts. Investment Banking's customers are private individuals, companies and institutions. Investment Banking is responsible for the holding companies BG12 slhf., EAB 1 ehf. and Kolufell ehf.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of services. This includes among other deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into five clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Retail Banking's 23 branches all around Iceland have a total of more than 100,000 customers.

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

Other divisions and Subsidiaries include market making in domestic securities and currencies. The subsidiaries are Eignarhaldsfélagið Landey ehf., Okkar líftryggingar hf., Valitor Holding hf. and other smaller entities of the Group.

Headquarters include: Overhead, Risk Management, Accounting, Legal, Corporate Development and Marketing, Human Resources and Operations.

4. Operating segments

2015	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub- sidiaries	Head- quarters and Elimination	Total
Net interest income	462	6,023	101	13,877	5,803	708	18	26,992
Net fee and commission income	4,183	1,059	2,153	2,656	(313)	4,106	640	14,484
Net financial income	226	(37)	8,304	158	872	814	2,507	12,844
Share of profit of associates	-	-	25,436	-	-	513	3,517	29,466
Other operating income	11	(33)	440	(345)	396	1,505	795	2,769
Operating income	4,882	7,012	36,434	16,346	6,758	7,646	7,477	86,555
Operating expense	(1,451)	(547)	(1,152)	(6,011)	(256)	(6,001)	(12,778)	(28,196)
Bank levy	-	-	-	-	-	-	(2,818)	(2,818)
Net impairment	-	(3,074)	3,030	(2,258)	11	(868)	72	(3,087)
Earnings before tax	3,431	3,391	38,312	8,077	6,513	777	(8,047)	52,454
Net seg. rev. from ext. customers	2,589	14,245	37,119	26,947	(9,809)	8,033	7,431	86,555
Net seg. rev. from other segments	2,293	(7,233)	(685)	(10,601)	16,567	(387)	46	-
Operating income	4,882	7,012	36,434	16,346	6,758	7,646	7,477	86,555
Depreciation and amortisation	-	-	-	287	-	576	793	1,656
Total assets	5,884	236,621	62,904	448,547	179,375	50,166	27,546	1,011,043
Total liabilities	1,027	180,588	22,114	396,514	161,154	30,615	17,137	809,149
Allocated equity	4,857	56,033	40,790	52,033	18,221	19,551	10,409	201,894
2014								
Net interest income	449	7,001	135	12,612	4,871	191	(1,039)	24,220
Net fee and commission income	3,546	1,337	2,050	2,333	(126)	3,840	329	13,309
Net financial income	137	57	5,268	304	(290)	843	971	7,290
Share of profit of associates	-	-	179	-	-	3,384	(65)	3,498
Other operating income	12	1,086	8	28	(1)	3,828	712	5,673
Operating income	4,144	9,481	7,640	15,277	4,454	12,086	908	53,990
Operating expense	(1,409)	(570)	(722)	(6,047)	(268)	(5,226)	(12,800)	(27,042)
Bank levy	-	-	-	-	-	-	(2,643)	(2,643)
Net impairment	-	3,392	(497)	(1,037)	295	(45)	27	2,135
Earnings before tax	2,735	12,303	6,421	8,193	4,481	6,815	(14,508)	26,440
Net seg. rev. from ext. customers	2,349	17,762	8,146	23,614	(12,087)	12,043	2,163	53,990
Net seg. rev. from other segments	1,795	(8,281)	(506)	(8,337)	16,541	43	(1,255)	-
Operating income	4,144	9,481	7,640	15,277	4,454	12,086	908	53,990
Depreciation and amortisation	-	-	-	458	-	339	1,237	2,034
Total assets	5,230	231,575	33,730	416,912	160,210	65,459	20,620	933,736
Total liabilities	2,415	188,374	28,333	364,266	129,928	40,131	18,077	771,524
Allocated equity	2,815	43,201	5,397	52,646	30,282	25,328	2,543	162,212

Arion Bank Consolidated Financial Statements 2015 17 Amounts are in ISK millions

4. Operating segments, continued

Geographic information

2015	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	26,614	772	17	(851)	375	65	26,992
Net fee and commission income	8,376	1,731	605	3,672	95	5	14,484
Net financial income	10,315	(60)	(175)	2,850	(106)	20	12,844
Other income	11,390	-	20,845	-	-	-	32,235
Operating income	56,695	2,443	21,292	5,671	364	90	86,555

2014	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	23,117	126	42	559	347	29	24,220
Net fee and commission income	10,690	988	231	1,373	20	7	13,309
Net financial income	7,101	154	34	(206)	234	(27)	7,290
Other income	9,171	-	-	-	-	-	9,171
Operating income	50,079	1,268	307	1,726	601	9	53,990

Discontinued operations are excluded from the profit and loss segment information.

Arion Bank Consolidated Financial Statements 2015 18 Amounts are in ISK millions

QUARTERLY STATEMENTS

5. Operations by quarters

2015	Q4	Q3	Q2	Q1	Total
Net interest income	6,705	7,112	7,392	5,783	26,992
Net fee and commission income	3,758	3,292	3,677	3,757	14,484
Net financial income	2,668	453	2,184	7,539	12,844
Share of profit of associates	22,510	2,739	6	4,211	29,466
Other operating income	537	709	1,032	491	2,769
Operating income	36,178	14,305	14,291	21,781	86,555
Salaries and related expense	(4,572)	(3,153)	(3,675)	(3,492)	(14,892)
Other operating expense	(4,288)	(3,012)	(3,108)	(2,896)	(13,304)
Bank levy	(650)	(779)	(659)	(730)	(2,818)
Net impairment	(2,973)	(33)	(1,863)	1,782	(3,087)
Earnings before tax	23,695	7,328	4,986	16,445	52,454
Income tax expense	504	(1,272)	(647)	(1,720)	(3,135)
Net earnings from continuing operations	24,199	6,056	4,339	14,725	49,319
Net gain from discontinued operations, net of tax	83	15	79	183	360
Net earnings	24,282	6,071	4,418	14,908	49,679

2014	Q4	Q3	Q2	Q1	Total
Net interest income	5,911	6,343	6,483	5,483	24,220
Net fee and commission income	3,190	3,526	3,445	3,148	13,309
Net financial income	1,429	1,994	4,439	(572)	7,290
Share of profit of associates	3,525	53	(16)	(64)	3,498
Other operating income	1,683	636	2,372	982	5,673
Operating income	15,738	12,552	16,723	8,977	53,990
Salaries and related expense	(3,953)	(2,862)	(3,714)	(3,450)	(13,979)
Other operating expense	(4,465)	(2,787)	(3,064)	(2,747)	(13,063)
Bank levy	(635)	(633)	(715)	(660)	(2,643)
Net impairment	(742)	876	34	1,967	2,135
Earnings before tax	5,943	7,146	9,264	4,087	26,440
Income tax expense	(223)	(1,989)	(1,152)	(1,315)	(4,679)
Net earnings from continuing operations	5,720	5,157	8,112	2,772	21,761
Net gain from discontinued operations, net of tax	241	67	6,433	92	6,833
Net earnings	5,961	5,224	14,545	2,864	28,594

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

Arion Bank Consolidated Financial Statements 2015 19 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

6. Net interest income

	2015	2014
Interest income		
Cash and balances with Central Bank	736	703
Loans	49,414	45,810
Securities	3,532	3,664
Other	864	695
Interest income	54,546	50,872
Interest expense		
Deposits	(15,453)	(15,982)
Borrowings	(11,344)	(9,270)
Subordinated liabilities	(701)	(1,291)
Other	(56)	(109)
Interest expense	(27,554)	(26,652)
Net interest income	26,992	24,220
Net interest income from assets and liabilities at fair value	3,532	3,664
Interest income from assets not at fair value	51,014	47,208
Interest expense from liabilities not at fair value	(27,554)	(26,652)
Net interest income	26,992	24,220
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	3.0%	2.8%

7. Net fee and commission income

	2015			2014		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	4,463	(218)	4,245	3,863	(162)	3,701
Cards	11,532	(5,945)	5,587	9,223	(4,150)	5,073
Collection and payment services	1,349	(93)	1,256	1,288	(93)	1,195
Investment banking	1,740	(56)	1,684	1,886	(40)	1,846
Lending and guarantees	1,431	-	1,431	1,430	-	1,430
Other	719	(438)	281	757	(693)	64
Net fee and commission income	21,234	(6,750)	14,484	18,447	(5,138)	13,309

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.

Arion Bank Consolidated Financial Statements 2015 20 Amounts are in ISK millions

8. Net financial income

	2015	2014
Dividend income	7,954	875
Net gain (loss) on financial assets and financial liabilities classified as held for trading	1,157	(150)
Net gain on financial assets and financial liabilities designated at fair value through profit or loss	3,915	5,752
Net foreign exchange (loss) gain	(182)	813
Net financial income	12,844	7,290

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

	2015	2014
Equity instruments designated at fair value	3,692	5,963
Interest rate instruments designated at fair value	223	(211)
Net gain on financial assets and financial liabilities designated at fair value through profit or loss	3,915	5,752

9. Other operating income

	2015	2014
Rental income from investment property	40	1,236
Fair value changes on investment property	422	1,091
Realised gain on investment property	286	1,231
Earned premiums, net of reinsurance	1,145	1,005
Other income	876	1,110
Other operating income	2,769	5,673

10. Personnel and salaries

Number of employees

	2015	2014
Average number of full time equivalent positions during the year	1,139	1,128
Full time equivalent positions at the end of the year	1,147	1,120

The Bank's number of employees

	2015	2014
Average number of full time equivalent positions during the year	885	890
Full time equivalent positions at the end of the year	876	865

Salaries and related expense

	2015	2014
Salaries	11,522	10,903
Defined contribution pension plans	1,637	1,539
Salary related expense	1,733	1,537
Salaries and related expense	14,892	13,979

Salaries and related expense for the Bank

	2015	2014
Salaries	8,780	8,458
Defined contribution pension plans	1,216	1,164
Salary related expense	1,432	1,393
Salaries and related expense	11,428	11,015

In 2015 the Group made a provision of ISK 599 million (2014: ISK 542 million) for performance plan payments, including salary related expense, thereof the Bank made a provision of ISK 461 million (2014: ISK 477 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for financial undertakings. At the end of the year the Group's accrual for performance plan payments amounts to ISK 1,056 million (31.12.2014: ISK 741 million), thereof the Bank's accrual amounts to ISK 852 million (31.12.2014: ISK 639 million).

Arion Bank Consolidated Financial Statements 2015 21 Amounts are in ISK millions

10. Personnel and salaries, continued

Compensation of key management personnel	2015 Fixed remuner-ation*	2015 Additional remuner-ation**	2015 Total	2014 Fixed remuner-ation*	2014 Additional remuner-ation**	2014 Total
Monica Caneman, Chairman of the Board	18.4	2.4	20.7	17.7	2.2	19.9
Guðrún Johnsen, Vice Chairman of the Board	6.9	4.7	11.6	6.6	5.4	12.0
Benedikt Olgeirsson, Director	4.6	1.8	6.4	4.4	1.4	5.8
Brynjólfur Bjarnason, Director from 20.11.2014	4.6	1.4	6.0	0.6	-	0.6
Kirstín Þ. Flygenring, Director from 20.3.2014	4.6	1.8	6.4	3.4	1.4	4.8
Måns Höglund, Director	9.3	4.2	13.5	8.9	4.0	12.9
Þóra Hallgrímsdóttir, Director	4.6	3.7	8.3	4.4	3.6	8.0
Agnar Kofoed-Hansen, Director until 20.3.2014	-	-	-	1.1	0.9	2.0
Björgvin Skúli Sigurðsson, Director until 9.10.2014	-	-	-	3.4	0.9	4.3
Alternate directors of the Board	2.5	-	2.5	1.6	0.9	2.5
Total remuneration	55.4	20.0	75.4	52.1	20.7	72.8

	2015 Salaries	2015 Performance based payments	2014 Salaries	2014 Performance based payments
Höskuldur H. Ólafsson, CEO	55.9	7.2	52.2	6.3
Nine managing directors of the Bank's divisions being members of the Bank's Executive Committee	254.7	26.4	227.5	24.0

Performance based payments in 2015 are based on the Group's performance in 2014.

Board Members receive remuneration for their involvement in board committees. In addition to 16 Board meetings (2014: 11), during the year 11 Board Credit Committee meetings (2014: 12), 7 Board Audit and Risk Committee meetings (2014: 5) and 7 Board Remuneration Committee meetings (2014: 7) were held. Four committee meetings with alternate directors of the Board were held in 2015 (2014: 4).

The 2015 Annual General Meeting of the Bank held on 19 March 2015 approved the monthly salaries for 2015 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 770,000, ISK 577,500 and ISK 385,000 (2014: ISK 750,000; 562,500; 375,000) respectively. It was also approved that the salary of Alternate Board Members would be ISK 195,000 (2014: ISK 187,500) per meeting, up to a maximum of ISK 385,000 (2014: ISK 375,000) per month. For foreign Board Members, the aforementioned figures are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 154,000 (2014: ISK 150,000) per month for each committee they serve on and the Chairman of the board committees ISK 200,000 (2014: ISK 195,000).

* Fixed remuneration represents Board Member compensation for their attendance at meetings of the Board of Directors.
** Additional remuneration represents Board Member compensation for their participation in Board Committees.

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11. Other operating expense

	2015	2014
Administration expense	10,330	9,532
Depositors' and investors' guarantee fund	836	829
Depreciation of property and equipment	849	1,456
Amortisation of intangible assets	807	578
Direct operating expense derived from investment properties	97	327
Claims incurred, net of reinsurance	385	341
Other operating expense	13,304	13,063

Auditor's fee

	2015	2014
Audit and review of the Financial Statements for the relevant fiscal year	150	171
Other audit related services for the relevant fiscal year	3	16
Auditor's fee	153	187
Thereof fee to others than the auditor of the Parent company	3	8

12. Bank levy

The Bank levy is 0.376% on total debt excluding tax liabilities, in excess of ISK 50 billions. Non-financial subsidiaries are exempt from this tax. The tax is assessed on financial institutions to meet the funding of a special index and interest relief provided to individual tax payers.

