



Consolidated Financial Statements  
for the year 2010

Arion banki hf.  
Borgartún 19  
105 Reykjavík  
Iceland

Reg. no. 581008 - 0150

# Contents

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	page		page
Endorsement and Statement by the Board of Directors and the CEO .....	3-4	Consolidated Statement of Changes in Equity .....	8
Independent Auditor's Report .....	5	Consolidated Statement of Cash Flows .....	9
Consolidated Statement of Comprehensive Income .....	6	Notes to the Consolidated Financial Statements .....	10-81
Consolidated Statement of Financial Position .....	7		

# Endorsement and Statement by the Board of Directors and the CEO

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The Consolidated Financial Statements of Arion banki hf. for the year ended 31 December 2010 include the Financial Statements of Arion banki hf. and its subsidiaries, together referred to as "the Bank".

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

On 8 January 2010 Kaupskil hf. a company owned by the creditors of Kaupthing, signed an agreement with the Icelandic State on capitalization and future ownership of 87% shareholding in Arion banki hf. The Icelandic State remains a 13% shareholder of the Bank. The impact on the financial position of the Bank is described in note 35.

On 18 March 2010 new Board of Directors was appointed for Arion banki hf. representing the new ownership and on 1 June 2010 Höskuldur H. Ólafsson assumed the role as Chief Executive Officer of the Bank.

The average number of full time equivalent positions was 1,201. Information about salaries of staff, management and board members are in notes 54-55.

## Operations in 2010

Consolidated net earnings amounted to ISK 12,557 million for the year ended 31 December 2010. The Board of Directors proposes that profits will be added to equity and that no dividend will be paid, unless conditions as per note 35 apply. Consolidated total equity amounted to ISK 109,536 million at the end of the year, including share capital amounting to ISK 2,000 million. The capital adequacy ratio of the Bank, calculated according to the Act on Financial Undertakings, was 19.0%. By law this ratio is required to be no lower than 8.0%, but the Icelandic Financial Supervisory Authority ("FME") requires it to be no less than 16%. The Bank's liquidity ratio and cash ratio strengthened during the year and were 24.8% and 11.2% respectively at the end of 2010.

Due to the capital controls in Iceland, Arion banki hf. has a currency imbalance that results in net earnings being very sensitive to changes in the exchange rate. The Bank's objective is to close the imbalance in 2011.

Arion banki hf. generally performed well in 2010 despite the challenging economic environment. Its core banking performance was particularly strong in retail banking and asset management. The focus of corporate banking continued to be on recovery work which progressed well during the year. It was only in capital markets and investment banking activities where the performance fell below expectations, mainly as a consequence of the unusual market conditions. The group structure underwent some changes during the year, the most important being the Bank's acquisition of a larger share in Valitor, a credit card company, during the fourth quarter. Valitor is now a subsidiary of the Bank. Other changes related to the sale of companies that the Bank has acquired in the debt restructuring process. Changes to the group structure are discussed in more detail in notes 36 to 39.

The restructuring of the Bank's loan book and other assets transferred from Kaupthing has been a key task since Arion banki hf. was founded. The Bank made good progress in this regard in 2010 and the restructuring of its largest customers' debts is in its final stages. The focus in recent months has thus shifted on to solutions for smaller entities. The Bank expects the recovery work to be largely completed during 2011.

## Currency-linked lending

In February 2011 the Supreme Court of Iceland issued two judgments on currency-linked loans to companies. The court decided that the loans were illegal in the same way as it had in the 2010 judgments which led to new legislation on mortgage loans to individuals. The new judgments create certain uncertainties over currency-linked loans to smaller companies if such loans were taken to court. The Bank has already allowed for exchange rate adjustment in its accounts in relation to an agreement with the other banks and the authorities. However, if the corporate loans were to be largely deemed illegal the Bank would suffer substantial losses but this would not jeopardize the 16% capital ratio requirement.

# Endorsement and Statement by the Board of Directors and the CEO

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## Outlook

The Bank's near-term prospects are to some extent contingent on its economic environment. Investments in Iceland have been very low in recent quarters but are expected to increase as the projected medium-term economic growth materializes. The progress made in recovery work relating to corporates and individuals will further stimulate growth and investments in the near term. The lifting of capital controls in the near to medium term is likely to have an impact on deposits. The Bank's objective is therefore to extend its funding profile in collaboration with Icelandic and international investors. The relaxation of the capital controls will have a positive effect on the Bank's commission income through an increase in FX trading, an activity which has been at a low over the last two years. In other respects the Bank's aim is to continue its success in core banking activities in the Icelandic market. The Bank's strategy is to offer universal banking services to its clients and its business model will take full effect in 2011. The Bank's objective is for its universal banking activities, based on trust and close relationships with its customers, to characterize the business of the Bank going forward.

## Statement by the Board of Directors and the CEO

The Consolidated Financial Statements for the year ended 31 December 2010 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU.

It is our opinion that the Consolidated Financial Statements give a true and fair view of the consolidated financial performance of the Bank for the year 2010, its consolidated financial position as at 31 December 2010 and its consolidated cash flows in 2010.

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

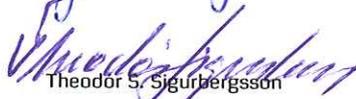
The Board of Directors and the CEO have today discussed the Consolidated Financial Statements of Arion banki hf. for the year 2010 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements be approved at the Annual General Meeting of Arion banki hf.

Reykjavik, 2 March 2011

### Board of Directors

  
Monica Caneman  
Chairman

  
Gudrun Johnsen

  
Theodor S. Sigurbergsson

  
Jón G. Briem

  
Kristján Jóhannsson

  
Gudrun Björnsdóttir

### Chief Executive Officer

  
Höskuldur H. Ólafsson

# Independent Auditor's Report

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To the Board of Directors and Shareholders of Arion banki hf.

We have audited the accompanying Consolidated Financial Statements of Arion banki hf. and its subsidiaries (the "Bank"), which comprise the Endorsement and Statement by the Board of Directors and the CEO, the Consolidated Statement of Comprehensive Income, the Consolidated Statement of Financial Position as at 31 December 2010, the Consolidated Statement of Changes in Equity and the Consolidated Statement of Cash Flows for the year then ended, and the summary of significant accounting policies and other explanatory notes.

## Management's Responsibility for the Financial Statements

Management is 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 misstatements, 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 Financial Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Financial Statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the 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 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 Bank'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 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 at 31 December 2010, of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

## Emphasis of matter

Without qualifying our opinion we draw your attention to notes 2d), 34 and 109 to the Consolidated Financial Statements concerning the carrying values of assets involving accounting estimates and judgements, and the sensitivity of these carrying values to changes in reasonably possible alternative assumptions and estimates. Actual amounts realised in the future from these assets could differ from current estimates and significant uncertainty exists over whether the differences may be material to the Consolidated Financial Statements.

Reykjavík, 2 March 2011

Ernst & Young hf.