13. Net impairment

	2015	2014
Increase in book value of loans to corporates	2,488	2,448
Increase in book value of loans to individuals	2,208	1,907
Increase in book value of other assets	-	715
Net change in impairment of loans to corporates	(3,818)	(148)
Net change in impairment of loans to individuals	(3,421)	(2,391)
Net change in collective impairment on loans	(517)	(367)
Impairment of intangible assets	(27)	(29)
Net impairment	(3,087)	2,135

Arion Bank Consolidated Financial Statements 2015 23 Amounts are in ISK millions

14. Income tax expense

	2015	2014
Current tax expense	1,659	4,474
Deferred tax expense	1,476	205
Income tax expense	**3,135**	**4,679**

Reconciliation of effective tax rate	2015		2014	
Earnings before tax		52,454		26,440
Income tax using the Icelandic corporation tax rate	20.0%	10,491	20.0%	5,288
Additional 6% tax on financial institutions	1.2%	628	3.4%	894
Non-deductible expenses	0.0%	13	0.8%	201
Tax exempt revenue	(16.4%)	(8,597)	(7.7%)	(2,047)
Non-deductible taxes	1.1%	564	2.0%	529
Other changes	0.1%	36	(0.7%)	(186)
Effective tax rate	6.0%	3,135	17.7%	4,679

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

Tax exempt revenues consist mainly of profit from equity positions.

15. Net gain from discontinued operations, net of tax

	2015	2014
Net gain from associated companies	-	6,290
Net gain from real estates and other assets	360	543
Net gain from discontinued operations, net of tax	**360**	**6,833**

16. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2015	2014	2015	2014
Net earnings attributable to the shareholders of Arion Bank	44,524	21,632	44,884	28,465
Weighted average number of outstanding shares for the year, million	2,000	2,000	2,000	2,000
Basic earnings per share	22.26	10.82	22.44	14.23

There were no instruments at the end of the year that could potentially dilute basic earnings per share (31.12.2014: none).

Arion Bank Consolidated Financial Statements 2015 24 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

17. Cash and balances with Central Bank

	2015	2014
Cash on hand	4,921	5,255
Cash with Central Bank	30,546	6,873
Mandatory reserve deposit with Central Bank	12,635	8,935
Cash and balances with Central Bank	48,102	21,063

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

18. Loans to credit institutions

	2015	2014
Bank accounts	74,533	79,587
Money market loans	7,976	23,007
Other loans	4,982	6,198
Loans to credit institutions	87,491	108,792

19. Loans to customers

2015	Individuals	Corporates	Total
Overdrafts	16,840	24,248	41,088
Credit cards	10,842	1,054	11,896
Mortgage loans	271,895	12,889	284,784
Other loans	38,058	334,849	372,907
Provision on loans	(13,016)	(17,309)	(30,325)
Loans to customers	324,619	355,731	680,350

2014			
Overdrafts	17,955	24,420	42,375
Credit cards	11,065	943	12,008
Mortgage loans	271,639	10,406	282,045
Other loans	33,763	303,998	337,761
Provision on loans	(13,111)	(13,570)	(26,681)
Loans to customers	321,311	326,197	647,508

The total book value of pledged loans that were pledged against amounts borrowed was ISK 199 billion at the end of the year (31.12.2014: ISK 197 billion). Pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies.

Further analysis of loans is provided in Risk Management Disclosures.

Arion Bank Consolidated Financial Statements 2015 25 Amounts are in ISK millions

19. Loans to customers, continued

Changes in the provision for losses on loans to customers

2015	Specific	Collective	Total
Balance at the beginning of the year	22,214	4,467	26,681
Provision for losses	7,239	517	7,756
Write-offs	(5,492)	-	(5,492)
Payment of loans previously written off	1,380	-	1,380
Balance at the end of the year	25,341	4,984	30,325

2014			
Balance at the beginning of the year	25,126	4,100	29,226
Provision for losses	2,539	367	2,906
Write-offs	(5,937)	-	(5,937)
Payment of loans previously written off	486	-	486
Balance at the end of the year	22,214	4,467	26,681

Significant accounting estimates and judgements

Key sources of estimation uncertainty are impairment losses on loans.

The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 54. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the Credit Risk function.

20. Financial instruments

	2015	2014
Bonds and debt instruments	78,794	66,466
Shares and equity instruments with variable income	35,504	25,232
Derivatives	2,401	1,026
Securities used for hedging	16,492	9,104
Financial instruments	133,191	101,828

Arion Bank Consolidated Financial Statements 2015 26 Amounts are in ISK millions

21. Financial assets and financial liabilities

2015	Amortised cost	Trading	Designated at fair value	Available for sale	Total
Loans					
Cash and balances with Central Bank	48,102	-	-	-	48,102
Loans to credit institutions	87,491	-	-	-	87,491
Loans to customers	680,350	-	-	-	680,350
Loans	815,943	-	-	-	815,943
Bonds and debt instruments					
Listed	-	2,526	74,757	-	77,283
Unlisted	-	99	1,412	-	1,511
Bonds and debt instruments	-	2,625	76,169	-	78,794
Shares and equity instruments with variable income					
Listed	-	2,138	13,869	-	16,007
Unlisted	-	1,668	10,665	5,852	18,185
Bond funds with variable income, unlisted	-	1,090	222	-	1,312
Shares and equity instruments with variable income	-	4,896	24,756	5,852	35,504
Derivatives					
OTC derivatives	-	2,401	-	-	2,401
Derivatives	-	2,401	-	-	2,401
Securities used for hedging					
Bonds and debt instruments, listed	-	1,519	-	-	1,519
Shares and equity instruments with variable income, listed	-	14,276	-	-	14,276
Shares and equity instruments with variable income, unlisted	-	697	-	-	697
Securities used for hedging	-	16,492	-	-	16,492
Other financial assets	4,581	-	-	-	4,581
Financial assets	820,524	26,414	100,925	5,852	953,715
Liabilities at amortised cost					
Due to credit institutions and Central Bank	11,387	-	-	-	11,387
Deposits	469,347	-	-	-	469,347
Borrowings	256,058	-	-	-	256,058
Subordinated liabilities	10,365	-	-	-	10,365
Liabilities at amortised cost	747,157	-	-	-	747,157
Financial liabilities at fair value					
Short position in bonds	-	4,616	-	-	4,616
Derivatives	-	2,993	-	-	2,993
Financial liabilities at fair value	-	7,609	-	-	7,609
Other financial liabilities	38,667	-	-	-	38,667
Financial liabilities	785,824	7,609	-	-	793,433

Arion Bank Consolidated Financial Statements 2015 27 Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

2014	Amortised cost	Trading	Designated at fair value	Available for sale	Total
Loans					
Cash and balances with Central Bank	21,063	-	-	-	21,063
Loans to credit institutions	108,792	-	-	-	108,792
Loans to customers	647,508	-	-	-	647,508
Loans	777,363	-	-	-	777,363
Bonds and debt instruments					
Listed	-	3,157	61,421	-	64,578
Unlisted	-	36	1,852	-	1,888
Bonds and debt instruments	-	3,193	63,273	-	66,466
Shares and equity instruments with variable income					
Listed	-	1,538	7,079	-	8,617
Unlisted	-	1,613	13,901	-	15,514
Bond funds with variable income, unlisted	-	928	173	-	1,101
Shares and equity instruments with variable income	-	4,079	21,153	-	25,232
Derivatives					
OTC derivatives	-	1,026	-	-	1,026
Derivatives	-	1,026	-	-	1,026
Securities used for hedging					
Bonds and debt instruments, listed	-	3,212	-	-	3,212
Shares and equity instruments with variable income, listed	-	4,911	-	-	4,911
Shares and equity instruments with variable income, unlisted	-	981	-	-	981
Securities used for hedging	-	9,104	-		9,104
Other financial assets	3,514	-	-	-	3,514
Financial assets	780,877	17,402	84,426	-	882,705
Liabilities at amortised cost					
Due to credit institutions and Central Bank	22,876	-	-	-	22,876
Deposits	454,973	-	-	-	454,973
Borrowings	200,580	-	-	-	200,580
Subordinated liabilities	31,639	-	-	-	31,639
Liabilities at amortised cost	710,068	-	-	-	710,068
Financial liabilities at fair value					
Short position in bonds	-	8,238	-	-	8,238
Derivatives	-	905	-	-	905
Financial liabilities at fair value	-	9,143	-	-	9,143
Other financial liabilities	39,032	-	-	-	39,032
Financial liabilities	749,100	9,143	-	-	758,243

Arion Bank Consolidated Financial Statements 2015 28 Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

Bonds and debt instruments designated at fair value specified by issuer	2015	2014
Financial and insurance activities	9,258	3,403
Public sector	59,246	58,730
Corporates	7,665	1,140
Bonds and debt instruments designated at fair value	76,169	63,273

The total amount of pledged bonds at the end of the year was ISK 21.5 billion (31.12.2014: ISK 18.0 billion). Pledged bonds comprise Icelandic Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

22. Fair value hierarchy

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

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

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

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

2015	Level 1	Level 2	Level 3	Total
Assets at fair value				
Bonds and debt instruments	32,813	45,799	182	78,794
Shares and equity instruments with variable income	14,331	15,299	5,874	35,504
Derivatives	-	2,401	-	2,401
Securities used for hedging	15,706	786	-	16,492
Investment property	-	-	7,542	7,542
Assets at fair value	62,850	64,285	13,598	140,733
Liabilities at fair value				
Short position in bonds	4,616	-	-	4,616
Derivatives	-	2,993	-	2,993
Liabilities at fair value	4,616	2,993	-	7,609

Arion Bank Consolidated Financial Statements 2015 29 Amounts are in ISK millions

22. Fair value hierarchy, continued

2014	Level 1	Level 2	Level 3	Total
Assets at fair value				
Bonds and debt instruments	26,677	38,611	1,178	66,466
Shares and equity instruments with variable income	8,072	17,062	98	25,232
Derivatives	-	1,026	-	1,026
Securities used for hedging	7,789	1,315	-	9,104
Investment property	-	-	6,842	6,842
Assets at fair value	42,538	58,014	8,118	108,670
Liabilities at fair value				
Short position in bonds	8,238	-	-	8,238
Derivatives	-	905	-	905
Liabilities at fair value	8,238	905	-	9,143

Transfers from Level 2 to Level 1 amounted to ISK 8,106 million during the year due to listing of companies on Nasdaq Iceland (2014: none). There have been no transfers from Level 1 to Level 2 during the year (2014: none).

The level of the fair value hierarchy of assets is determined at the end of each reporting period.

Fair value of assets and liabilities

The fair value of asset and liabilities is the amount at which the asset and liability could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Group to measure assets and liabilities. If quoted prices for a asset fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

Methods for establishing fair value

Level 1: Fair value established from quoted market prices

The best evidence of the fair value of a asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of a asset in Note 21 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from the market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

Level 2: Fair value established using valuation techniques with observable market information

For assets and liabilities, for which the market is not active, the Group applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable and willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

For assets and liabilities for which quoted prices on active markets are not available, the fair value is derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

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22. Fair value hierarchy, continued

In most cases the valuation is based on theoretical financial models, such as the Black Scholes model or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

The fair value for deposits with stated maturities is calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Statement of Financial Position.

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

In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of assets with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organisations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

The Group applies management valuation for determining fair value of investment properties. Management valuation is either based on recent transactions and offers for similar assets or present value calculations which involve estimation of future cash flow and the assessment of appropriate discount rate.

Movements in Level 3 assets measured at fair value	Investment property		Financial assets		Total	
	2015	2014	2015	2014	2015	2014
Balance at the beginning of the year	6,842	28,523	1,276	1,667	8,118	30,190
Net fair value changes	422	1,091	5,857	(373)	6,279	718
Additions	1,026	2,148	77	5	1,103	2,153
Disposal	(843)	(25,503)	(1,154)	(23)	(1,997)	(25,526)
Transfers into Level 3	95	583	-	-	95	583
Balance at the end of the year	7,542	6,842	6,056	1,276	13,598	8,118

Line items where effects of Level 3 assets are recognised in the Statement of Comprehensive Income	2015	2014
Net interest income	25	74
Net financial income	(20)	(447)
Other operating income	708	2,322
Net gain on AFS financial assets, net of tax	2,903	-
Effects recognised in the Statement of Comprehensive Income	3,616	1,949

Arion Bank Consolidated Financial Statements 2015 31 Amounts are in ISK millions

22. Fair value hierarchy, continued

Carrying values and fair values of financial assets and financial liabilities that are not carried at fair value in the Financial Statements. The table does not include the fair values of non-financial assets and non-financial liabilities.

2015	Carrying value	Fair value	Unrealised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central bank	48,102	48,102	-
Loans to credit institutions	87,491	87,491	-
Loans to customers	680,350	688,196	7,846
Other financial assets	4,581	4,581	-
Financial assets not carried at fair value	820,524	828,370	7,846
Financial liabilities not carried at fair value			
Due to credit institutions and Central bank	11,387	11,387	-
Deposits	469,347	469,347	-
Borrowings	256,058	264,839	(8,781)
Subordinated loans	10,365	10,365	-
Other financial liabilities	38,667	38,667	-
Financial liabilities not carried at fair value	785,824	794,605	(8,781)

2014	Carrying value	Fair value	Unrealised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central bank	21,063	21,063	-
Loans to credit institutions	108,792	108,792	-
Loans to customers	647,508	657,261	9,753
Other financial assets	3,514	3,514	-
Financial assets not carried at fair value	780,877	790,630	9,753
Financial liabilities not carried at fair value			
Due to credit institutions and Central bank	22,876	22,876	-
Deposits	454,973	455,133	(160)
Borrowings	200,580	197,115	3,465
Subordinated loans	31,639	31,639	-
Other financial liabilities	39,032	39,032	-
Financial liabilities not carried at fair value	749,100	745,795	3,305

Financial assets and financial liabilities predominantly bear interest at floating rates. For assets and liabilities not at floating rates fair value is determined by Level 2 methods for which the valuation input is market observable interest rates.

Retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account mortgaging. Defaulted loans are presented at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value. Other loans, including corporate loans, are presented at book value as they are generally of a shorter duration than retail mortgages and the interest rate risk on them is therefore limited.