Margrét Pétursdóttir, Partner

# Consolidated Statement of Comprehensive Income for the year 2010

	Notes	2010	2009
Interest income .....		52,369	66,905
Interest expense .....		(32,584)	(54,717)
<b>Net interest income.....</b>	42	<b>19,785</b>	<b>12,188</b>
Increase in value of loans and receivables .....	43	40,269	20,199
Impairment on loans and receivables .....	44	(26,787)	(9,939)
Changes in compensation instrument .....	74	(11,604)	(10,556)
<b>Net interest income less valuation changes on loans and receivables.....</b>		<b>21,663</b>	<b>11,892</b>
Fee and commission income .....		10,373	8,291
Fee and commission expense .....		(3,507)	(2,429)
<b>Net fee and commission income.....</b>	45	<b>6,866</b>	<b>5,862</b>
Net financial income .....	46-49	402	1,638
Fair value change to Drómi bond .....	50	(3,500)	-
Net foreign exchange gain .....	51	4,459	8,715
Share of profit or loss of associates .....	76	556	369
Other operating income .....	52-53	5,177	3,389
<b>Operating income.....</b>		<b>35,623</b>	<b>31,865</b>
Salaries and related expense .....	54-55	(9,272)	(8,073)
Administration expense .....		(7,154)	(5,260)
Depositors' and investors' guarantee fund .....	94	(324)	(683)
Depreciation and amortisation .....	78	(819)	(759)
Other operating expense .....	58-59	(723)	(571)
<b>Earnings before tax.....</b>		<b>17,331</b>	<b>16,519</b>
Income tax expense .....	61	(3,481)	(2,568)
Bank Levy .....	61	(290)	-
<b>Net earnings from continuing operations.....</b>		<b>13,560</b>	<b>13,951</b>
Net gain (loss) from discontinued operations net of tax .....	60	(1,003)	(1,080)
<b>Net earnings.....</b>		<b>12,557</b>	<b>12,871</b>
<b>Other comprehensive income</b>			
Exchange difference on translating foreign operations .....	92	(203)	(37)
<b>Total comprehensive income for the year.....</b>		<b>12,354</b>	<b>12,834</b>
<b>Attributable to:</b>			
Shareholders of Arion banki hf. ....		12,178	12,933
Non-controlling interest .....		176	(99)
<b>Total comprehensive income for the year.....</b>		<b>12,354</b>	<b>12,834</b>
<b>Earnings per share</b>			
Basic and diluted earnings per share attributable to the shareholders of Arion banki hf. (ISK) .....	62	5.52	1.02

*The notes on pages 10 to 81 are an integral part of these Consolidated Financial Statements.*

# Consolidated Statement of Financial Position

## as at 31 December 2010

<b>Assets</b>	Notes	2010	2009
Cash and balances with Central Bank .....	63	30,628	41,906
Loans and receivables to credit institutions .....	64-65	67,846	38,470
Loans and receivables to customers .....	66-69	451,219	357,734
Bonds and debt instruments .....	71-72	120,112	173,482
Shares and equity instruments with variable income .....	71	10,316	7,078
Derivatives .....	71,89	1,126	6
Securities used for hedging .....	71	3,213	2,236
Compensation instrument .....	74	24,188	34,371
Investment property .....	75	27,642	22,947
Investments in associates .....	76	2,713	5,985
Property and equipment .....	77-78	7,365	10,700
Intangible assets .....	79	4,352	3,512
Tax assets .....	85-88	295	1,415
Non-current assets and disposal groups held for sale .....	80	44,464	41,527
Other assets .....	81-82	17,136	15,975
<b>Total Assets</b>		<u>812,615</u>	<u>757,344</u>
<b>Liabilities</b>			
Due to credit institutions and Central Bank .....	71	95,646	113,647
Deposits .....	71	457,881	495,465
Borrowings .....	71,83	65,278	11,042
Subordinated liabilities .....	84	26,257	-
Financial liabilities at fair value .....	71	999	88
Tax liabilities .....	85-88	4,454	2,841
Non-current liabilities and disposal groups held for sale .....	80	13,514	19,230
Other liabilities .....	90	39,050	24,997
<b>Total Liabilities</b>		<u>703,079</u>	<u>667,310</u>
<b>Equity</b>			
Share capital .....	91	2,000	12,646
Share premium .....	91	73,861	59,354
Other reserves .....	92	1,525	1,729
Retained earnings .....		28,531	16,150
<b>Total Shareholders' Equity</b>		<u>105,917</u>	<u>89,879</u>
Non-controlling interest .....		3,619	155
<b>Total Equity</b>		<u>109,536</u>	<u>90,034</u>
<b>Total Liabilities and Equity</b>		<u>812,615</u>	<u>757,344</u>

*The notes on pages 10 to 81 are an integral part of these Consolidated Financial Statements.*

# Consolidated Statement of Changes in Equity for the year 2010

	Share capital and share premium	Other reserves	Retained earnings	<b>Total Share- holders' equity</b>	Non- controlling interest	<b>Total equity</b>
<b>2010</b>						
Equity 1 January 2010 .....	72,000	1,729	16,150	89,879	155	90,034
Redeemed share capital .....	(62,139)			(62,139)		(62,139)
Issued share capital .....	66,000			66,000		66,000
Total comprehensive income for the year						
attributable to the shareholders of Arion banki hf. ....		(203)	12,381	12,178		12,178
Total comprehensive income for the year						
attributable to the non-controlling interest .....					176	176
Non-controlling interests acquired during the year .....					3,288	3,288
<b>Equity 31 December 2010 .....</b>	<b>75,861</b>	<b>1,525</b>	<b>28,531</b>	<b>105,917</b>	<b>3,619</b>	<b>109,536</b>
<b>2009</b>						
Equity 1 January 2009 .....	72,000	129	4,817	76,946		76,946
Total comprehensive income for the year						
attributable to the shareholder of Arion banki hf. ....		(37)	12,970	12,933		12,933
Total comprehensive income for the year						
attributable to the non-controlling interest .....					(99)	(99)
Transfer to statutory reserve .....		1,637	(1,637)	-		-
Non-controlling interests acquired during the year .....					254	254
<b>Equity 31 December 2009 .....</b>	<b>72,000</b>	<b>1,729</b>	<b>16,150</b>	<b>89,879</b>	<b>155</b>	<b>90,034</b>

*The notes on pages 10 to 81 are an integral part of these Consolidated Financial Statements.*

# Consolidated Statement of Cash Flows

## for the year 2010

	Notes	2010	2009
<b>Cash flows from (used in) operating activities:</b>			
Earnings before income tax .....		17,331	16,519
Adjustments to reconcile earnings before income tax to net cash from (used in) operating activities:			
Non-cash items included in net earnings before income tax and other adjustments .....	100	(6,386)	(15,879)
Changes in operating assets and liabilities .....	101	(7,991)	(36,474)
Income taxes paid .....		(748)	(585)
		2,206	(36,419)
<b>Net cash from (used in) operating activities</b>			
<b>Cash flows from (used in) investing activities:</b>			
Purchase of investment property .....		(1,120)	(2,865)
Investment in associated companies .....		(66)	(612)
Proceeds from sale of investment property .....		1,705	
Proceeds from sale of associated companies .....		54	193
Purchase of intangible assets .....		(121)	(152)
Purchase of property and equipment .....		(381)	(208)
Proceeds from sale of property and equipment .....		110	138
Proceeds from sale of legal entities acquired exclusively with view to resale .....		706	-
Proceeds from the sale of individual properties included in discontinued operations .....		1,870	-
		2,757	(3,506)
<b>Net cash from (used in) investing activities</b>			
Net increase (decrease) in cash and cash equivalents .....		4,963	(39,925)
Cash and cash equivalents at beginning of the year .....		56,094	92,910
Cash and cash equivalents acquired through business combinations .....		18,110	804
Effect of exchange rate changes on cash and cash equivalents .....		(6,370)	2,305
		72,797	56,094
<b>Cash and cash equivalents at the end of the year.....</b>	102		
<b>Non-cash investing and financing transactions:</b>			
Loans and receivables received through changes in capitalization, see note 35 .....		112,824	-
Bonds and debt instruments delivered through changes in capitalization, see note 35 .....		(32,595)	-
Liabilities due to credit institutions and central bank			
transferred due to changes in capitalization, see note 35 .....		14,428	-
Borrowings transferred due to changes in capitalization, see note 35 .....		(61,252)	-
Subordinated loans transferred due to changes in capitalization, see note 35 .....		(29,543)	-
Net changes in equity due to changes in capitalization .....		(3,862)	-
Equity contribution by the Icelandic state settled			
through the receipt of Icelandic government bonds .....		-	71,225
Bond claim on Drómi and Sparisjódabanki Íslands hf. in consideration for deposits and overdrafts ..		-	91,860
Deposits and overdrafts transferred from Spron and Sparisjódabanki Íslands hf .....		-	(91,860)
Assets acquired from Sparisjódur Mýrasýslu .....		-	9,714
Bond issued to the creditors of Sparisjódur Mýrasýslu .....		-	(9,714)
Assets acquired through foreclosure on collateral from legal entities with view to resale .....		9,816	30,944
Settlement of loans and receivables through foreclosure on collateral from legal entities			
with view to resale .....		(9,816)	(30,944)

*The notes on pages 10 to 81 are an integral part of these Consolidated Financial Statements.*

# Notes to the Consolidated Financial Statements

## Contents

	page		page
Accounting Policies		Borrowings .....	48
General information .....	11	Subordinated liabilities .....	48
Significant accounting policies .....	12-23	Tax assets and tax liabilities .....	49-50
Changes within the Bank .....	24-26	Derivatives .....	50
Operating Segment Reporting	27-28	Other liabilities .....	50
Notes to the Consolidated Statement of Comprehensive Income		Equity	
Net interest income .....	29	Share capital and share premium .....	51
Increase in value of loans and receivables .....	29	Other reserves .....	51
Impairment on loans and receivables .....	29	Off Balance Sheet information	
Net fee and commission income .....	30	Obligations .....	51
Net financial income (expense) .....	31	Operating lease commitments .....	52
Other operating income .....	32	Assets under management and	
Personnel .....	32-33	and under custody .....	52
Auditor's fee .....	34	Contingent liabilities .....	52
Other operating expense .....	34	Notes to the Cash Flow Statement	53
Net gain (loss) from discontinued operations		Risk Management Disclosures	
net of tax .....	34	Introduction .....	54
Tax expense .....	35	Credit risk .....	56
Earnings per share .....	35	Market risk .....	67
Notes to the Consolidated Statement of Financial Position		Liquidity risk .....	73
Cash and balances with Central Bank .....	36	Operational risk .....	75
Loans and receivables to credit institutions .....	36	Capital Adequacy and ICAAP strategy .....	76
Loans and receivables to customers .....	36-37	Other information	
Renegotiated loans .....	38	The uncertainty regarding the book value	
Additional information on loans and receivables .....	39	of currency-linked lending .....	78
Financial assets and liabilities .....	39-43	Related parties .....	79
Compensation instrument .....	44	Offsetting agreement between Arion banki hf.	
Investment property .....	44	and Kaupthing banki hf. ....	80
Investment in associates .....	45	Events after the Balance Sheet date .....	80
Property and equipment .....	46	Subsidiaries .....	81
Intangible assets .....	47		
Non-current assets and disposal groups held for sale ...	47		
Other assets .....	48		

# Notes to the Consolidated Financial Statements

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## General information

### 1. Reporting entity

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The Bank was initially named New Kaupthing banki hf. but on 21 November 2009 the name was changed to Arion banki hf. The address of Arion banki hf.'s registered office is Borgartún 19, Reykjavík. The Consolidated Financial Statements for the year ended 31 December 2010 comprise Arion banki hf. and its subsidiaries (together referred to as "the Bank"). The Bank offers integrated financial services to companies, institutional investors and individuals. These services include corporate banking, capital market services, retail banking, corporate financing, asset management and comprehensive wealth management for private banking clients.

The Bank has acquired a number of entities exclusively with view to resale. The acquisitions were the result of foreclosures. As the operation of these entities is different to the Bank's core operations the effects only appear in a limited number of line items in the Consolidated Statement of Comprehensive Income and the Consolidated Statement of Financial Position.

The Consolidated Financial Statements were approved and authorised for issue by the Board of Directors of Arion banki hf. on 2 March 2011.

### 2. Basis of preparation

#### a) *Statement of compliance*

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as endorsed by the European Union.

#### b) *Basis of measurement*

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

- Financial assets/liabilities held for trading are measured at fair value
- Financial assets/liabilities designated at fair value through profit and loss are measured at fair value
- Investment properties are measured at fair value
- Compensation instrument is measured at fair value

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

#### c) *Functional and presentation currency*

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

#### d) *Use of estimates and judgements*

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

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.

Judgements made by management that have a significant effect on the Consolidated Financial Statements and estimates with a significant risk of material adjustment within the next financial year are discussed in notes 34, 73, 109, 110 and 111.

# Notes to the Consolidated Financial Statements

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## Significant accounting policies

The accounting policies set out below have been applied consistently in these Consolidated Financial Statements.

### 3. Going concern assumption

The Bank's management has made an assessment of the Bank's ability to continue as a going concern and is satisfied that the Bank has the resources to continue. The Consolidated Statement of Financial Position of the Bank presents uncertainty due to the asset-liability mismatches of significant risks as described in the Risk Management disclosures. A considerable portion of the purchased assets from Kaupthing banki hf. are denominated in low interest rate foreign currencies and are funded with deposits denominated in Icelandic króna, a high interest rate currency. Liquidity risk, as well as risks related to imbalances in currency, duration and interest rate base are outlined in the Risk Management disclosures. Whilst the Bank's stress testing has resulted in the Bank management assessing that it is sufficiently capitalised to deal with market shocks, significant market shocks during the realignment period of the Bank's risk profile, poses some uncertainty.

The Bank is making progress in adapting to the new economic reality in Iceland with a focus on strengthening the infrastructure and internal control. The main focus has been on safeguarding the value of the Bank's assets through the recovery process and a team of specialists has been put together to work with defaulting customers. A favourable outcome from this process is already strengthening the Bank's business. Further information on risk factors in the Bank's operation are provided in the Risk Management Disclosures.

### 4. Principles underlying the consolidation

#### a) *Subsidiaries*

Subsidiaries are entities controlled by the Bank. Control exists when the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Bank holds more than 50% of the voting power of the subsidiary. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. 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 from 1 January 2010

The acquisition method of accounting is used to account for the acquisition of businesses and subsidiaries by the Bank. The cost of an acquisition is measured as the aggregate of the consideration transferred, measured at acquisition date fair value and the amount of any non-controlling interest in the acquiree. For each business combination, the Bank measures the non-controlling interest in the acquiree either at fair value or at the proportionate share of the acquiree's identifiable net assets. Acquisition costs incurred are expensed and included in administrative expenses. If the business combination is achieved in stages, the acquisition date fair value of the acquirer's previously held equity interest in the acquiree is remeasured to fair value at the acquisition date through profit or loss. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any non-controlling interest.

Goodwill is initially measured at cost being the excess of the aggregate of the consideration transferred and the amount recognised for non-controlling interest over the net identifiable assets acquired and liabilities assumed. If this consideration is lower than the fair value of the net assets of the subsidiary acquired, the difference is recognised in the Consolidated Statement of Comprehensive Income. After initial recognition, goodwill is measured at cost less any accumulated impairment losses.

#### 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 subsidiary is classified as held for sale the investment is accounted for, as non-current asset held for sale from the date of classification.

#### Business combinations prior to 1 January 2010

In comparison to the above-mentioned requirements, the following differences applied:

Business combinations were accounted for using the purchase method. Transaction costs directly attributable to the acquisition formed part of the acquisition costs. The non-controlling interest (formerly known as minority interest) was measured at the proportionate share of the acquiree's identifiable net assets. Business combinations achieved in stages were accounted for as separate steps. Any additional acquired share of interest did not affect previously recognised goodwill.

#### b) *Non-controlling interest*

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Bank; such interests are presented separately in the Consolidated Statement of Comprehensive Income and are included in equity in the Consolidated Statement of Financial Position, separately from equity attributable to owners of the Bank. Losses within a subsidiary are attributed to the non-controlling interest even if that results in a deficit balance. Changes in the Bank's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

#### c) *Funds management*

The Bank manages and administers assets held in investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Consolidated Financial Statements except when the Bank controls the entity.