Arion Bank Consolidated Financial Statements 2015 32 Amounts are in ISK millions

22. Fair value hierarchy, continued

Derivatives	Notional	Fair value	
2015	value	Assets	Liabilities
Forward exchange rate agreements, unlisted	49,435	231	287
Interest rate and exchange rate agreements, unlisted	103,369	1,948	710
Bond swap agreements, unlisted	3,811	43	28
Share swap agreements, unlisted	13,099	178	1,934
Options - purchased agreements, unlisted	66	1	34
Derivatives	169,780	2,401	2,993

2014			
Forward exchange rate agreements, unlisted	17,625	63	172
Interest rate and exchange rate agreements, unlisted	21,961	215	271
Bond swap agreements, unlisted	3,976	40	34
Share swap agreements, unlisted	6,942	230	397
Options - purchased agreements, unlisted	475	478	31
Derivatives	50,979	1,026	905

Arion Bank Consolidated Financial Statements 2015 33 Amounts are in ISK millions

23. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

	Assets subject to netting arrangements			Netting potential not recognized in the balance sheet				
2015	Gross assets before balance sheet nettings	Balance sheet nettings with gross liabilities	Assets recognised on balance sheet, net	Financial liabilities	Collateral received	Assets after consideration of netting potential	Assets not subject to enforceable netting arr- angements	Total assets re- cognised on balance sheet
Reverse repurchase agreements	22,100	(490)	21,610	(4,929)	-	16,681	-	21,610
Derivatives	964	-	964	(400)	-	564	1,437	2,401
Total assets	23,064	(490)	22,574	(5,329)	-	17,245	1,437	24,011
2014								
Reverse repurchase agreements	10,044	-	10,044	(8,238)	-	1,806	-	10,044
Derivatives	117	-	117	(1)	-	116	909	1,026
Total assets	10,161	-	10,161	(8,239)	-	1,922	909	11,070

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the balance sheet				
2015	Gross liabilities before balance sheet nettings	Balance sheet nettings with gross assets	Liabilities recognised on balance sheet, net	Financial assets	Collateral pledged	Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arr- angements	Total liabilities recognised on balance sheet
Repurchase agreements	4,929	-	4,929	(4,929)	-	-	-	4,929
Derivatives	400	-	400	(400)	-	-	2,593	2,993
Total liabilities	5,329	-	5,329	(5,329)	-	-	2,593	7,922
2014								
Repurchase agreements	8,238	-	8,238	(8,238)	-	-	-	8,238
Derivatives	1	-	1	(1)	-	-	904	905
Total liabilities	8,239	-	8,239	(8,239)	-	-	904	9,143

Accounting policies for offsetting are provided in Note 54.

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24. Investments in associates

The Group's interest in its principal associates	2015	2014
Auðkenni hf., Borgartún 31, Reykjavík, Iceland	22.4%	20.9%
Bakkavor Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	46.0%	46.0%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	39.3%	39.3%
Klakki ehf., Ármúli 1, Reykjavík, Iceland	-	31.8%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	23.0%	21.7%
Reitir fasteignafélag hf., Kringlan 4-12, Reykjavík, Iceland	-	25.6%
Síminn hf., Ármúli 25, Reykjavík, Iceland	-	38.3%
Urriðaland ehf., Laugavegur 182, Reykjavík, Iceland	41.4%	41.4%
220 Fjörður ehf., Fjarðargötu 13-15, Hafnarfjörður, Iceland	38.5%	-

Investments in associates		
Carrying amount at the beginning of the year	21,966	17,929
Acquisitions	262	7,557
Dividend received	(611)	(16)
Transfers	(6,458)	(2,636)
Disposals	(17,148)	(4,603)
Exchange difference	(178)	237
Share of profit of associates and reversal of impairment	29,466	3,498
Investment in associates	27,299	21,966

The Bank's subsidiary BG12 slhf. has valued the shareholding in its associated company Bakkavor Group Ltd. according to the equity method, less impairment. In January 2016 BG12 slhf. sold its entire shareholding in Bakkavor Group Ltd. resulting in a change in valuation of the shareholding at year end 2015 when it was presented at sales value, less cost of sale. The total revaluation of the shareholding during the year was ISK 20,845 million, presented as Share of profit of associates in the Statement of Comprehensive Income in 2015. Arion Bank's shareholding in BG12 slhf. is 62% and thus a Non-controlling interest of ISK 7,921 million is presented in the Statement of Comprehensive income due to aforementioned change in valuation. The revaluation resulted in net earnings attributable to shareholders of Arion Bank for the amount of ISK 12,924 million in 2015.

Prior to the listing of Síminn hf. the Bank sold a 10% shareholding in the company and around 20% in connection with the listing of Síminn hf. on Nasdaq Iceland in October. The total effect from the sale on the Statement of Comprehensive Income is ISK 4,185 million. The remaining shareholding in Síminn hf. is classified as Financial instruments at year end.

In January the Group sold 3.5% shareholding in Reitir fasteignafélag hf. and 13.3% shareholding was sold in connection with the listing of the company on Nasdaq Iceland in April. The total effect on the Statement of Comprehensive Income in the first half of 2015 is ISK 4,224 million. The remaining shareholding in Reitir fasteignafélag hf. is classified as Financial instruments at year end.

The subsidiary Eignarhaldsfélagið Landey ehf. established the entity 220 Fjörður ehf. in partnership with others to manage specific investment property.

In 2015 the Bank sold its shareholding in Klakki ehf. with minor effects on the Statement of Comprehensive Income.

The Group accounts for investments in associates based on the equity method less applicable impairment. The impairment testing uses management valuation techniques and assumptions such as EBITDA multiples. Alternative assumptions could potentially result in significantly different carrying values but the management is of the opinion that the impaired value is based on the most probable outcomes under current market conditions.

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25. Intangible assets

Intangible assets comprise four categories: Goodwill, Infrastructure, Customer relationships and related agreements and Software. Goodwill arises on the acquisition of subsidiaries. Infrastructure and Customer relationships and related agreements originate as a premium in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Group's operations.

Towards the end of 2014 Valitor Holding hf. acquired the Danish group AltaPay A/S. The acquisition was designed to support Valitor's strategy to expand its online business in the Nordic region. Total of ISK 4,217 million intangible assets were recognized, mainly related to the expertise of the employees of AltaPay A/S and the business opportunities inherent in a rapidly growing market, and the synergy with Valitor hf. in the future. When distributing the purchase price to separate assets the free cash flow method and management forecasts on the operations of AltaPay A/S were used. The original distribution of purchase price was revisited in 2015, and thus within the 12 months permitted timeframe from the acquisition date. Following this revisit there was a transfer of ISK 506 million from Customer relationship and related agreements to Goodwill.

Infrastructure, which is capitalized as an intangible asset, is connected to two business segments at the Group, namely Asset Management within the Bank and within the Bank's subsidiary Stefnir hf. and credit card operation at the Bank's subsidiary Valitor Holding hf. In both cases the business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as described below.

Customer relationships and related agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries and agreements bought. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationships related to individual customers through SPRON and the subsidiary Okkar líftryggingar. The customer relationship is tested for impairment and related agreements are amortized over a period of 5 years.

Software is acquired computer software licenses and is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

2015	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,171	3,046	1,539	2,840	9,596
Additions and transfers	506	-	(435)	530	601
Additions, internally developed	-	-	-	289	289
Exchange difference	(270)	-	(40)	(57)	(367)
Impairment	-	(25)	(2)	-	(27)
Amortisation	-	-	(208)	(599)	(807)
Intangible assets	2,407	3,021	854	3,003	9,285

2014					
Balance at the beginning of the year	-	3,075	1,144	1,164	5,383
Acquisition through business combination	2,171	-	598	1,448	4,217
Additions	-	-	-	562	562
Additions, internally developed	-	-	-	41	41
Impairment	-	(29)	-	-	(29)
Amortisation	-	-	(203)	(375)	(578)
Intangible assets	2,171	3,046	1,539	2,840	9,596

Impairment testing

The methodology for impairment testing on the Infrastructure, which is part of intangible assets, is based on discounted cash flow model which uses inputs that consider features of the business and the environment.

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis impairment of ISK 27 million was recognized in 2015 (2014: ISK 29 million).

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25. Intangible assets, continued

Discount and growth rates	2015 Discount rates	2015 Growth rates	2014 Discount rates	2014 Growth rates
Asset Management operation	12.6%	2.5%	14.7%	2.5%
Credit card operation	12.6%	3-25%	14.7%	3-14%

26. Tax assets and tax liabilities

	2015 Assets	2015 Liabilities	2014 Assets	2014 Liabilities
Current tax	-	3,272	-	4,499
Deferred tax	205	1,650	655	624
Tax assets and tax liabilities	205	4,922	655	5,123

Deferred tax assets and tax liabilities are attributable to the following:

	2015 Assets	2015 Liabilities	2014 Assets	2014 Liabilities
Foreign currency denominated assets and liabilities	4	(222)	7	(205)
Investment property and property and equipment	101	(271)	95	(333)
Financial assets	494	(1,171)	564	-
Other assets and liabilities	256	(495)	188	(529)
Deferred tax related to foreign exchange gain	-	(141)	-	(78)
Tax loss carry forward	-	-	322	-
	855	(2,300)	1,176	(1,145)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(650)	650	(521)	521
Deferred tax assets and tax liabilities	205	(1,650)	655	(624)

Subsidiaries own tax loss carry forward with asset value of the amount of ISK 546 million (31.12.2014: ISK 726 million) that is not recognised in the Financial Statements, due to uncertainty about the utilisation possibilities of the loss.

Changes in deferred tax assets and tax liabilities

2015	At 1 Jan.	Addition / disposal	Recognised through equity	Recognised in profit or loss	At 31 Dec.
Foreign currency denominated assets and liabilities	(198)	-	-	(20)	(218)
Investment property and property and equipment	(238)	-	-	68	(170)
Financial assets	564	-	(1,171)	(70)	(677)
Other assets and liabilities	(341)	-	-	102	(239)
Deferred foreign exchange differences	(78)	-	-	(63)	(141)
Tax loss carry forward	322	-	-	(322)	-
Change in deferred tax assets and tax liabilities	31	-	(1,171)	(305)	(1,445)

2014	At 1 Jan.	Addition / disposal	Recognised through equity	Recognised in profit or loss	At 31 Dec.
Foreign currency denominated assets and liabilities	(187)	-	-	(11)	(198)
Investment property and property and equipment	(1,626)	1,102	-	286	(238)
Financial assets	580	-	-	(16)	564
Other assets and liabilities	424	(458)	-	(307)	(341)
Deferred foreign exchange differences	79	-	-	(157)	(78)
Tax loss carry forward	322	-	-	-	322
Change in deferred tax assets and tax liabilities	(408)	644	-	(205)	31

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27. Other assets

	2015	2014
Non-current assets and disposal groups held for sale	5,082	3,958
Property and equipment	6,766	7,080
Accounts receivable	2,433	2,474
Unsettled securities trading	685	138
Sundry assets	2,612	1,836
Other assets	17,578	15,486

Vast majority of the Non-current assets and disposal groups held for sale consist of real estates that are generally the result of foreclosures on companies and individuals.

Property and equipment	Real estate	Equip-ment	Total 2015	Total 2014
Gross carrying amount at the beginning of the year	6,214	6,211	12,425	10,904
Additions	2	709	711	1,866
Disposals and transfers	(65)	(168)	(233)	(335)
Gross carrying amount at the end of the year	6,151	6,752	12,903	12,435
Accumulated depreciation at the beginning of the year	(1,408)	(3,947)	(5,355)	(3,961)
Depreciation	(149)	(700)	(849)	(1,456)
Disposals and transfers	12	55	67	62
Accumulated depreciation at the end of the year	(1,545)	(4,592)	(6,137)	(5,355)
Property and equipment	4,606	2,160	6,766	7,080

The official real estate value (Registers Iceland) amounts to ISK 4,603 million at the end of the year (31.12.2014: ISK 4,781 million) and the insurance value amounts to ISK 9,597 million (31.12.2014: ISK 9,479 million).

28. Other liabilities

	2015	2014
Accounts payable	23,296	20,909
Provision for settled FX loans	2,882	2,791
Unsettled securities trading	754	217
Depositors' and investors' guarantee fund	2,873	2,880
Insurance claim	2,574	2,402
Withholding tax	1,643	1,507
Bank levy	2,811	2,688
Sundry liabilities	12,628	13,796
Other liabilities	49,461	47,190

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29. Borrowings

	Issued	Maturity	Maturity type	Terms of interest	2015	2014
Covered bond in ISK	2012	2015	At maturity	Fixed, 6.50%	-	14,493
Covered bond in ISK	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,483	4,508
Covered bond in ISK	2014	2021	At maturity	Fixed, CPI linked, 3.50%	5,096	1,134
Covered bond in ISK	2015	2022	At maturity	Fixed, 6.50%	7,737	-
Covered bond in ISK	2014	2029	At maturity	Fixed, CPI linked, 3.50%	15,279	5,232
Covered bond in ISK	2005	2033	Amortizing	Fixed, CPI linked, 3.75%	17,108	17,428
Covered bond in ISK	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	2,249	2,541
Covered bond in ISK	2008	2045	Amortizing	Fixed, CPI linked, 4.00%	6,182	6,165
Covered bond in ISK	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	77,916	77,557
Covered bonds					136,050	129,058
Senior unsecured bond in NOK	2013	2016	At maturity	Floating, NIBOR +5.00%	1,547	8,478
Senior unsecured bond in EUR	2009	2018	Amortizing	Floating, EURIBOR +1.00%	1,177	1,714
Senior unsecured bond in ISK	2010	2018	Amortizing	Floating, REIBOR +1.00%	1,600	2,130
Senior unsecured bond in EUR	2015	2018	At maturity	Fixed, 3.125%	43,350	-
Senior unsecured bond in NOK	2015	2020	At maturity	Floating, NIBOR +2.95%	11,900	-
Bonds issued					59,574	12,322
Central Bank, secured, various curr.	2010	2022	At maturity	Floating, LIBOR + 3.00%	56,024	55,102
Bills issued					4,081	3,186
Other					329	912
Other loans/bills					60,434	59,200
Borrowings					256,058	200,580

Book value of listed bonds was ISK 196,927 million at the end of the year (31.12.2014: ISK 140,721 million). Market value of those bonds was ISK 205,720 million (31.12.2014: ISK 137,715 million).

The Group repurchased own debts during the year for the amount of ISK 10 billion (2014: ISK 20 billion) with minor effects on the Statement of Comprehensive Income.

30. Subordinated liabilities

	Issued	Maturity	Maturity type	Terms of interest	2015	2014
Tier II capital in various currencies	2010	2020	At maturity	Floating, EURIBOR/LIBOR + 5.00%	10,365	31,639
Subordinated liabilities					10,365	31,639

At the end of March Arion Bank prepaid ISK 10 billion of the subordinated liabilities with the Ministry of Finance and Economic Affairs. Additional prepayment was made at end of June for the same amount. Arion Bank aims to pay the remaining subordinated liability when conditions are favourable.

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31. Pledged assets

Pledged assets against liabilities	2015	2014
Assets, pledged as collateral against borrowings	222,046	233,191
Assets, pledged as collateral against loans from credit institutions and short positions	21,611	17,973
Pledged assets against liabilities	243,657	251,164

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 222 billion at the end of the period (31.12.2014: ISK 233 billion). Those assets were mainly pool of mortgage loans to individuals, loans to real estate companies, wholesale and retal and industry and energy companies. The book value of those borrowings was ISK 192 billion at the end of the year (31.12.2014: ISK 184 billion).

Assets are primarily pledged against borrowings associated with the acquisition of the pledged assets. Two major events are most significant. Assets were acquired from the Central Bank of Iceland in conjunction with the recapitalization of Arion Bank on 8 January 2010 and a portfolio of mortgages was acquired from Kaupthing hf. and is pledged against a structured covered bond that Arion Bank took over as issuer of from Kaupthing hf. at the end of 2011.

The Group has pledged bonds against short term lending from the Central Bank of Iceland and against short positions, related to swap agreements, to hedge market risk of those assets.

32. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	2015	Number (million)	2014
Issued share capital	2,000	75,861	2,000	75,861

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

Other reserves	2015	2014
Statutory reserve	1,637	1,637
Available-for-sale reserve	2,903	-
Foreign currency translation reserve	8	(5)
Other reserves	4,548	1,632

OTHER INFORMATION

33. Legal matters

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, if appropriate, to account for any adverse effects which the claims may have on its financial standing. When the Group is of the opinion that it is to the detriment of the Group's case to disclose potential amounts relating to legal claims, it elects not to do so. At the end of the year, the Group had several unresolved legal claims.

Contingent liabilities

Investigation and legal proceedings regarding alleged breaches of competition law

The Icelandic Competition Authority (ICA) has opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including Arion Bank. The investigation was initiated by separate complaints from BYR hf. and MP banki hf. made in 2010. The complaints from BYR hf. and MP banki 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 extent of the investigation and outcome is still uncertain. However, if the Bank were deemed to have violated the Competition Act, it could result in a fine or restrictions by the ICA.

In April 2013 the ICA imposed a ISK 500 million fine on Valitor hf. for abusing its dominant position on the payment card market and violating conditions set out in an earlier decision of the Authority. Valitor hf. appealed the decision to the Competition Appeals Committee. In October 2013 the Committee confirmed the decision of the Competition Authority. Valitor hf. referred the case to the courts. In May 2015 the District Court of Reykjavik rejected Valitor's reasoning that the decision be nullified, but agreed to its claim to lower the fine to ISK 400 million. The case has been appealed to the Supreme Court. The final judgement of the Supreme Court is expected in 2016.

With a writ issued in June 2013, Kortaþjónustan ehf. claimed damages from the Arion Bank hf., Íslandsbanki hf., Landsbanki hf., Borgun hf. and Valitor hf. to the amount of ISK 1.2 billion plus interest, due to damage Kortaþjónustan hf. contends the five parties caused the company due to violations of the Competition Act. The Bank has put forward its arguments in the case and has demanded acquittal of Kortaþjónustan's claims. The case has been put on hold as Kortaþjónustan's court-appointed evaluator prepares its report on Kortaþjónustan's alleged loss.

Legal proceedings regarding damages

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., have filed two cases against the Bank claiming damages in the amount of more than ISK 4 billion plus interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagið Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. The Bank believes it likely that it will be acquitted of the plaintiffs' claims in both cases and has not therefore made any provision.

Other legal matters

Legal proceedings regarding CPI loans

Recently, there were three cases being heard by the Icelandic courts for the purpose of verifying the legitimacy of loans linked to the Consumer Price Index (CPI). In short, these three cases revolve around whether, on the one hand, the provisions contained in the debt instrument, as regards the increase of the principal of the loan due to linkage to the CPI, is an unfair contractual condition and on the other hand whether the loan provider was authorized to take “0% inflation” into account when calculating borrowing costs. The courts requested advisory opinions from the EFTA Court as regards certain issues in two of the cases, which the EFTA Court delivered on 28 August and 24 November 2014. By the decisions of the District Court of Reykjavík issued on 6 February 2015, the district court resolved two of the above cases, where the lender's reasoning was upheld in both cases. Both of the cases were appealed to the Supreme Court. With a judgment on 13 May 2015 (case no 160/2015), the Supreme Court stated that there were no grounds to consider the price indexation terms of the debt instrument to be unfair. The Supreme Court, moreover, was of the opinion that the lender had fulfilled its duty to provide information to the lender in regards to said loan. The Supreme Court, therefore, upheld the lender's reasoning as regards both issues that the borrower's contested as regards the price indexation. With a judgment of 26 November 2015 (case no. 243/2015) a lender was acquitted of a borrowrs' claim in a case which dealt to a large extent with the same issues covered in the previous case. The Bank is aware of at least one further case, which specifically deals with legal issues regarding the CPI, that is now before the District Court.

33. Legal matters, continued

The Bank made no provision due to court cases regarding the CPI as the likelihood of the courts finding with the plaintiffs in the cases is considered to be remote.

The uncertainty regarding the book value of foreign currency loans

The uncertainty of legality of FX loans has continued in 2015 and the Group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans. Although there is more clarity in the matters of FX loans there still remains uncertainty regarding foreign currency linked loans in certain respects, such as regarding the legality of particular loans and the recalculation and settlement of foreign currency linked loans. Nevertheless, the Group considers its portfolio of foreign currency linked loans fully provisioned for the most likely outcome.

Legal matters concluded

In 2012 Kortaþjónustan hf. filed a suit against Valitor hf., Borgun hf. and Greiðsluveitan ehf., claiming damages for the alleged loss suffered by Kortaþjónustan hf. due to alleged breaches of competition law based on a settlement made by Valitor hf., Borgun hf. and Greiðsluveitan ehf. with the ICA, published in an ICA Decision No 4/2008. The case was dropped in September 2014, and a new claim filed based on the findings of a court appointed evaluators on Kortaþjónustan hf.'s alleged damage. The case was settled in early March 2015 with a payment of ISK 250 million to Kortaþjónustan hf.

34. Visa Inc. acquisition of Visa Europe Ltd.

In November 2015 Visa Inc. and Visa Europe Ltd. announced a definitive agreement for Visa Inc. to acquire Visa Europe Ltd. The transaction consists of upfront consideration with the potential for an additional earn-out following the fourth anniversary of closing. Arion Bank is member of Visa Europe Ltd. through its subsidiary Valitor Holding hf. The transaction is subject to regulatory approvals and is expected to be completed in the second quarter of 2016. In relation to this transaction the Group reports AFS financial asset. The value of the AFS asset is based on the Group's expected share of profit from the sale of Visa Europe Ltd. The total gain from this transaction is estimated ISK 2,903 million after taking into account estimated tax effects and conditional payment to Landsbankinn hf., which was part of the agreement when Arion Bank acquired 38% shareholding in Valitor Holding hf. from Landsbankinn hf. in 2014.

35. Acquisition of the insurance company Vörður

In October Arion Bank concluded a conditional purchase agreement with BankNordik according to which Arion Bank acquires 51% of shares in the Icelandic insurer Vörður. Parallel to the sale Arion Bank and BankNordik signed an agreement on the purchase of the remaining shareholding in Vörður, which will come into effect when restrictions on the sale of the remaining minority shareholding have been lifted and no later than in 2017. The purchase price for the 100% of the shares is EUR 37 million. Net earnings of Vörður amounted to ISK 385 million in 2014 and total assets amounted to ISK 10,264 million at year end 2014. Vörður will be classified as a subsidiary of Arion Bank. The transactions are conditional on the approval of the relevant Icelandic authorities, and the parties expect to complete the sale of 51% of shares in the coming months.

OFF BALANCE SHEET INFORMATION

36. Obligations

Guarantees, unused overdraft and loan commitments the Group has granted its customers	2015	2014
Guarantees	19,162	9,542
Unused overdrafts	42,100	38,890
Loan commitments	126,068	56,363

Depositors' and Investors' Guarantee fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. Even though the law has not been amended Icelandic bank's have made quarterly payments to a separate division within the fund since 2010. Despite this change in execution and due to uncertainty of the shape of future legislation the liability brought forward from previous years is not changed from the balance of ISK 2,669 million. The Group has granted the Fund a guarantee for obligations amounting to ISK 3,210 million.

37. Operating lease commitments

Group as a lessee

The Group has concluded lease agreements regarding some of the real estate it uses for its operations. These lease agreements are for a period of up to 10 years. The majority of the contracts include renewal options for various periods of time.

	2015	2014
Less than one year	279	292
Over 1 year and up to 5 years	684	829
Over 5 years	346	606
Future minimum lease payments under non-cancellable leases	1,309	1,727

Group as a lessor

The Group has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 8 years, with majority being non-cancellable agreements.

	2015	2014
Less than one year	120	93
Over 1 year and up to 5 years	127	125
Over 5 years	25	16
Future minimum lease payments under non-cancellable leases	272	234

38. Assets under management and under custody

Assets under management	996,648	923,599
Assets under custody	1,427,269	1,337,561

Assets under management represent the total market value of the financial assets which the Group manages on behalf of its customers.

The Group, acting as custodian, is responsible for safeguarding a firm's or individual's financial assets, hold in safekeeping securities such as stocks, bonds and securities funds, arrange the settlement of trades and movements of securities, process corporate actions such as income on bonds and dividends on shares; and pricing on securities.

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39. Events after Balance Sheet date

Arion Bank and Kaupthing reach funding agreement

Arion Bank reached an agreement with Kaupthing ehf. under which Arion Bank will issue a bond in the amount of USD 747 million (ISK 97 billion). The bond is being issued under Arion Bank's EMTN programme. It is a 7-year instrument and is callable on interest payment dates during the first two years. The bond bears floating LIBOR plus 2.6% for the first two years and will then be repriced at market terms.

The bond will offset loans in foreign currency taken by Arion Bank from the Central Bank of Iceland and Kaupthing deposits in foreign currency at Arion Bank. This transaction will have no effect on the asset side of the Statement of Financial Position but the liability side will be affected as stated in the table below.

	31.12.2015	Trans-actions	12.01.2016
Due to credit institutions and Central Bank	11,387	-	11,387
Deposits	469,347	(41,149)	428,198
Financial liabilities at fair value	7,609	-	7,609
Tax liabilities	4,922	-	4,922
Other liabilities	49,461	-	49,461
Borrowings	256,058	41,149	297,207
Central Bank, secured in various currencies	-	(56,024)	(56,024)
New EMTN issuance	-	97,173	97,173
Subordinated liabilities	10,365	-	10,365
Total Liabilities	809,149	-	809,149

The loan from Central Bank was covered by assets on the Balance Sheet of Arion Bank, mainly mortgage loans to individuals and other loans to large Icelandic corporates. With this loan settled the encumbrance ratio of the Group decreases from 24% to 18%.

Disposal of shareholding in Bakkavor Group Ltd.

In January 2016 the Bank's subsidiary BG12 slhf. completed the sale of its 46% shareholding in the associated company Bakkavor Group Ltd. The net effects on the Statement of Comprehensive Income in 2015 was ISK 20,845 million as the shareholding was revalued at year end based on the sales value, less cost to sell. See Note 24.

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RELATED PARTY

40. Related party

The Group has a related party relationship with Kaupskil ehf., being the ultimate controlling party with 87% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., being the parent company of Kaupskil ehf.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13% stake in Arion Bank and thus has influence over the Group. ISFI and related entities are defined as related parties.

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

No unusual transactions took place with related parties during the year. Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

2015

Balances with related parties	Assets	Liabilities	Net balance
Shareholders with control over the Group	212	(50,158)	(49,946)
Board of Directors and key Management personnel	232	(59)	173
Associates and other related parties	2,132	(241)	1,891
Balances with related parties	2,576	(50,458)	(47,882)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(762)	16	-
Shareholders with influence over the Group	-	(4)	15	(13)
Board of Directors and key Management personnel	12	(2)	5	-
Associates and other related parties	1,288	(617)	344	(276)
Transactions with related parties	1,300	(1,385)	380	(289)

2014

Balances with related parties	Assets	Liabilities	Net balance
Shareholders with control over the Group	577	(53,970)	(53,393)
Board of Directors and key Management personnel	260	(67)	193
Associates and other related parties	20,060	(22,861)	(2,801)
Balances with related parties	20,897	(76,898)	(56,001)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(1,184)	10	-
Shareholders with influence over the Group	-	-	26	(30)
Board of Directors and key Management personnel	13	(1)	3	-
Associates and other related parties	2,807	(804)	282	(377)
Transactions with related parties	2,820	(1,989)	321	(407)

Through the ownership of ISFI the Group has a related party relationship with Landsbankinn hf. Landsbankinn hf. provides banking services to the Bank's subsidiary Valitor hf. and has a traditional bank to bank relationship with Arion Bank hf. The Group holds assets amounting to ISK 14,038 million (31.12.2014: ISK 28,881 million) by Landsbankinn hf. and liabilities amounting to ISK 1,499 million at the end of the year (31.12.2014: ISK 7,332 million). Total interest income was ISK 120 million in 2015 (2014: ISK 73 million) and interest expense ISK 48 million (2014: ISK 172 million). Other income was ISK 500 million during the year (2014: ISK 301 million) and other expense was ISK 1,192 million (2014: ISK 347 million). Those amounts are not included in the table above.

Arion Bank Consolidated Financial Statements 2015 45 Amounts are in ISK millions

RISK MANAGEMENT DISCLOSURES

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

The Board of Directors is ultimately responsible for the Group's risk management framework and ensuring that satisfactory risk policies and governance for controlling the Group's risk exposure are in place. The Board allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board sets risk appetite, which is translated into exposure limits and targets monitored by the Bank's Risk Management division.