# Notes to the Consolidated Financial Statements

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## 5. Associates

Associates are those entities over which the Bank 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 Bank holds between 20% and 50% of the voting power, including potential voting rights. Investments in associates are initially recognised at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The Consolidated Financial Statements include the Bank'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 Bank's share of losses exceeds its interest in an equity accounted associate, the Bank's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Bank has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Bank resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

If an investment in an associate is classified as held for sale the equity method is no longer applied and the investment is accounted for, as a non-current asset held for sale.

## 6. Foreign currency

### a) *Functional currencies*

Items included in the Financial Statements of each of the Bank's subsidiaries are measured using the functional currency of the respective entity.

### b) *Foreign currency transactions*

Transactions in foreign currencies are translated to the respective functional currencies of Bank 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. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the year, and the amortised cost in foreign currency translated at the exchange rate at the end of the year. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

### c) *Foreign operations*

The assets and liabilities of foreign operations are translated to Icelandic króna, at exchange rates at the reporting date. The income and expenses of foreign operations are translated to Icelandic króna at exchange rates approximating the exchange rates current at the dates of the transactions.

Foreign exchange differences arising on translation are recognised in Consolidated Statement of Comprehensive Income. When a foreign operation is disposed of, in part or in full, the cumulative amount of the exchange differences relating to that foreign operation which is recorded in comprehensive income and accumulated in the separate component of equity, is transferred to the Consolidated Statement of Comprehensive Income when the gain or loss on disposal is recognised.

## 7. Income and Expense

### a) *Interest income and expense*

Interest income and expense are recognised in the Consolidated 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 liability and is not revised subsequently.

The calculation of the effective interest rate includes all fees paid or received, transaction costs, and discounts or premiums that are an integral part of the effective interest rate. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability.

Interest income and expense presented in the Consolidated Statement of Comprehensive Income include:

- Interest on financial assets and liabilities at amortised cost on an effective interest rate basis,
- Interest on trading assets and liabilities on an accrual basis,
- Interest on financial assets and financial liabilities designated at fair value through profit or loss on an accrual basis,
- Interest on derivatives on an accrual basis.

Interest income on non-performing assets are recognised in the Consolidated Statement of Comprehensive Income using the effective interest method. The Bank recognises losses for impaired loans to offset the recognised interest income when appropriate.

# Notes to the Consolidated Financial Statements

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7. cont.

b) *Fee and commission income and expense*

The Bank provides various services to its clients and earns income therefrom, such as income from Corporate banking, Retail banking, Capital Markets, Corporate Finance and 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.

c) *Net financial income*

Net financial income comprises Dividend income, Net gain on financial assets and liabilities at fair value through profit or loss and Net gain on disposal of financial assets and liabilities not at fair value.

- i) Dividend income is recognised when the right to receive income is established. Usually this is the ex-dividend date for equity securities.
- ii) Net gain on financial assets and liabilities at fair value through profit or loss comprises: Net gain on trading portfolio, Net gain on assets and liabilities designated at fair value through profit or loss.

*Net gain on trading portfolio*

Net gains on financial instruments held for trading comprise gains and losses related to financial assets and financial liabilities held for trading, and includes all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below).

*Net gain on assets and liabilities designated at fair value through profit or loss*

Net gains on financial instruments designated at fair value through profit or loss comprise gains and losses related to financial assets and financial liabilities designated at fair value through profit or loss, and includes all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below).

- iii) Net foreign exchange gains 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 gains 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 gains and losses are also recognised in profit or loss.

- iv) Net gain on financial assets and liabilities not at fair value through profit or loss relates to derecognition of certain financial assets and liabilities and comprises Net realised gain or loss on financial liabilities measured at amortised cost and other net realised gain or loss. It does not include either unrealised foreign exchange gains and losses or interest income and expense which are included in other line items.

d) *Income tax*

*Income tax* comprises current and deferred tax. Income tax is recognised in the Consolidated Statement of Comprehensive Income except to the extent that it relates to items recognised directly in other comprehensive income or equity, in which case it is recognised in other comprehensive income or equity.

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.

The deferred income tax asset / liability has been calculated and entered in the Consolidated Statement of Financial Position. The calculation is based on the difference between Consolidated Statement of Financial Position items as presented in the tax return on the one hand, and in the Consolidated Financial Statements on the other. This difference is due to the fact that tax assessments are based on premises that differ from those governing the Consolidated Financial Statements, mostly because revenues and settlement is not expected at the same time. A deferred tax asset is only offset against income tax liability if they are due to tax assessment from the same tax authorities.

A deferred tax asset is recognised only 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.

# Notes to the Consolidated Financial Statements

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## 8. Impairment of financial assets

At each reporting date the Bank 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.

An impairment loss is recognised whenever the carrying amount of a financial asset exceeds its recoverable amount. Impairment losses are recognised as described below.

### a) *Impairment on loans and receivables*

The Bank recognises losses for impaired loans when there is objective evidence that impairment of a loan or portfolio of loans has occurred. This is done on a consistent basis in accordance with the Bank's guidelines.

There are two basic methods of calculating impairment losses, those calculated on individual loans and those losses assessed on a collective basis. Losses expected as a result of future events, no matter how likely, are not recognised.

Objective evidence of impairment includes observable data about the following loss events:

- i) Significant financial difficulty of the borrower;
- ii) A breach of contract, such as a default on instalments or on interest or principal payments;
- iii) The Bank granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a refinancing concession, that the lender would not otherwise consider;
- iv) It becomes probable that the borrower will enter bankruptcy or undergo other financial reorganisation;
- v) Deterioration in collateral to loan ratio; or
- vi) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of loans since the initial recognition of those assets, even if the decrease cannot yet be identified with the individual financial assets in the group, including:
  - Adverse changes in the payment status of borrowers in the group; or
  - General national or local economic conditions connected with the assets in the group.

### Individually assessed loans

Impairment losses on individually assessed accounts are determined by an evaluation of the exposures on a case-by-case basis. The Bank assesses at each reporting date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining such impairment losses on individually assessed accounts, the following factors are considered:

- The Bank'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 security (or other credit mitigates) and likelihood of successful repossession; and
- The likely deduction of any costs involved in recovery of amounts outstanding.

Impairment loss is calculated by comparing the present value of the expected future cash flows, discounted at the original effective interest rate of the loan, with its current carrying value and the amount of any loss is charged in the Consolidated Statement of Comprehensive Income. The carrying amount of impaired loans is reduced through the use of an allowance account. In the case of a loan at variable interest rates, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

### Collectively assessed loans

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. This loss covers loans that are impaired at the reporting date but which will not be individually identified as such until some time in the future. The estimated collective impairment loss is recognised through the use of an allowance account.

# Notes to the Consolidated Financial Statements

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8. cont.

The collective impairment loss is determined after taking into account:

- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash flows of the asset
- Historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);
- The estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan;
- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash; and
- Management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification is determined for each identified portfolio.

Estimates of changes in future cash flows for groups of assets should be consistent with changes in observable data from period to period, for example, changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to minimise any differences between loss estimates and actual losses.

#### Loan write-offs

Loans are normally 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 security have been received.

#### Reversals of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised or acquired, the previously recognised or acquired impairment loss is reversed. The amount of any reversal is recognised in the Consolidated Statement of Comprehensive Income.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Bank includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Bank revises its estimate of payments or receipts, the Bank adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Bank 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 and receivables in profit or loss when recalculation results in an increase in carrying amount and impairment when decrease in carrying amount.

#### Assets acquired in exchange for loans

Assets acquired in exchange for loans are recorded as non-current assets held for sale in the Consolidated Statement of Financial Position if its sale is highly probable and management is committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan have been initiated. The non-current asset held for resale is recorded at the lower of its fair value less costs to sell, and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the Consolidated Statement of Comprehensive Income. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the Consolidated Statement of Comprehensive Income.

#### b) *Calculation of recoverable amount*

The recoverable amount of the Bank's investments in financial assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate, i.e. the effective interest rate computed at initial recognition of these financial assets.

#### c) *Impairment on investments in associates*

After applying the equity method to account for investments in associates, the Bank determines whether it is necessary to recognise any impairment loss with respect to its investments in associates. The Bank first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Bank 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 Bank. The excess of the carrying amount over the recoverable amount is recognised in the Consolidated Statement of Comprehensive Income as an impairment loss. Impairment losses are subsequently reversed through the Consolidated Statement of Comprehensive Income if the reasons for the impairment loss no longer apply.

# Notes to the Consolidated Financial Statements

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## 9. Impairment of non-financial assets

The carrying amounts of the Bank'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.

## 10. 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 Consolidated Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and other gains and losses. Interest income is recognised on an accrual basis. Derivatives with positive fair values are recognised as Derivatives and derivatives with negative fair values are recognised as Financial liabilities at fair value.

The fair value of derivatives is determined in accordance with the accounting policy presented in note 13.

## 11. Cash and cash equivalents

Cash and cash equivalents in the Consolidated 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.

## 12. Loans and receivables

Loans and receivables are financial instruments with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term. Loans include loans provided by the Bank to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

When the Bank purchases a financial 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 Bank's Financial Statements.

Loans and receivables are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and receivables.

# Notes to the Consolidated Financial Statements

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## 13. Financial assets measured at fair value through profit and loss

### a) *Trading assets*

Trading assets 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.

### b) *Financial assets designated at fair value through profit or loss*

The Bank classifies certain financial assets upon their initial recognition as financial assets held at fair value with fair value changes recognised in the Consolidated Statement of Comprehensive Income as Net financial income if doing so results in more relevant information because:

- i) the assets are managed, evaluated and reported internally on a fair value basis;
- ii) the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- iii) the assets contain an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

The assets classified according to the above mentioned conditions consist of equity and debt instruments which are acquired by the Bank with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Interest and dividend income that arises from these assets are included in Interest income and Net financial income, respectively.

## 14. Determination of fair value

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. For all other financial instruments fair value is determined by using valuation techniques. Valuation techniques include net present value techniques, the discounted cash flow method, comparison to similar instruments for which market observable prices exist, and valuation models. The Bank 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 Consolidated Statement of Financial Position.

## 15. Recognition and derecognition of financial assets and financial liabilities

Purchases and sales of financial assets are recognised using trade date accounting, i.e. they are recognised on the date on which the Bank commits to purchase or sell the asset, except for loans which are recognised when cash is advanced to the borrowers.

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all risks and rewards of ownership.

Financial liabilities are recognised when the Bank becomes a party to the contractual provisions of the liability instrument. Financial liabilities are derecognised when the obligation of the Bank specified in the contract is discharged or cancelled or expires.

## 16. Offsetting financial assets and financial liabilities

Financial assets and liabilities are set off and the net amount reported in the Consolidated Statement of Financial Position when, and only when, the Bank 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 Bank's trading activity.

# Notes to the Consolidated Financial Statements

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## 17. Amortised cost measurement of financial assets and financial liabilities

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.

## 18. Intangible assets

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. Internally generated intangible assets are not capitalised and expenditure is reflected in the Consolidated Statement of Comprehensive Income in the period in which the expenditure is incurred.

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

### a) *Subsequent expenditure*

Subsequent expenditure on capitalised intangible assets 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.

### b) *Amortisation*

Amortisation is recognised in the Consolidated Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of intangible assets. Intangible assets are amortised from the date they are available for use. The estimated useful lives are as follows:

Software.....	5 years
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## 19. 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 stated at fair value.

When determining the fair value of the properties, net present value of future cash flow over 30 years is calculated. When determining the cash flow general accepted valuation techniques are applied, such as international valuation standards, IVS no. 1 Market Value Basis of Valuation. The valuation model is based on estimated free cash flow to the owners and assumptions applied that reflect the market conditions at the accounting date. The cash flow of the properties is based on estimation of rental income less estimated expenses. There is great uncertainty about the actual fair value of investment properties, as further described in Note 34.

Rental income is estimated based on valid lease agreements. In the valuation model estimated market lease at the end of the current lease agreement is taken into consideration. Fundamental assumptions on estimated utilisation of the properties in the future, estimated discounts and loan provisioning are applied when estimating future rental income.

All related expenses, e.g. maintenance, real estate tax and other operating and financial expenses, is deducted from the estimated rental income. Real estate tax and insurances are based on historical data and foreseen future changes. Financial expense is estimated based upon market interest and expected interest yield (interest margin).

The net present value of free cash flow to owners, for each property, is determined by calculating the net present value of the cash flow with a factor representing current market uncertainty on amount and timing of the cash flow, including expected inflation. The CAPM model is used and the required rate of return is based on the risk free real interest on the accounting date, the risk factor of the real estate market and specific risk factors of each lessee.

When estimating the fair value of the investment properties' assets like fixtures, equipment and furniture are not accounted for separately as they are considered part of the fair value of the properties. The fair value of the properties does not reflect the possible future increase in the value due to further investments in the property.

The fair value of investment property in progress is mainly based on offers received for the properties.

# Notes to the Consolidated Financial Statements

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## 20. Property and equipment

### a) *Recognition and measurement*

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.

### b) *Subsequent costs*

The cost of replacing part of an item of property and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Bank and its cost can be measured reliably. All other costs are recognised in the Consolidated Statement of Comprehensive Income as an expense as incurred.

### c) *Depreciation*

The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Consolidated 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.

## 21. Non-current assets and disposal groups held for sale

The Bank 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 Consolidated Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement.

## 22. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortised cost using the effective interest method.

## 23. Borrowings

Some of the borrowings of the Bank 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 Consolidated 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.

## 24. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Bank'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 116. The subordinated liabilities have no maturity date and the Bank may only retire them with the permission of the Financial Supervisory Authority. The liabilities qualify as Tier II capital in the calculation of the equity ratio.

Subordinated liabilities are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at amortised cost with any difference between cost and redemption value being recognised in the Consolidated Statement of Comprehensive Income over the period of the borrowings on an effective interest basis.

# Notes to the Consolidated Financial Statements

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## 25. Financial liabilities at fair value

### *Trading liabilities*

Trading liabilities primarily consist of derivatives with negative fair values. Hedging derivatives such as those used for internal risk control but not qualifying for hedge accounting under IAS 39 are also disclosed under this item.

Trading liabilities are measured at fair value. Gains and losses realised on disposal or redemption and unrealised gains and losses from changes in the fair value of trading liabilities are reported as Net gain on financial assets and liabilities measured at fair value. Interest expenses on trading liabilities are included in Interest expenses.

## 26. Other assets and other liabilities

Other assets and other liabilities are stated at cost less impairment.

## 27. Equity

### *Dividends on shares*

Dividends on shares are recognised in equity in the period in which they are approved by the Bank's shareholders.

### *Statutory reserve*

According to the Icelandic companies Act No. 2/1995 at least 10% of the profit of the Bank 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.

### *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.

## 28. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to equity holders of the Bank by the weighted average number of ordinary shares outstanding during the year.

## 29. Financial guarantees

In the ordinary course of business, the Bank 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 Bank's liability under each guarantee is measured at the higher of the amount initially recognised less, when appropriate, cumulative amortisation recognised in the Consolidated 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 Consolidated Statement of Comprehensive Income. The premium received is recognised in the Consolidated Statement of Comprehensive Income in *Net fees and commission income* on a straight line basis over the life of the guarantee.

## 30. Fiduciary activities

The Bank provides asset custody, asset management, investment management and advisory services to its clients. These services require the Bank to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Bank's custody are not reported in its Consolidated Statement of Financial Position.

## 31. Employee benefits

All entities within the Bank have defined contribution plans. The entities pay fixed contribution to publicly or privately administered pension plans on a mandatory and contractual basis. The Bank has no further payment obligations once these contributions have been paid. The contributions are recognised as an expense in the Consolidated Statement of Comprehensive income when they become due. The Bank has no defined benefit pension plan.