The Chief Executive Officer (CEO) is responsible for sustaining an effective risk management framework, processes and control as well as maintaining a high level of risk awareness among the employees, making risk everyone's business.

The Bank operates several committees to manage risk. The Board Audit and Risk Committee (BARC) is responsible for supervising the Bank's risk management framework, risk appetite and the internal capital adequacy assessment process (ICAAP). The Asset and Liability Committee (ALCO), is responsible for managing the asset-liability mismatch, liquidity risk, market risk, and interest rate risk and capital management. The Underwriting and Investment Committee (UIC) decides on underwriting and principal investments. The Bank operates four credit committees: The Board Credit Committee (BCC) which decides on all major credit risk exposures, the Arion Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's capital, and the Corporate Credit Committee (CCC) and Retail Branch Committees (RBC) which operate within tighter credit granting limits.

The Bank's Internal Audit conducts independent reviews of the Bank's and several subsidiaries' operations, risk management framework, processes and measurements. Internal Audit discusses its results with management and reports its findings and recommendations to the BARC.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralised and reports directly to the CEO. The division is divided into four units: Credit Analysis, which supports and monitors the credit granting process; Credit Control, which monitors credit exposures on a customer-by-customer basis; Balance Sheet Risk, which oversees all risks related to asset and liability mismatch, including capital and is reponsible for the Bank's ICAAP; and Operational Risk which monitors risks associated with the daily operation of the Bank. The Bank's Security Officer is a part of the Risk Management division.

The most significant risks the Group is exposed to are credit risk, including concentration risk, liquidity risk, currency risk, interest rate risk and legal risk. These risk factors are to the largest extent encountered within the Bank. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities.

The total sum of large exposures is 11% compared to 24% in the previous year.

The Group is exposed to currency risk due to a net currency position on the balance sheet. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities.

Liquidity risk is a large risk factor in the Group's operation due to maturity mismatch between assets and liabilities. The maturity of loans exceeds the maturity of deposits, of which 67% is on-demand or with less than 30 day term.

Further information on risk management and capital adequacy is provided in the annual Financial Statements for 2015 and in the Pillar 3 Risk Disclosures for 2015. The Pillar 3 Risk Disclosures 2015 will be published in March 2016 and be available on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures will not be subject to external audit.

41. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off balance sheet items such as commitments and guarantees.

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

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

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

41. Credit risk, continued

Maximum exposure to credit risk and credit concentration by industry sectors

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the year before the effect of mitigation due to collateral agreements or other credit enhancements. The Group uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard.

2015

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

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Cash & balances with Central Bank	-	-	-	-	-	48,102	-	-	-	-	-	48,102
Loans to credit institutions	-	-	-	-	-	87,491	-	-	-	-	-	87,491
Loans to customers	324,629	102,624	75,850	30,802	51,784	33,460	21,384	6,001	19,864	8,193	5,759	680,350
Financial instruments	135	175	72	11	-	14,894	9,430	29	400	61,624	-	86,770
Other assets with credit risk	289	564	29	80	67	3,018	3	1	455	65	10	4,581
Total on-balance sheet maximum exposure to credit risk	325,053	103,363	75,951	30,893	51,851	186,965	30,817	6,031	20,719	69,882	5,769	907,294

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

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	1,352	3,032	1,253	1,225	4,145	729	3,299	2,244	1,855	22	6	19,162
Unused overdrafts	24,373	1,977	596	632	5,093	1,622	2,013	377	2,403	2,639	375	42,100
Loan commitments	188	39,196	27,711	11,463	14,083	3,544	14,017	10,618	2,183	3,000	65	126,068
Total off-balance sheet maximum exposure to credit risk	25,913	44,205	29,560	13,320	23,321	5,895	19,329	13,239	6,441	5,661	446	187,330
Maximum exposure to credit risk	350,966	147,568	105,511	44,213	75,172	192,860	50,146	19,270	27,160	75,543	6,215	1,094,624

Amounts are in ISK millions

41. Credit risk, continued

2014

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

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Cash & balances with Central Bank	-	-	-	-	-	21,063	-	-	-	-	-	21,063
Loans to credit institutions	-	-	-	-	-	108,792	-	-	-	-	-	108,792
Loans to customers	321,311	81,228	76,340	23,314	55,034	27,693	25,284	5,529	18,382	7,746	5,647	647,508
Financial instruments	82	80	86	12	-	6,181	1,189	529	1,235	63,233	-	72,627
Other assets with credit risk	399	440	34	22	24	1,854	9	15	626	87	4	3,514
Total on-balance sheet maximum exposure to credit risk	321,792	81,748	76,460	23,348	55,058	165,583	26,482	6,073	20,243	71,066	5,651	853,504

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

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	390	2,300	784	573	1,128	1,201	1,322	709	1,101	27	7	9,542
Unused overdrafts	22,621	2,007	578	561	4,554	1,491	1,952	264	2,038	2,384	440	38,890
Loan commitments	392	7,281	9,010	3,587	9,040	1,797	6,183	10,679	970	7,392	32	56,363
Total off-balance sheet maximum exposure to credit risk	23,403	11,588	10,372	4,721	14,722	4,489	9,457	11,652	4,109	9,803	479	104,795
Maximum exposure to credit risk	345,195	93,336	86,832	28,069	69,780	170,072	35,939	17,725	24,352	80,869	6,130	958,299

Amounts are in ISK millions

41. Credit risk, continued

Loans to customers specified by sectors	2015	2014
Individuals	47.7%	49.6%
Real estate activities and construction	15.1%	12.5%
Fishing industry	11.1%	11.8%
Information and communication technology	4.7%	3.6%
Wholesale and retail trade	7.6%	8.5%
Financial and insurance activities	4.9%	4.3%
Industry, energy and manufacturing	3.1%	3.9%
Transportation	0.9%	0.9%
Services	2.9%	2.8%
Public sector	1.2%	1.2%
Agriculture and forestry	0.8%	0.9%
	100.0%	100.0%

Collateral and other credit enhancements

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- Retail loans to individuals: Mortgages on residential properties.
- Corporate loans: Real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

The value of collateral is based on estimated market value. The valuation of real estate is built on market price, official valuation of the Icelandic Property Registry, or the opinion of internal or external specialists. The valuation of fishing vessels takes into account related fishing quota.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses.

The collateral value in the table below is capped by the exposure amount.

Collateral held against different types of financial assets

2015	Cash and securities	Real estate	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	428	289,862	24	4,107	294,421
Real estate activities and construction	1,032	89,039	8	1,025	91,104
Fishing industry	53	7,956	57,945	7,037	72,991
Information and communication technology	76	2,369	-	18,630	21,075
Wholesale and retail trade	210	20,424	7	22,912	43,553
Financial and insurance activities	15,947	4,367	-	1,577	21,891
Industry, energy and manufacturing	461	12,792	3	4,416	17,672
Transportation	91	875	173	3,891	5,030
Services	13	4,847	40	2,623	7,523
Public sector	73	3,732	-	99	3,904
Agriculture and forestry	5	3,493	-	112	3,610
Financial instruments	7,474	-	-	-	7,474
Guarantees	885	4,232	623	1,445	7,185
Collateral held against different types of financial assets	26,748	443,988	58,823	67,874	597,433

Arion Bank Consolidated Financial Statements 2015 50 Amounts are in ISK millions

41. Credit risk, continued

2014	Cash and securities	Real estates	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	440	282,871	43	1,093	284,447
Real estate activities and construction	635	66,910	11	2,976	70,532
Fishing industry	70	7,513	57,190	3,176	67,949
Information and communication technology	14	2,059	-	18,327	20,400
Wholesale and retail trade	261	16,522	5	30,173	46,961
Financial and insurance activities	12,108	2,584	-	2,886	17,578
Industry, energy and manufacturing	5,977	9,823	3	4,171	19,974
Transportation	42	587	153	3,019	3,801
Services	144	3,147	96	1,110	4,497
Public sector	18	3,700	-	152	3,870
Agriculture and forestry	5	2,546	-	124	2,675
Financial instruments	3,330	-	-	-	3,330
Guarantees	741	2,641	316	1,199	4,897
Collateral held against different types of financial assets	23,785	400,903	57,817	68,406	550,911

Collateral repossessed

During the year the Group took possession of assets due to foreclosures. The total amount of real estates the Group took possession of during the year and still holds at period end amount to ISK 2,761 million (31.12.2014: ISK 1,607 million) and other assets ISK 7 million (31.12.2014: ISK 10 million). The assets are held for sale, see Note 27.

Credit quality by class of financial assets

2015	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	48,102	-	-	48,102
Loans to credit institutions	87,491	-	-	87,491
Loans to customers				
Loans to corporates	337,153	17,302	1,276	355,731
Loans to individuals	291,277	26,532	6,810	324,619
Financial instruments	82,714	-	-	82,714
Other assets with credit risk	4,581	-	-	4,581
Credit quality by class of financial assets	851,318	43,834	8,086	903,238

2014				
Cash and balances with Central Bank	21,063	-	-	21,063
Loans to credit institutions	108,792	-	-	108,792
Loans to customers				
Loans to corporates	308,588	15,114	2,495	326,197
Loans to individuals	277,859	32,847	10,605	321,311
Financial instruments	70,704	-	-	70,704
Other assets with credit risk	3,514	-	-	3,514
Credit quality by class of financial assets	790,520	47,961	13,100	851,581

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41. Credit risk, continued

Neither past due nor impaired loans

The Bank uses internal credit rating models to monitor the development of credit risk and to estimate customers' probability of default (PD). The Bank rates customers with one of three models. For large corporates the Bank uses quantitative information based on financial statements as well as qualitative data. Credit ratings of individuals and SMEs are based on statistical models using historical information which has been found to be predictive. The models are updated annually and recalibrated with current data with the aim of improving their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement.

The table below shows loans to customers that are neither past due nor impaired, broken down by the Bank's classification scale, where 5 denotes the highest risk.

	Risk classification						
2015	1	2	3	4	5	Not rated	Total
Individuals	54,822	148,472	63,027	18,553	4,693	1,710	291,277
Real estate activities and construction	36,550	23,792	29,776	3,790	154	3,279	97,341
Fishing industry	21,807	33,232	7,657	5,415	1,249	1,341	70,701
Information and communication technology	17,346	4,252	8,949	126	-	-	30,673
Wholesale and retail trade	9,447	18,356	18,260	2,064	198	33	48,358
Financial and insurance activities	3,012	17,784	11,308	223	-	456	32,783
Industry, energy and manufacturing	3,088	14,256	2,930	324	135	-	20,733
Transportation	3,320	1,094	1,040	274	28	-	5,756
Services	2,326	4,805	9,918	539	19	-	17,607
Public sector	357	3,396	2,342	1,038	133	545	7,811
Agriculture and forestry	336	1,558	2,887	609	-	-	5,390
Neither past due nor impaired loans	152,411	270,997	158,094	32,955	6,609	7,364	628,430
2014							
Individuals	57,039	139,569	51,547	17,397	6,818	5,489	277,859
Real estate activities and construction	2,898	13,931	49,417	5,679	98	4,767	76,790
Fishing industry	25,757	26,757	13,681	2,182	1,599	1,596	71,572
Information and communication technology	371	19,469	3,205	219	-	-	23,264
Wholesale and retail trade	7,248	20,332	21,292	2,843	160	381	52,256
Financial and insurance activities	679	1,907	14,707	90	-	8,032	25,415
Industry, energy and manufacturing	7,804	8,017	6,996	517	363	621	24,318
Transportation	268	3,575	958	593	3	62	5,459
Services	820	9,848	3,577	533	13	2,571	17,362
Public sector	209	3,427	1,817	340	35	1,422	7,250
Agriculture and forestry	225	1,283	1,754	386	388	866	4,902
Neither past due nor impaired loans	103,318	248,115	168,951	30,779	9,477	25,807	586,447

Exposures that are 'Not rated' are typically due to newly formed entities and entities for which the Bank's rating models are not applicable.

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41. Credit risk, continued

Past due but not impaired loans by class of loans

2015	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	9,638	3,779	1,681	662	1,542	17,302
Loans to individuals	3,706	9,437	5,237	554	7,598	26,532
Past due but not impaired loans	13,344	13,216	6,918	1,216	9,140	43,834

2014						
Loans to corporates	6,553	2,434	2,267	565	3,295	15,114
Loans to individuals	3,436	10,589	5,974	847	12,001	32,847
Past due but not impaired loans	9,989	13,023	8,241	1,412	15,296	47,961

Loans past due up to three days are mainly overdrafts that were not renewed in time. The majority of the past due but not impaired loans are considered fully secured with collateral or have been acquired at discount. Loans aquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

Impaired loans to customers specified by sector	2015 Impair-ment amount	2015 Gross carrying amount	2014 Impair-ment amount	2014 Gross carrying amount
Individuals	10,593	17,403	11,016	21,621
Real estate activities and construction	1,515	1,867	1,396	1,981
Fishing industry	257	373	1,115	2,366
Information and communication technology	308	332	251	251
Wholesale and retail trade	681	893	751	831
Financial and insurance activities	5,953	6,011	6,739	6,756
Industry, energy and manufacturing	828	1,025	296	474
Transportation	4,433	4,440	18	18
Services	504	682	375	641
Public sector	143	215	27	35
Agriculture and forestry	126	186	230	340
	25,341	33,427	22,214	35,314

Arion Bank Consolidated Financial Statements 2015 53 Amounts are in ISK millions

41. Credit risk, continued

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's capital base according to FME rule No. 625/2013. The legal maximum for individual large exposures is 25% of the capital base, net of eligible collateral.

The largest exposure to a group of connected clients at the end of the period was ISK 22 billion (31.12.2014: ISK 25 billion) before taking account of eligible collateral.

The Group has one large exposure at the end of the year (31.12.2014: two exposures) net of eligible collateral.

	2015		2014	
No.	Gross	Net	Gross	Net
1	11%	11%	<10%	<10%
2	<10%	<10%	14%	14%
3	<10%	<10%	11%	10%
Sum of large exposure gross and net > 10%	11%	11%	25%	24%

No large exposure exceeds the legal limit of 25% of the Group's capital base at the end of the year.

42. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments.

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

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

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

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

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair value of financial instruments. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities. This mismatch is characterised by a gap between the interest fixing period of assets and liabilities, with a large amount of liabilities being demand deposits while the interest rates of assets are predominantly fixed to some extent, resulting in a repricing risk for the Group. The Group also faces interest basis risk between interest bearing assets and interest bearing liabilities due to different types of floating rate indices in different currencies, of which the largest one is EUR.

The Group's strategy for managing its interest rate risk is to strive to contain interest rate mismatches within acceptable levels by maintaining partly matched funding for its loans to customers, offering deposit incentives and by targeted lending practices.

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42. Market risk, continued

Interest rate risk in the banking book

The following table shows the Group's interest bearing assets and liabilities by interest fixing periods. The figures for loans to customers and borrowings are shown on a fair value basis, see Note 22, and are therefore different from the amounts shown in the Financial Statements. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category.

The Group's interest bearing assets and liabilities by interest rate adjustement periods

2015 Assets	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	43,181	-	-	-	-	43,181
Loans to credit institutions	87,491	-	-	-	-	87,491
Loans to customers	347,571	64,594	127,907	5,255	142,869	688,196
Financial instruments	43,925	10,002	8,556	7,786	242	70,511
Assets	522,168	74,596	136,463	13,041	143,111	889,379
Liabilities						
Due to credit institutions and Central Bank	11,387	-	-	-	-	11,387
Deposits	464,998	3,501	848	-	-	469,347
Borrowings	72,010	4,509	48,705	12,982	126,632	264,838
Subordinated loans	10,365	-	-	-	-	10,365
Liabilities	558,760	8,010	49,553	12,982	126,632	755,937
Derivatives and other off-balance sheet items (net position)	(46,330)	(1,802)	49,346	-	-	1,214
Net interest gap	(82,922)	64,784	136,256	59	16,479	134,656

2014 Assets	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	15,808	-	-	-	-	15,808
Loans to credit institutions	108,792	-	-	-	-	108,792
Loans to customers	358,943	56,338	78,887	2,845	160,248	657,261
Financial instruments	39,963	1,552	12,609	4,672	1,046	59,842
Assets	523,506	57,890	91,496	7,517	161,294	841,703
Liabilities						
Due to credit institutions and Central Bank	22,876	-	-	-	-	22,876
Deposits	449,638	2,124	3,270	-	101	455,133
Borrowings	62,821	18,307	7,313	1,124	107,550	197,115
Subordinated loans	31,639	-	-	-	-	31,639
Liabilities	566,974	20,431	10,583	1,124	107,651	706,763
Derivatives and other off-balance sheet items (net position)	56	(2,760)	2,778	-	-	74
Net interest gap	(43,412)	34,699	83,691	6,393	53,643	135,014

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42. Market risk, continued

Sensitivity analysis of interest rate risk in the banking book

The following table shows the sensitivity of the Group's net present value of interest bearing assets and liabilities to changes in interest rates by currencies. Sensitivity is quantified as the net change in value of interest bearing assets and liabilities when assuming a simultaneous parallel shift upwards and downwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income and is not an estimate of risk.

	2015		2014	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI indexed linked	1,850	(1,763)	5,278	(4,525)
ISK, Non Indexed linked	751	(735)	995	(955)
EUR	185	(178)	321	(296)
Other	522	(494)	405	(380)

Interest rate risk in the trading book

The following table shows the total basis point value (BPV) of the Group's bond and derivatives in the trading book at market value (MV). BPV denotes the change in value given a basis point (0.01%) yield change.

	2015			2014		
Trading financial instruments, long positions	MV	Duration	BPV	MV	Duration	BPV
ISK, CPI Indexed linked	4,544	3.6	(1.6)	1,924	6.3	(1.2)
ISK, Non Indexed linked	5,849	(1.8)	1.1	3,353	(2.1)	0.7
FX	64,226	(0.6)	3.9	22,844	0.1	(0.2)
Total	74,619	(0.5)	3.4	28,121	0.3	(0.7)
Trading financial instruments, short positions						
ISK, CPI Indexed linked	393	9.7	(0.4)	1,003	6.1	(0.6)
ISK, Non Indexed linked	7,953	0.3	(0.3)	7,139	0.4	(0.3)
FX	64,172	(0.5)	2.9	22,243	0.1	(0.2)
Total	72,518	(0.3)	2.3	30,385	0.4	(1.1)

Sensitivity analysis of interest rate risk in the trading book

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

	2015		2014	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI indexed linked	126	(121)	62	(58)
ISK, Non Indexed linked	(142)	130	(104)	93
EUR	19	(20)	13	(12)
Other	(122)	115	(13)	13

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42. Market risk, continued

Indexation risk

The Group is exposed to indexation risk when there is a mismatch between index-linked assets and liabilities. The total amount of indexed assets is ISK 311.6 billion (31.12.2014: ISK 289.2 billion) and the total amount of indexed liabilities is ISK 216.6 billion (31.12.2014: ISK 204.0 billion).

Transaction maturity profile of indexed assets and liabilities

2015 Assets, CPI indexed linked	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans to customers	13,629	76,393	209,485	299,507
Financial instruments	3,412	-	-	3,412
Off-balance sheet position	749	7,940	-	8,689
Assets, CPI indexed linked	17,790	84,333	209,485	311,608
Liabilities, CPI indexed linked				
Deposits	72,352	12,899	1,916	87,167
Borrowings	2,128	14,164	112,350	128,642
Other	-	-	782	782
Liabilities, CPI indexed linked	74,480	27,063	115,048	216,591
Net on-balance sheet position	(57,439)	49,330	94,437	86,328
Net off-balance sheet position	749	7,940	-	8,689
CPI Balance	(56,690)	57,270	94,437	95,017

2014 Assets, CPI indexed linked	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans to customers	9,566	74,705	200,030	284,301
Financial instruments	2,090	-	-	2,090
Off-balance sheet position	825	1,952	-	2,777
Assets, CPI indexed linked	12,481	76,657	200,030	289,168
Liabilities, CPI indexed linked				
Deposits	66,489	19,615	2,415	88,519
Borrowings	2,019	13,703	99,277	114,999
Off-balance sheet position	524	-	-	524
Liabilities, CPI indexed linked	69,032	33,318	101,692	204,042
Net on-balance sheet position	(56,852)	41,387	98,338	82,873
Net off-balance sheet position	301	1,952	-	2,253
CPI Balance	(56,551)	43,339	98,338	85,126

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42. Market risk, continued

Currency risk

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

Breakdown of assets and liabilities by currency

2015

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	47,357	252	167	37	96	37	156	48,102
Loans to credit institutions	20,923	24,741	19,478	7,260	3,182	4,125	7,782	87,491
Loans to customers	568,196	44,532	37,395	6,487	11,357	9	12,374	680,350
Financial instruments	84,752	24,852	13,227	6,145	63	3,248	904	133,191
Investment property	7,542	-	-	-	-	-	-	7,542
Investments in associates	1,043	-	-	26,256	-	-	-	27,299
Intangible assets	5,575	-	-	-	3,710	-	-	9,285
Tax assets	205	-	-	-	-	-	-	205
Other assets	16,711	482	170	177	22	14	2	17,578
Assets	752,304	94,859	70,437	46,362	18,430	7,433	21,218	1,011,043
Liabilities and equity								
Due to credit inst. and Central Bank	9,471	381	74	6	1	-	1,454	11,387
Deposits	388,228	18,041	50,913	6,865	1,523	2,156	1,621	469,347
Financial liabilities at fair value	6,790	584	104	10	4	-	117	7,609
Tax liabilities	4,501	-	-	-	422	-	(1)	4,922
Other liabilities	41,098	2,648	1,484	1,432	832	347	1,620	49,461
Borrowings	142,060	44,526	33,442	8,511	-	13,447	14,072	256,058
Subordinated liabilities	-	3,942	2,603	3,820	-	-	-	10,365
Shareholders' equity	192,786	-	-	-	-	-	-	192,786
Non-controlling interest	9,108	-	-	-	-	-	-	9,108
Liabilities and equity	794,042	70,122	88,620	20,644	2,782	15,950	18,883	1,011,043
Net on-balance sheet position	(41,738)	24,737	(18,183)	25,718	15,648	(8,517)	2,335	
Net off-balance sheet position	9,619	(13,684)	20,273	(1,470)	(17,856)	5,481	(2,363)	
Net position	(32,119)	11,053	2,090	24,248	(2,208)	(3,036)	(28)	

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42. Market risk, continued

2014 Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	19,472	5	904	178	107	46	351	21,063
Loans to credit institutions	35,076	16,570	13,141	13,646	2,946	11,084	16,329	108,792
Loans to customers	538,828	40,526	27,606	6,605	14,734	5,376	13,833	647,508
Financial instruments	73,851	14,963	7,776	3,436	47	1,736	19	101,828
Investment property	6,842	-	-	-	-	-	-	6,842
Investments in associates	16,052	-	-	5,914	-	-	-	21,966
Intangible assets	5,469	-	-	-	4,127	-	-	9,596
Tax assets	655	-	-	-	-	-	-	655
Other assets	14,665	485	128	123	26	52	7	15,486
Assets	710,910	72,549	49,555	29,902	21,987	18,294	30,539	933,736
Liabilities and equity								
Due to credit inst. and Central Bank	16,752	2,103	958	5	1	-	3,057	22,876
Deposits	374,063	25,949	16,247	11,348	9,306	8,075	9,985	454,973
Financial liabilities at fair value	8,971	43	127	-	1	-	1	9,143
Tax liabilities	4,642	-	-	-	481	-	-	5,123
Other liabilities	37,336	2,217	3,470	975	2,199	174	819	47,190
Borrowings	135,285	1,714	22,475	8,812	-	8,478	23,816	200,580
Subordinated liabilities	-	25,133	2,550	3,956	-	-	-	31,639
Shareholders' equity	160,711	-	-	-	-	-	-	160,711
Non-controlling interest	1,501	-	-	-	-	-	-	1,501
Liabilities and equity	739,261	57,159	45,827	25,096	11,988	16,727	37,678	933,736
Net on-balance sheet position	(28,351)	15,390	3,728	4,806	9,999	1,567	(7,139)	
Net off-balance sheet position	9,454	(9,065)	(397)	56	(8,963)	-	8,915	
Net position	(18,897)	6,325	3,331	4,862	1,036	1,567	1,776	

Sensitivity analysis on currency risk

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

	2015		2014	
Currency	-10%	+10%	-10%	+10%
EUR	(1,105)	1,105	(633)	633
USD	(209)	209	(333)	333
GBP	(2,425)	2,425	(486)	486
DKK	221	(221)	(104)	104
NOK	304	(304)	(157)	157
Other	3	(3)	(178)	178

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42. Market risk, continued

Equity risk

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. The non-trading equity price risk exposure is mainly due to restructuring of the Group's assets i.e. restructuring of troubled companies which the Group has taken over. For information on assets seized and held for sale and equity exposures, see Notes 27 and 21 respectively.

Sensitivity analysis on equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices on the income statement. A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase. Investments in associates are excluded.

	2015		2014	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(214)	214	(154)	154
Banking book - listed	(1,387)	1,387	(708)	708
Banking book - unlisted	(1,819)	1,819	(1,551)	1,551

Derivatives

Customers can enter into derivatives contracts with the Bank. The types of derivatives currently offered by the Group are FX swaps and forwards, interest rate swaps, cross-currency swaps, as well as options and forwards on listed bonds and equities. Eligible underlying instruments, limits on exposures and required collateral are determined in accordance with the Group's risk appetite. The Group also uses derivatives to reduce market risk on its balance sheet. The Group's exposure to derivative instruments is not considered a material risk.

Prepayment risk

Prepayment risk is the risk that the Group will incur a financial loss because its customers and counterparties repay or request repayment earlier or later than expected, such as fixed rate mortgages when interest rates fall. The Group is not materially exposed to prepayment risk at year end 2015.

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43. Liquidity and Funding risk

Liquidity risk is defined as the risk that the Group, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

The Group's primary source of funding is deposits from individuals, businesses and financial institutions. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 57% is on-demand.

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

The Group's strategy is to always maintain sufficient liquidity by maintaining a high ratio of liquid assets and available funding to near term liabilities and possible payment outflows. Uncertainties in relation to the capital controls have been significantly reduced and in January 2016 Kaupthing's deposits in foreign currency with the Group were termed out into EMTN funding. As a result, liquidity risk due to entities in winding-up has been reduced.