# Notes to the Consolidated Financial Statements

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## 32. New standards and amendments to standards

### a) New standards and amendments to standards effective in 2010

The accounting policies adopted are consistent with those of the previous financial year, except for the following new and amended IFRS effective as of 1 January 2010:

#### *IFRS 3 Business Combinations (Revised) and IAS 27 Consolidated and Separate Financial Statements (Amended)*

IFRS 3 (Revised) introduces significant changes in the accounting for business combinations occurring after becoming effective. Changes affect the valuation of non-controlling interest, the accounting for transaction costs, the initial recognition and subsequent measurement of a contingent consideration and business combinations achieved in stages. These changes will impact the amount of goodwill recognised, the reported results in the period that an acquisition occurs and future reported results.

IAS 27 (Amended) requires that a change in the ownership interest of a subsidiary (without loss of control) is accounted for as a transaction with owners in their capacity as owners. Therefore, such transactions will no longer give rise to goodwill, nor will it give rise to a gain or loss. Furthermore, the amended standard changes the accounting for losses incurred by the subsidiary as well as the loss of control of a subsidiary. The changes by IFRS 3 (Revised) and IAS 27 (Amended) affect acquisitions or loss of control of subsidiaries and transactions with non-controlling interests after 1 January 2010.

#### *Improvements to IFRS - May 2008 and April 2009*

As part of the annual "Improvements to IFRS", in May 2008 and April 2009 the IASB issued an omnibus of amendments to its standards, primarily with a view to removing inconsistencies and clarifying wording. They comprised amendments that result in accounting changes for presentation, recognition or measurement purposes as well as terminology or editorial amendments related to a variety of individual IFRS standards. They were effective for annual periods beginning on or after 1 January 2009 (already adopted in 2009), 1 July 2009 or 1 January 2010 and had no impact on the accounting policies, financial position or performance of the Bank.

### b) New standards and amendments to standards not yet adopted

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2010, and have not been applied in preparing these Consolidated Financial Statements. Relevant to the Bank's reporting are:

*IFRS 9 Financial Instruments.* In November 2009, the IASB issued IFRS 9 *Financial instruments*, which includes new classification and measurement criteria for financial assets. The publication of IFRS 9 represents the completion of the first part of a multi-stage project to replace IAS 39 *Financial instruments: recognition and measurement*. Under the revised guidance, a financial asset is to be accounted for at amortized cost only if it is held within a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Non-traded equity instruments may be accounted for at fair value, with unrealised and realised fair value gains recognised through other comprehensive income, but the subsequent release of amounts booked directly to other comprehensive income to profit or loss is no longer permitted. All other financial assets are measured at fair value through profit or loss. The Bank is currently assessing the impact of the new standard on its consolidated financial statements. If endorsed by the EU, the effective date for mandatory adoption is 1 January 2013.

## 33. Segment reporting

The Bank's segmental reporting is based on the management and internal reporting structure. The Bank comprises two main business segments; Corporate banking & Capital Markets and Retail banking.

# Notes to the Consolidated Financial Statements

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## 34. Critical accounting estimates and judgements in applying accounting policies

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

These disclosures supplement the risk management disclosures, provided elsewhere in these consolidated financial statements.

### *Key sources of estimation uncertainty*

#### i) Impairment losses on loans and receivables

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

#### ii) Fair value of financial instruments

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

#### iii) Assets classified as held for sale

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

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

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

#### iv) Fair value of Investment Property

In Iceland, there is no third party that provides information on the market value of investment properties located in Iceland. As the market is relatively inactive and assets are often quite dissimilar it is difficult to obtain comparison. The international financial crises and the financial crisis in Iceland had significant influence on the real estate market in Iceland. The effects of that resulted in a relatively passive market and with disparate properties on the market it can be complicated to determine prices of recent market transactions of comparable properties. This being the case there is great uncertainty about the actual fair value of the properties.

#### v) Intangible assets

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

# Notes to the Consolidated Financial Statements

## Changes within the Bank

### 35. Changes in ownership and capitalization of Arion banki hf.

On 3 September 2009, the Resolution Committee of Kaupthing banki hf., on behalf of Kaupskil ehf., signed an agreement with the Icelandic Ministry of Finance regarding capitalization and future ownership of Arion banki hf. Based on the agreement Kaupskil hf. acquired a majority shareholding of 87% in Arion banki hf. The remaining shareholding of 13% is held by the Icelandic State.

On 30 November 2009, the Resolution Committee of Kaupthing banki hf., on behalf of Kaupskil ehf., approved the decision to acquire a 87% shareholding in Arion banki hf.

Following an approval from FME, the annual shareholders' meeting of Arion banki hf. held 8 January 2010 approved the transfer of 87% of the Icelandic state shareholding to Kaupskil ehf.

These Consolidated Financial Statements reflect changes in capitalization following the changes in ownership of Arion banki hf. 8 January 2010.

Changes following shareholder approval 8 January 2010:

<b>Assets</b>	8.1.2010
Loans and receivables to customers .....	112,824
Bonds and debt instruments .....	(32,595)
<b>Total Assets</b>	<b>80,229</b>
<b>Liabilities</b>	
Due to credit institutions and Central Bank .....	(14,428)
Borrowings .....	61,252
Subordinated liabilities .....	29,543
<b>Liabilities</b>	<b>76,367</b>
<b>Equity</b>	
Share capital .....	(10,646)
Share premium .....	14,508
<b>Total Equity</b>	<b>3,862</b>
<b>Total Liabilities and Equity</b>	<b>80,229</b>

Following the agreement made on 8 January 2010 the Icelandic State received a capital return of 87% of its shareholding in Arion banki hf. equity, amounting to ISK 62,138 million. The Icelandic State provided Arion banki hf. with a ISK 29,543 million subordinated loan, as calculated 4% Tier 2 capital. Net payment of government bonds to the Icelandic State was ISK 32,595 million. After this transaction Kaupskil hf. owned approximately 65% of total capital (equity and subordinated loans) and the Icelandic State approximately 35%.

With new shareholder and changes in capitalization the share capital was increased by ISK 66,000 million. The capital increase consists of the following transactions:

<b>Capitalization</b>	8.1.2010
ISK mortgage loans .....	6,584
Due to credit institutions and Central Bank .....	14,428
Corporate loans .....	28,770
Other loans .....	16,218
	<b>66,000</b>
<b>Related funding agreement with Central Bank</b>	
FX mortgage loans .....	38,094
ISK mortgage loans .....	23,158
Borrowings .....	(61,252)
	<b>-</b>

# Notes to the Consolidated Financial Statements

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## 35. cont.

According to the agreement Arion banki hf. shall pay to the Icelandic State a special dividend amounting to ISK 6,500 million which shall be deducted from the retained earnings, by a way of single one time payment if the following conditions are met:

- i) The Core Tier 1 ratio of Arion banki hf. has to be at least 12%.
- ii) The Core Tier 1 ratio shall be calculated according to the audited annual accounts results of Arion banki hf. (year end), the first accounts for this purposes being for operating year of 2010, and annually thereafter.
- iii) For the purpose of this calculation ISK 6,5 billion of retained earnings are disregarded.

As these conditions were met at year end 2010 the Bank will discuss with the Icelandic State an arrangement for this payment.

## 36. Acquisition of legal entities acquired exclusively with view to resale.

In order to secure assets placed as collateral against loans to customers the Bank was compelled to foreclose on several legal entities in 2010, the largest of which are set out below. These entities are deemed to be not significant in comparison to the activities of the Bank.

The Bank holds as a consequence 100% shareholdings in Langalína 2 ehf., B.M. Vallá ehf. and Fram foods hf. These legal entities were acquired exclusively with view a to resale.