Group's assets and liabilities at carrying amount by residual maturity

2015 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	48,102	35,467	-	12,635	-	-	-
Loans to credit institutions	87,491	50,151	37,340	-	-	-	-
Loans to customers	680,350	3,984	42,429	90,014	234,035	309,888	-
Financial instruments	133,191	4,765	1,711	10,861	54,392	10,985	50,477
Derivatives - assets leg	*56,171*	-	*24,671*	*1,478*	*29,509*	*513*	-
Derivatives - liabilities leg	*(53,770)*	-	*(24,262)*	*(1,421)*	*(27,688)*	*(399)*	-
Investment property	7,542	-	-	-	-	-	7,542
Investments in associates	27,299	-	-	-	-	-	27,299
Intangible assets	9,285	-	-	-	-	-	9,285
Tax assets	205	-	-	-	205	-	-
Other assets	17,578	1,017	2,592	174	793	-	13,002
Assets	1,011,043	95,384	84,072	113,684	289,425	320,873	107,605
Liabilities							
Due to credit institutions and Central Bank	11,387	9,881	-	1,481	25	-	-
Deposits	469,347	268,727	95,191	89,937	13,575	1,917	-
Financial liabilities at fair value	7,609	-	6,346	536	631	96	-
Derivatives - assets leg	*(49,199)*	-	*(36,552)*	*(5,662)*	*(6,518)*	*(467)*	-
Derivatives - liabilities leg	*52,192*	-	*38,282*	*6,198*	*7,149*	*563*	-
Short position bonds and derivatives	*1,309*	-	*1,309*	-	-	-	-
Short position bonds used for hedging	*3,307*	-	*3,307*	-	-	-	-
Tax liabilities	4,922	-	-	3,274	1,648	-	-
Other liabilities	49,461	17,002	14,724	5,192	3,529	6	9,008
Borrowings	256,058	-	7,081	4,308	69,933	174,736	-
Subordinated liabilities	10,365	-	-	-	3,942	6,423	-
Liabilities	809,149	295,610	123,342	104,728	93,283	183,178	9,008
Off-balance sheet items							
Guarantees	19,162	3,402	2,371	7,589	3,954	1,846	-
Unused overdraft	42,100	842	10,071	14,984	15,768	435	-
Loan commitments	126,068	-	50,628	35,542	34,506	5,392	-
Off-balance sheet items	187,330	4,244	63,070	58,115	54,228	7,673	-
Net assets (liabilities)	14,564	(204,470)	(102,340)	(49,159)	141,914	130,022	98,597

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43. Liquidity and Funding risk, continued

2014 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	21,063	12,285	-	8,778	-	-	-
Loans to credit institutions	108,792	52,119	56,673	-	-	-	-
Loans to customers	647,508	11,678	50,642	89,332	230,055	265,801	-
Financial instruments	101,828	7,562	742	2,203	52,527	7,670	31,124
Derivatives - assets leg	*28,234*	-	*6,654*	*15,659*	*5,921*	-	-
Derivatives - liabilities leg	*(27,209)*	-	*(5,912)*	*(15,524)*	*(5,773)*	-	-
Investment property	6,842	-	-	-	-	-	6,842
Investments in associates	21,966	-	-	-	-	-	21,966
Intangible assets	9,596	-	-	-	-	-	9,596
Tax assets	655	-	-	-	655	-	-
Other assets	15,486	47	2,283	46	1,121	17	11,972
Assets	933,736	83,691	110,340	100,359	284,358	273,488	81,500
Liabilities							
Due to credit institutions and Central Bank	22,876	13,652	2,238	6,962	24	-	-
Deposits	454,973	263,899	96,009	46,412	45,102	3,551	-
Financial liabilities at fair value	9,143	-	8,663	227	253	-	-
Derivatives - assets leg	*(15,693)*	-	*(4,525)*	*(10,504)*	*(664)*	-	-
Derivatives - liabilities leg	*16,598*	-	*4,950*	*10,731*	*917*	-	-
Short position bonds and derivatives	*5,478*	-	*5,478*	-	-	-	-
Short position bonds used for hedging	*2,760*	-	*2,760*	-	-	-	-
Tax liabilities	5,123	-	1,125	3,374	624	-	-
Other liabilities	47,190	667	30,372	5,192	2,680	120	8,159
Borrowings	200,580	-	1,776	20,057	24,908	153,839	-
Subordinated liabilities	31,639	-	-	-	-	31,639	-
Liabilities	771,524	278,218	140,183	82,224	73,591	189,149	8,159
Off-balance sheet items							
Guarantees	9,542	2,373	1,234	2,389	1,753	1,793	-
Unused overdraft	38,890	658	10,163	17,738	10,273	58	-
Loan commitments	56,363	2,432	21,419	15,705	16,807	-	-
Off-balance sheet items	104,795	5,463	32,816	35,832	28,833	1,851	-
Net assets (liabilities)	57,417	(199,990)	(62,659)	(17,697)	181,934	82,488	73,341

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43. Liquidity and Funding risk, continued

The net stable funding ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per definition of the Central Bank of Iceland rules No. 1032. In general, RSF is determined by applying different weights to different asset classes depending on the level of liquidity. ASF however is calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness. In 2016, the ratio for foreign currency shall be at least 90% and from 2017 the ratio shall exceed 100%.

Calculations of the NSFR are based on consolidated figures for the Bank and Arion Bank Mortgages Institutional Investor Fund. When calculating the FX ratio, a negative FX imbalance is subtracted from the numerator and a positive FX imbalance is subtracted from the denominator. The FX imbalance discrepancy between the Group's official FX imbalance and the imbalance reported in the NSFR is due to the fact that the Bank's subsidiaries have a substantial positive FX imbalance but are settled in ISK.

When calculating the FX ratio, a negative FX imbalance is subtracted from the numerator and a positive FX imbalance is subtracted from the denominator.

2015	ISK	FX	Total
Available stable funding	540,864	129,273	670,137
Required stable funding	539,841	95,511	635,352
FX imbalance		(11,363)	
Net stable funding ratio	100%	123%	105%

2014			
Available stable funding	494,300	103,542	597,842
Required stable funding	553,205	70,850	624,055
FX imbalance		3,444	
Net stable funding ratio	89%	154%	96%

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43. Liquidity and Funding risk, continued

Liquidity coverage ratio

The liquidity coverage ratio (LCR) is part of the standards introduced in the Basel III Accord. The LCR is the result of a stress test that is designed to ensure that banks have the necessary assets on hand to withstand short-term liquidity disruptions. More accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, assets must be non-pledged, liquid and easily priced on the market, repoable at the Central Bank and not issued by the Group or related entities.

The Central Bank has set rules for minimum LCR. In 2015, the LCR requirement was 100% in foreign currency and 80% in total (ISK and foreign currency). The latter minimum is 90% in 2016 and 100% from 2017.

The following table shows the breakdown for the Group's LCR calculations broken down on currencies; ISK , FX and total. All amounts are weighted by their respective LCR weights as defined by the Central Bank.

Liquidity coverage ratio

2015	ISK	FX	Total
Liquid Assets	98,647	30,850	129,497
Liquid assets level 1 *	98,647	24,981	123,628
Liquid assets level 2 **	-	5,869	5,869
Cash outflows	140,073	56,511	196,584
Deposits	122,275	21,640	143,915
Market Borrowing	1,502	122	1,624
Other Cash outflows	16,296	34,749	51,045
Cash inflows	12,961	87,338	100,299
Short term deposits in other banks ***	3,768	57,881	61,649
Other Cash inflows	9,193	29,457	38,650
Liquidity coverage ratio (LCR) ****	78%	218%	134%

2014			
Liquid Assets	77,859	21,874	99,733
Liquid assets level 1 *	77,859	20,831	98,690
Liquid assets level 2 **	-	1,043	1,043
Cash outflows	121,271	34,454	155,725
Deposits	107,948	20,472	128,420
Market Borrowing	1,474	-	1,474
Other Cash outflows	11,849	13,982	25,831
Cash inflows	22,571	75,802	98,373
Short term deposits in other banks ***	16,953	62,937	79,890
Other Cash inflows	5,618	12,865	18,483
Liquidity coverage ratio (LCR) ****	79%	254%	174%

* Level 1 assets receive a 100% weight in LCR calculations and include the Groups Cash and Central Bank deposits, domestic bonds eligable as collateral at the Central Bank, foreign government bonds and the government liquidity facility.

** Level 2 assets include the Group's covered bonds with a minimum rating of AA- and receive a 85% weight in LCR calculations.

*** Short term deposits in other banks are defined as cash inflows in LCR calculations.

**** LCR is defined as: LCR = Weighted liquid assets / (weighted cash ouflows - weighted cash inflows) where weighted cash inflows are capped at 75% of weighted cash ouflows.

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43. Liquidity and Funding risk, continued

Composition of liquid assets

2015	ISK	USD	EUR	Other	Total
Cash and Cenral Bank deposits	46,521	349	531	759	48,160
Short term deposits in other banks	3,768	16,741	20,824	20,316	61,649
Domestic bonds eligable as collateral at the Central Bank	22,614	-	-	-	22,614
Foreign government bonds	-	10,658	8,700	3,984	23,342
Government liquidity facility	29,513	-	-	-	29,513
Covered bonds with a minimum rating of AA-	-	-	2,122	4,783	6,905
Total liquidity reserve	102,416	27,748	32,177	29,842	192,183

2014					
Cash and Cenral Bank deposits	18,787	1,059	500	1,069	21,415
Short term deposits in other banks	16,953	8,354	12,696	41,887	79,890
Domestic bonds eligable as collateral at the Central Bank	19,722	-	-	-	19,722
Foreign government bonds	-	7,053	8,082	3,067	18,202
Government liquidity facility	39,350	-	-	-	39,350
Covered bonds with a minimum rating of AA-	-	-	-	1,228	1,228
Total liquidity reserve	94,812	16,466	21,278	47,251	179,807

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43. Liquidity and Funding risk, continued

LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. Some similar categories are grouped together. The table contains deposits at the Bank and at banking subsidiaries. Thus, amounts due to Central Bank and amounts due to credit institutions at non-banking subsidiaries are excluded.

LCR categorization - amounts and LCR outflow weights

	Deposits maturing within 30 days					
2015	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Retail	86,095	10%	39,598	5%	53,599	179,292
SME	37,884	10%	3,928	5%	4,327	46,139
Operational relationship	-	25%	-	5%	-	-
Corporations	36,300	40%	823	20%	4,945	42,068
Sovereigns, central-banks and PSE	11,900	40%	-	-	1,304	13,204
Financial entities being wound up	16,948	100%	-	-	47,062	64,010
Pension funds	41,609	100%	-	-	35,104	76,713
Domestic financial entities	32,727	100%	-	-	11,016	43,743
Foreign financial entities	5,193	100%	-	-	-	5,193
Other foreign parties	3,707	100%	3,260	25%	1,923	8,890
Total	272,363		47,609		159,280	479,252
2014						
Retail	78,659	10%	36,076	5%	53,803	168,538
SME	36,060	10%	3,895	5%	6,011	45,966
Operational relationship	-	25%	-	5%	1,190	1,190
Corporations	36,961	40%	830	20%	5,873	43,664
Sovereigns, central-banks and PSE	12,196	40%	-	-	2,870	15,066
Financial entities being wound up	19,796	100%	-	-	67,105	86,901
Pension funds	36,824	100%	-	-	19,765	56,589
Domestic financial entities	22,634	100%	-	-	16,752	39,386
Foreign financial entities	4,532	100%	-	-	522	5,054
Other foreign parties	3,425	100%	3,026	25%	2,082	8,533
Total	251,087		43,827		175,973	470,887

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

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44. Operational risk

Operational risk is the risk of direct or indirect loss, or damage to the Group's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Group's image and operational earnings.

Each business unit within the Group is primarily responsible for taking and managing their own operational risk. Operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Group's operational risk.

The Group uses the standardised approach to the calculation of capital requirements for operational risk.

45. Capital management

The capital base amounts to ISK 195,729 million at the end of the period. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 24,2%, exceeding the minimum legal requirement of 8%.

The Group uses the standardised approach to calculate the capital requirements for credit risk, market risk, and operational risk.

The Bank carries out an on-going process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank's total risk exposure. The ICAAP is aimed at identifying and measuring the Groups risk across all risk types and ensure that the Group has sufficient capital in accordance to its risk profile. FME supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole.

The Group is subject to capital requirements which are specified by the FME following the Supervisory Review and Evaluation Process (SREP). The Group's capital base exceeds the FME's SREP requirements.

Capital Base	2015	2014
Total equity	201,894	162,212
Non-controlling interest not eligible for inclusion in CET1 capital*	(9,108)	(1,385)
Intangible assets	(9,285)	(9,596)
Tax assets	(205)	(655)
Other statutory deductions	(3,151)	(111)
Common equity Tier 1 capital*	180,145	150,465
Non-controlling interest not eligible for inclusion in CET1 capital*	9,108	1,385
Tier 1 capital	189,253	151,850
Subordinated liabilities	10,365	31,639
Regulatory adjustments to Tier 2 capital**	(771)	-
Other statutory deductions	(3,118)	(101)
Tier 2 capital	6,476	31,538
Total capital base	195,729	183,388

* CET1 capital according to CRR definition while Tier 1, capital base and RWA are calculated according to The Act on Icelandic Undertakings No. 161/2002. Capital ratios according to CRR are generally lower than the ratios shown here.

** Straight-line amortization for maturities within five years.

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45. Capital management, continued

Risk weighted assets	2015	2014
Credit risk	681,034	591,994
Market risk FX	38,401	18,915
Market risk other	7,035	2,890
Operational risk	81,441	82,211
Total risk weighted assets	807,911	696,010

Capital ratios		
CET1 ratio using current RWA *	22.3%	21.6%
Tier 1 ratio	23.4%	21.8%
Capital adequacy ratio	24.2%	26.3%

* CET1 capital according to CRR definition while Tier 1, capital base and RWA are calculated according to The Act on Icelandic Undertakings No. 161/2002. Capital ratios according to CRR are generally lower than the ratios shown here.

Leverage ratio

As part of the Basel III regulatory framework, the leverage ratio is seen as a complementary measure to the risk-based Capital adequacy ratio.

	2015	2014
On-balance sheet exposures	982,348	912,303
Derivative exposures	3,789	1,348
Securities financing transaction exposures	16,287	10,044
Off-balance sheet exposures	127,675	59,922
Total exposure	1,130,099	983,617
Tier 1 capital	189,253	151,850
Leverage ratio	16.7%	15.4%

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SIGNIFICANT ACCOUNTING POLICIES

The accounting policies adopted in the preparation of these Consolidated Financial Statements are consistent with those followed in the preparation of the Group's Consolidated Financial Statements for the year ended 31 December 2014 except for new and amended IFRS adopted by the European Union, that became effective as of 1 January 2015, see Note 71, and amendmends to Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions.

46. Going concern assumption

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

47. Principles underlying the consolidation

Subsidiaries

Subsidiaries are entities controlled by the Group. The Financial Statements of subsidiaries are included in the Financial Statements from the date that control commences until the date that control ceases. The Financial Statements of the subsidiaries are prepared for the same reporting period as the parent entity, using consistent accounting policies.

Business combinations

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if, and only if, the Group has:

- power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee);
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect its returns.

Generally, there is a presumption that a majority of voting rights result in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an investee, the Group considers all relevant facts and circumstances in assessing whether it has power over an investee, including (i) the contractual arrangement with the other vote holders of the investee, (ii) rights arising from other contractual arrangements and (iii) the Group's voting rights and potential voting rights. The Group re-assesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

The Group measures goodwill at the acquisition date as:

- the fair value of the consideration transferred; plus
- the recognised amount of any non-controlling interests in the acquiree; less
- if the business combination is achieved in stages, the fair value of the pre-existing equity interest in the acquiree; less
- the net recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed.

When the excess is negative, a bargain purchase gain is recognised immediately in profit or loss.

Transaction costs incurred are expensed and included in administration expense.

Non-controlling interests

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Group; such interests are presented separately in the Statement of Comprehensive Income and are included in equity in the Statement of Financial Position, separately from equity attributable to owners of the Group.

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:

- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

Changes in the Group's interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

47. Principles underlying the consolidation, continued

Loss of control

On the loss of control, the Group derecognises the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss.

Transactions eliminated on consolidation

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Financial Statements.

If an investment in subsidiary is classified as held for sale the investment is accounted for, as non-current asset and disposal groups held for sale from the date of classification.

Funds management

The Group manages and administers assets held in unit trusts and investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Financial Statements except when the Group controls the entity.

When assessing whether to consolidate investment funds, the Group reviews all facts and circumstances to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal, and hence controls and consolidates a fund, when the Group acts as fund manager and cannot be removed without cause, has variable returns through significant holdings, and is able to influence the returns of the funds by exercising its power. The Group is defined as agent in all instances.

48. Associates

Associates are those entities over which the Group has significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Group holds 20% or more of the voting power, including potential voting rights, unless it can be clearly demonstrated that this is not the case. Investments in associates are initially recognised at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The considerations made in determining significant influence are similar to those necessary to determine control over subsidiaries.

The Group's investments in its associate are accounted for using the equity method.

The Financial Statements include the Group's share of the total recognised income and expenses of associates from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its carrying value of associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

Upon loss of significant influence over the associate, the Group measures and recognises any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognised in profit or loss.

Impairment on investments in associates

After applying the equity method to account for investments in associates, the Group determines whether it is necessary to recognise any impairment loss with respect to its investments in associates. The Group first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Group then tests the entire carrying amount of the investment for impairment, by comparing its recoverable amount, which is the higher of value in use and fair value less costs to sell, with its carrying amount. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the Group. The excess of the carrying amount over the recoverable amount is recognised in the Statement of Comprehensive Income as an impairment loss. Impairment losses are subsequently reversed through the Statement of Comprehensive Income if the reasons for the impairment loss no longer apply.

49. Foreign currency

Items included in the Financial Statements of each of the Group's subsidiaries are measured using the functional currency of the respective entity.

Foreign currency transactions

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. All differences arising on settlement or translation of monetary items are taken to the Statement of Comprehensive Income. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

50. Interest

Interest income and expense are recognised in the Statement of Comprehensive Income using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and financial liability and is not revised subsequently.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the Statement of Comprehensive Income include:

- interest on financial assets and liabilities at amortised cost on an effective interest rate basis;
- interest on financial assets and liabilities held for trading; and
- interest on financial assets designated at fair value through profit or loss.

51. Fee and commission

The Group provides various services to its clients and earns income therefrom, such as income from Corporate banking, Retail banking, Capital Markets, Corporate Finance, Asset Management and Private banking. Fees earned from services that are provided over a certain period of time are recognised as the services are provided. Fees earned from transaction type services are recognised when the service has been completed. Fees that are performance linked are recognised when the performance criteria are fulfilled.

Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

52. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and financial liabilities classified as held for trading, Net gain on financial assets and liabilities at fair value, Net foreign exchange gain.

i) Dividend income is recognised when the right to receive dividend is established. Usually this is the ex-dividend date for equity securities.

ii) Net gain on financial assets and liabilities at fair value comprises all realised and unrealised fair value changes in trading portfolio and assets and liabilities designated at fair value through profit or loss, except for interest (which is included in Interest income and Interest expense) and foreign exchange gain and losses (which are included in Net foreign exchange gains as described below).

iii) Net foreign exchange gain comprise all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous Financial Statements.

Net foreign exchange gain also include foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognised in profit or loss.

53. Income tax expense

Tax expense comprises current and deferred tax. Income tax for the year has been calculated and recognised in the Financial Statements.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities and the realization of foreign exchange gain or loss, for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantively enacted at the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

54. Financial assets and financial liabilities

Recognition

The Group initially recognises loans, deposits, debt securities issued and subordinated liabilities on the date that they are originated. Regular way purchases and sales of financial assets are recognised on the trade date at which the Group commits to purchase or sell the asset. All other financial assets and liabilities are recognised on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

Classification

The Group classifies its financial assets in one of the following categories:

- amortised cost;
- at fair value through profit or loss and within the category as:
  - held for trading; or
  - designated at fair value through profit or loss; or
- AFS financial assets at fair value through other comprehensive income.

The Group classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortised cost or held for trading.

Designation at fair value through profit or loss

The Group has designated financial assets and liabilities at fair value through profit or loss in either of the following circumstances:

- the assets or liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

54. Financial assets and financial liabilities, continued

Derecognition

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

Financial liabilities are derecognised when the obligation of the Group specified in the contract is discharged or cancelled or expires.

Offsetting

Financial assets and liabilities are set off and the net amount reported in the Statement of Financial Position when, and only when, the Group has a legal right to offset the recognised amounts and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains or losses arising from a group of similar transactions such as in the Group's trading activity.

Disclosures on offsetting are provided in Note 23.

Amortised cost measurement

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

All consumer price indexed assets and liabilities are revalued based on the index rate at the end of the year.

Fair value measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Group measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses, and option pricing models. The Group uses widely recognised valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the Statement of Financial Position.

Identification and measurement of impairment

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

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

54. Financial assets and financial liabilities, continued

The Group considers evidence of impairment for loans at both a borrower-specific and a collective level. Borrowers for specific assessment are sampled based on a combination of the borrowers' exposure, days in default and an internal classification where customers are classified according to financial position, defaults and credit rating. In determining specific provisions for impairment on individually assessed borrowers, the following factors are considered:

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

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow.

Collective provisions are taken for all loans other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default, but have been determined not to require specific impairment.

In assessing collective impairment, two deciding, quantitative components need to be addressed in order to perform the calculation i.e. probability of default (PD) and loss given default (LGD). The Group uses internally developed probability-of-default models, which are regularly benchmarked against actual outcomes to ensure the predictive power of the models. For loss given default the Group uses internally developed models as well.

Impairment losses are recognised in profit or loss and reflected in an allowance account against loans. When an event occurring after the impairment was recognised causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as increase in value of loans in profit or loss when recalculation results in an increase in carrying amount and impairment when decrease in carrying amount.

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

55. Cash and cash equivalents

Cash and cash equivalents in the Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition. Cash and cash equivalents are carried at amortised cost in the Statement of Financial position.

56. Loans

Loans are financial instruments with fixed or determinable payments that are not quoted in an active market and that the Group does not intend to sell immediately or in the near term. Loans include loans provided by the Group to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

Loans are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method.

When the Group is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, the arrangement is classified as a capital lease and a receivable equal to the net investment in the lease is recognised and presented within loans.

When the Group purchases a asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date reverse repo or stock borrowing, the arrangement is accounted for as a loan, and the underlying asset is not recognised in the Group's Financial Statements.

57. Financial instruments

Trading assets and liabilities

Trading assets and liabilities are financial instruments acquired principally for the purpose of generating profits from short term price fluctuations or from a dealer's margin, and derivative financial instruments.

Securities used for hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts.

Financial assets designated at fair value through profit or loss

Assets classified designated at fair value through profit or loss consist of equity and debt instruments which are acquired by the Group with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial instruments and trading liabilities are initially and subsequently measured at fair value in the Statement of Financial position, with transaction costs recognised in profit or loss. All changes in fair value are recognised as part of net financial income in profit or loss.

Interest and dividend income that arises from these assets are included in Interest income and Net financial income, respectively.

Available-for-sale financial assets designated at fair value through Other comprehensive income

AFS financial assets include equity investments. Equity investments classified as AFS are those that are neither classified as held for trading nor designated at fair value through profit or loss. After initial measurement, AFS financial assets are subsequently measured at fair value with unrealised gains or losses recognised in OCI and credited in the AFS reserve until the investment is derecognised, at which time, the cumulative gain or loss is recognised in other operating income, or the investment is determined to be impaired, when the cumulative loss is reclassified from the AFS reserve to the statement of profit or loss in finance costs.

58. Derivatives

A derivative is a financial instrument or other contract, the value of which changes in response to a change in an underlying variable, such as share, commodity or bond prices, an index value or an exchange or interest rate, which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

Derivatives are recognised at fair value. Fair value changes are recognised in the Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and net financial gain or loss. Interest income is recognised on an accrual basis. Derivatives with positive fair values are recognised as Financial instruments and derivatives with negative fair values are recognised as Financial liabilities at fair value.

59. Intangible assets

Goodwill

Goodwill that arises on the acquisition of subsidiaries is presented with intangible assets. Subsequent to initial recognition goodwill is measured at cost less accumulated impairment losses.

Infrastucture and customer relationship

Infrastructure and customer relationship and related agreements are measured at cost less any accumulated impairment losses.

Software

Software acquired by the Group is measured at cost less accumulated amortisation and any accumulated impairment losses.

Subsequent expenditure on software is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Amortisation of intangible assets

Amortisation of intangible assets is recognised in the Statement of Comprehensive Income on a straight-line basis over the estimated useful life, from the date that it is available for use. The estimated useful life of intangible assets for the current and comparative periods is three to ten years.

60. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both.

Investment property is initially measured at cost and subsequently at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the statement of comprehensive income.

61. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than non-current assets held for resale, investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The recoverable amount of intangible assets is assessed annually.

An impairment loss is recognised if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised in profit or loss.

The recoverable amount of an asset is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss in respect of other assets, where impairment losses have been recognised in prior periods, are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

62. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortised cost using the effective interest method.

63. Borrowings

Some of the borrowings of the Group are classified as other financial liabilities and are initially recognised at fair value less attributable transaction costs. Subsequent to initial recognition, borrowings are measured at amortised cost with any difference between cost and redemption amount being recognised in the Statement of Comprehensive Income over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

64. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within Tier II, as shown in Note 45. The Group may only retire subordinated liabilities with the permission of the Icelandic Financial Supervisory Authority.

Subordinated liabilities are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at principal amount due plus accrued interest, which is recognised in the Statement of Comprehensive Income based on the contractual terms of the borrowing.

65. Other assets and other liabilities

Property and equipment

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses. When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

Subsequent expenditure is capitalised only when it is probable that the future economic benefits of the expenditure will flow to the Group. Ongoing repairs and maintenance are expensed as incurred.

The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives are as follows:

Buildings	10-33 years
Equipment	3-8 years

The depreciation methods, useful lives and residual values are reassessed annually.

Non-current assets and disposal groups held for sale

The Group classifies a non-current asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset or disposal group and the sale must be highly probable.

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognised at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement. Revaluation through the reversal of impairment in subsequent periods is limited so that the carrying amount of the held for sale, non-current assets or disposal group does not exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

Other assets and other liabilities

Other assets and other liabilities are stated at cost less impairment.

66. Equity

Dividends

Dividends on shares are recognised in equity in the period in which they are approved by Arion Bank's shareholders.

Statutory reserve

According to the Icelandic companies Act No. 2/1995 at least 10% of the profit of the Group which is not devoted to meeting losses from previous years and is not contributed to other legal reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital. When that limit has been reached the contribution must be at least 5% of the profit until the statutory reserve amounts to 25% of the share capital of the Bank.

Available-for-sale reserve

AFS reserve cpmprises all unrealised gain or losses related to fair value measurements of AFS financial assets.

Foreign currency translation reserve

The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the Financial Statements of foreign operations.

67. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to the shareholders of Arion Bank hf. by the weighted average number of ordinary shares outstanding during the year.

68. Financial guarantees

In the ordinary course of business, the Group gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognised in the Financial Statements at fair value, being the premium received. Subsequent to initial recognition, the Group's liability under each guarantee is measured at the higher of the amount initially recognised less, when appropriate, cumulative amortisation recognised in the Statement of Comprehensive Income, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is recorded in the Statement of Comprehensive Income. The premium received is recognised in the Statement of Comprehensive Income in Net fees and commission income on a straight line basis over the life of the guarantee.

69. Fiduciary activities

The Group provides asset custody, asset management, investment management and advisory services to its clients. These services require the Group to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Group's custody are not reported in its Statement of Financial Position.

70. Employee benefits

All entities with employees within the Group have defined contribution plans. The entities pay fixed contribution to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid. The contributions are recognised as an expense in the Statement of Comprehensive Income when they become due. The Group does not operate any pension fund which confers pension rights.

71. New standards and amendments to standards

New and amended standards and interpretations

The Consolidated Financial Statements are presented in accordance with the new and revised IFRS standards and new interpretations (IFRIC), applicable in the year 2015. These new and revised IFRSs did not have material effect on amounts nor information's reported in the Consolidated Financial Statements.

A number of new standards , amendments to standards and interpretations have been issued but are not yet effective for the year ended 31 December 2015, and have not been applied in preparing these Financial Statements. Relevant to the Group's reporting are:

IFRS 9 Financial Instruments. In July 2014, the IASB issued the final version of IFRS 9 Financial Instruments that replaces IAS 39 Financial Instruments: Recognition and Measurement and all previous versions of IFRS 9. The standard introduces new requirements for classification and measurement, impairment, and hedge accounting. IFRS 9 is effective for annual periods beginning on or after 1 January 2018, with early application permitted. Retrospective application is required, but comparative information is not compulsory. The Group is currently assessing the impact of the new standard on its Financial Statements and is expecting to have completed that work late 2016. The Group will not early adopt the standard. This standard has not been adopted by the European Union.

IFRS 15 Revenue from Contracts with Customers. The standard was issued in May 2014 and establishes a new five-step model that will apply to revenue arising from contracts with customers. Under IFRS 15 revenue is recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. The principles in IFRS 15 provide a more structured approach to measuring and recognising revenue. The new revenue standard will supersede all current revenue recognition requirements under IFRS. Either a full or modified retrospective application is required for annual periods beginning on or after 1 January 2018 with early adoption permitted. The Group is currently assessing the impact of IFRS 15.

IFRS 5 Non-current assets held for sale and discontinued operations. Assets (or disposal groups) are generally disposed of either through sale or distribution to owners. The amendment clarifies that changing from one of these disposal methods to the other would not be considered a new plan of disposal, rather it is a continuation of the original plan. There is, therefore, no interruption of the application of the requirements in IFRS 5. This improvement is effective for annual periods beginning on or after 1 January 2016. The improvement is not expected to have impact on the financial position or performance of the Group.

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