### i) B.M. Vallá ehf.

B.M. Vallá ehf. was acquired 21 May 2010. The company has been one of the leading companies within the Icelandic construction industry producing concrete, tiles and stones and a variety of other building materials. B.M. Vallá ehf. was classified as a subsidiary when it was first acquired.

### ii) Langalína 2 ehf.

Langalína 2 ehf. was acquired on 7 May 2010. The company holds a number of real estates in Iceland. Langalína 2 ehf. meets the criteria in IFRS 5 to be classified as a non-current asset and disposal group held for sale and has been accounted for as such in these Consolidated Financial Statements.

### iii) Fram foods hf.

Fram foods hf. was acquired on 11 November 2010. The company specialises in production and sale of chilled seafood. Fram foods Group consists of companies operating in Iceland, Sweden, Finland, France and Chile. Fram foods hf. meets the criteria in IFRS 5 to be classified as a non-current asset and disposal group held for sale and has been accounted for as such in these Consolidated Financial Statements.

## 37. Changes in classification of legal entities acquired exclusively with view to resale.

The following legal entities acquired exclusively with view to resale were reclassified in the fourth quarter of 2010 from subsidiaries to non-current asset and disposal groups held for sale:

- i) Subsidiaries of Hafrahlíd ehf., Hekla ehf., was sold in early 2011, and its affiliate Hekla fasteignir ehf. will be sold in the first half of 2011.
- ii) Penninn á Íslandi ehf. which at year-end was held by the Bank's wholly owned private equity company Eignabjarg.
- iii) B.M. Vallá ehf. which at year-end was held by the Bank's wholly owned private equity company Eignabjarg.

The Bank's equity holding in each of these entities rose in 2009 and 2010 through seizing the business as collateral against loans.

# Notes to the Consolidated Financial Statements

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## 38. Business combinations

Valitor Holding ehf.

Valitor Holding ehf. (Valitor) is the holding company of Valitor ehf. which holds a share in Visa Europe and provides all service to issuers of credit cards, i.e. banks and savings banks, in relation to credit card issuance and related payment transactions.

On 12 October 2010, the Bank received the approval of the FME to hold a controlling interest in Valitor. At year-end the Bank had a direct and indirect holding in total of 52.94%.

Prior to 12 October 2010, the Bank held 47.0% of Valitor which was recognised as an Investment in Associate. Consequently, the Bank has accounted for this business combination as a step acquisition. The fair value at 12 October 2010 of this previously held investment was ISK 3,889 million, which exceeded the previously equity-accounted book value of ISK 3,612 million. The amount of ISK 277 million, being the excess of the acquisition-date fair value over the book value of the previously held investment is included in Share of profit or loss of associates in the Consolidated Statement of Comprehensive Income.

The Bank has elected to measure the non-controlling interest in Valitor as disclosed in the Consolidated Statement of changes in Equity at fair value. The fair value of the non-controlling interest was estimated based on prices of recent transactions (to which the Bank has been a counterparty) in the acquiree's shares. Valitor is an unlisted company and as such no market information is available. Goodwill arising on this acquisition is disclosed in Note 79.

From the date the shareholding increased in Valitor the company has contributed ISK 184 million to the Net earnings attributable to the shareholders of the Bank. If the increase in shareholding of Valitor had taken place at the beginning of the year the Net earnings attributable to the shareholders of the Bank would have been ISK 36 million higher.

G-7 ehf.

G-7 ehf. became a subsidiary of the Bank on 1 November 2010. The legal entity holds investment properties in Iceland. Due to the current market condition the timing of the ultimate disposal is uncertain and the requirements of IFRS 5 to classify the asset as held for sale can therefore not be met. G-7 ehf. was classified as a subsidiary at year end. G-7 ehf. is not significant compared to the activities of the Bank.

## 39. Disposal of legal entity acquired exclusively with view to resale.

The Bank sold its shareholding in two legal entities in 2010. The legal entities were acquired exclusively with view to resale in 2009. Due to the market condition the timing of the ultimate disposal of the assets was uncertain at year end 2009 and the requirements of IFRS 5 to classify the assets as held for sale was not met. Thus these legal entities were classified as subsidiaries and included in the Consolidated Financial Statements for 2009. The Bank has recognised the resulting gain from these transactions in the Consolidated Statement of Comprehensive Income.

### i) Penninn Holding 1 Oy

On 24 August 2010 the Bank sold its 100% shareholding in Penninn Holding 1 Oy. At the end of June 2010 this legal entity was considered to meet the requirements of IFRS 5 and was classified as non current assets and disposal groups classified as held for sale.

### ii) Insomnia Ltd

On 17 December 2010, the Bank's subsidiary Icecorp Ltd. sold its 50.1% shareholding in Insomnia Ltd.

The results from the disposal of these entities is included in net earnings from discontinued operations net of tax.

# Notes to the Consolidated Financial Statements

## Operating Segment Reporting

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

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

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

### Business segments

The Bank comprises two main business segments:

**Corporate Banking and Capital Markets** serve large enterprises, investors and institutional investors. The role of the division is to provide universal financial services and tailored services to meet the needs of each customer. Corporate Banking and Capital Markets is organized into seven divisions: Corporate Trading, FX and Fixed Income Trading, Equities Trading, Research, Legal and Archives, and Credit Management.

**Retail Banking** provides a comprehensive range of services, including advice on deposits and loans, savings, payment cards, pension savings, insurance, securities, funds and more. To maximize operational efficiency the branch network is divided into seven clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Customers of Retail Banking's 24 branches all around Iceland are over 100,000.

**Other business segments are:** Asset Management, Corporate Finance, Overhead, Risk Management, Finance, Legal, Operations, Corporate Development and activities of other non-core entities.

41. Summary of the Bank's business segments:

2010	Corporate Banking	Retail Banking	Other Divisions and Elimination	Total
Net interest income .....	13,551	8,963	(2,729)	19,785
Increase in value of loans and receivables .....	25,877	5,050	9,342	40,269
Impairment on loans and receivables .....	(12,533)	(5,414)	(8,840)	(26,787)
Changes in compensation instrument .....	-	-	(11,604)	(11,604)
Net fee and commission income .....	804	3,246	2,816	6,866
Net financial and FX income (expense) .....	(4,047)	1,831	3,577	1,361
Other income .....	537	1,431	3,764	5,733
<b>Operating income</b> .....	<b>24,189</b>	<b>15,107</b>	<b>(3,673)</b>	<b>35,623</b>
Operating expense .....	(2,333)	(9,876)	(6,083)	(18,292)
<b>Earnings before tax</b> .....	<b>21,856</b>	<b>5,231</b>	<b>(9,756)</b>	<b>17,331</b>
Net segment revenue from external customers .....	33,605	9,193	(7,175)	35,623
Net segment revenue from other segments .....	(9,415)	5,913	3,502	-
<b>Operating income</b> .....	<b>24,190</b>	<b>15,106</b>	<b>(3,673)</b>	<b>35,623</b>
Depreciation and amortisation .....	1	290	528	819
<b>Total assets</b> .....	<b>273,502</b>	<b>233,288</b>	<b>305,825</b>	<b>812,615</b>
Allocated equity .....	(43,760)	(35,233)	(30,543)	(109,536)

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

# Notes to the Consolidated Financial Statements

41. cont.

2009	Corporate Banking	Retail Banking	Other Divisions and Elimination	Total
Net interest income .....	7	8,683	3,498	12,189
Increase in value of loans and receivables .....	14,508	213	5,478	20,199
Impairment on loans and receivables .....	(8,667)	(1,801)	529	(9,939)
Changes in compensation instrument .....	-	-	(10,556)	(10,556)
Net fee and commission income .....	1,117	1,751	2,994	5,862
Net financial and FX income (expense) .....	(33)	785	9,600	10,352
Other income .....	9	1,416	2,333	3,758
<b>Operating income</b> .....	<b>6,941</b>	<b>11,047</b>	<b>13,876</b>	<b>31,865</b>
Operating expense .....	(1,656)	(8,300)	(5,390)	(15,346)
<b>Earnings before tax</b> .....	<b>5,286</b>	<b>2,747</b>	<b>8,486</b>	<b>16,519</b>
Net segment revenue from external customers .....	29,223	(12,686)	15,328	31,865
Net segment revenue from other segments .....	(22,282)	23,734	(1,452)	-
<b>Operating income</b> .....	<b>6,941</b>	<b>11,047</b>	<b>13,876</b>	<b>31,865</b>
Depreciation and amortisation .....	1	278	481	759
<b>Total assets</b> .....	<b>540,459</b>	<b>137,364</b>	<b>79,521</b>	<b>757,344</b>
Allocated equity .....	75,470	14,671	(107)	90,034

Segment reporting for 2009 has been restated due to a change in the composition of reportable segments in 2010.

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

# Notes to the Consolidated Financial Statements

## Notes to the Consolidated Statement of Comprehensive Income

### Net interest income

42. Interest income and expense is specified as follows:

2010	Interest income	Interest expense	Net interest income
Cash and balances with Central Bank .....	937	-	937
Loans, receivables and deposits .....	38,004	28,222	9,782
Borrowings .....	-	2,683	(2,683)
Subordinated liabilities .....	-	1,250	(1,250)
Securities .....	11,320	-	11,320
Compensation instrument .....	1,256	-	1,256
Other .....	852	429	423
<b>Interest income and expense .....</b>	<b>52,369</b>	<b>32,584</b>	<b>19,785</b>
Interest income and expense from assets and liabilities at fair value .....	11,320	-	11,320
Interest income and expense from assets and liabilities not at fair value through profit or loss .....	41,049	32,584	8,465
<b>Interest income and expense .....</b>	<b>52,369</b>	<b>32,584</b>	<b>19,785</b>
<b>2009</b>			
Cash and balances with Central Bank .....	2,793	-	2,793
Loans, receivables and deposits .....	45,408	53,060	(7,652)
Borrowings .....	-	1,564	(1,564)
Securities .....	10,934	17	10,917
Compensation instrument .....	2,411	-	2,411
Other .....	5,359	76	5,283
<b>Interest income and expense .....</b>	<b>66,905</b>	<b>54,717</b>	<b>12,188</b>
Interest income and expense from assets and liabilities at fair value .....	10,934	17	10,917
Interest income and expense from assets and liabilities not at fair value through profit or loss .....	55,971	54,700	1,271
<b>Interest income and expense .....</b>	<b>66,905</b>	<b>54,717</b>	<b>12,188</b>

### Increase in value of loans and receivables

43. The increase in value of loans and receivables is determined in accordance with the accounting policy presented in note 8 a). Increase in book value of loans and receivables consists of adjustment to reflect actual and estimated cash flows.

### Impairment on loans and receivables

44. Impairment on loans and receivables is specified as follows:

	2010	2009
Impairment on loans and receivables to credit institutions .....	632	682
Impairment on loans and receivables to customers .....	25,985	8,317
Impairment on receivables and other assets .....	170	940
<b>Impairment .....</b>	<b>26,787</b>	<b>9,939</b>

Further information on the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in note 111 c).

# Notes to the Consolidated Financial Statements

## Net fee and commission income

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

2010	At fair value through profit or loss	Not at fair value through profit or loss	Trust and other fiduciary activity	Total
<b>Fee and commission income</b>				
Securities trading .....	-	-	189	189
Derivatives .....	169	-	-	169
Lending and guarantees .....	-	540	-	540
Asset management fees .....	-	-	2,582	2,582
Other fee and commission income - banking activities .....	-	-	6,364	6,364
Other fee and commission income .....	-	-	529	529
<b>Fee and commission income .....</b>	<b>169</b>	<b>540</b>	<b>9,664</b>	<b>10,373</b>
<b>Fee and commission expense</b>				
Securities trading .....	-	-	201	201
Asset management fees .....	-	-	199	199
Other fee and commission income - banking activities .....	-	-	2,961	2,961
Other fee and commission expense .....	-	-	146	146
<b>Fee and commission expense .....</b>	<b>-</b>	<b>-</b>	<b>3,507</b>	<b>3,507</b>
<b>Net fee and commission income .....</b>	<b>169</b>	<b>540</b>	<b>6,157</b>	<b>6,866</b>

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

The Bank has a service level agreement providing back office services for mortgage loans with fee income ISK 527 (2009: 179)

2009	At fair value through profit or loss	Not at fair value through profit or loss	Trust and other fiduciary activity	Total
<b>Fee and commission income</b>				
Securities trading .....	-	-	285	285
Derivatives .....	373	-	-	373
Lending and guarantees .....	-	622	-	622
Asset management fees .....	-	-	2,968	2,968
Other fee and commission income - banking activities .....	-	-	3,476	3,476
Other fee and commission income .....	-	-	567	567
<b>Fee and commission income .....</b>	<b>373</b>	<b>622</b>	<b>7,296</b>	<b>8,291</b>
<b>Fee and commission expense</b>				
Securities trading .....	-	-	170	170
Asset management fees .....	-	-	637	637
Other fee and commission income - banking activities .....	-	-	1,324	1,324
Other fee and commission expense .....	-	-	298	298
<b>Fee and commission expense .....</b>	<b>-</b>	<b>-</b>	<b>2,429</b>	<b>2,429</b>
<b>Net fee and commission income .....</b>	<b>373</b>	<b>622</b>	<b>4,867</b>	<b>5,862</b>

# Notes to the Consolidated Financial Statements

## Net financial income (expense)

46. Net financial income (expense) is specified as follows:	2010	2009
Dividend income .....	34	29
Net gain (loss) on financial assets and liabilities classified as held for trading .....	(531)	1,240
Net gain (loss) on financial assets and liabilities designated at fair value through profit or loss .....	899	369
<b>Net financial income</b> .....	<b>402</b>	<b>1,638</b>
47. Dividend income is specified as follows:		
Dividend income on trading assets .....	2	20
Dividend income on assets designated at fair value through profit or loss .....	32	9
<b>Dividend income</b> .....	<b>34</b>	<b>29</b>
48. Net gain (loss) on trading portfolio are specified as follows:		
Net gain (loss) on equity instruments and related derivatives .....	251	279
Net gain (loss) on interest rate instruments and related derivatives .....	(1,038)	194
Net gain (loss) on other derivatives .....	256	767
<b>Net gain (loss) on trading portfolio</b> .....	<b>(531)</b>	<b>1,240</b>
49. Net gain (loss) on assets/liabilities designated at fair value through profit or loss are specified as follows:		
Net gain (loss) on interest rate instruments designated at fair value .....	(119)	230
Net gain (loss) on equity instruments designated at fair value .....	1,018	139
<b>Net gain (loss) on assets/liabilities designated at fair value through profit and loss</b> .....	<b>899</b>	<b>369</b>
50. At the beginning of February 2011, the FME ruled in dispute between Arion banki hf. and Drómi to decrease the interest margin on the Drómi bond. The bond has been held at fair value in the Banks accounts since it was received in connection with the acquisition of the deposits from SPRON in March 2009. At the time the interest rate was REIBOR + 175 bps but the ruling of the FME was for the interest rate to be REIBOR flat, effective 1 July, 2010. The Bank will use every endeavour to have this ruling altered.		
51. Net gain (loss) on foreign exchange are specified as follows:		
FX gain (loss) on loans and receivables .....	(7,658)	15,059
FX gain (loss) on bank accounts .....	(6,370)	2,305
FX gain (loss) from deposits and borrowings .....	17,407	(9,597)
FX gain (loss) from subordinated liabilities .....	4,401	-
FX gain (loss) on bonds, equity and derivatives .....	(21)	445
FX gain (loss) from compensation instrument .....	(1,852)	1,373
FX gain (loss) on other assets and liabilities .....	(1,448)	(870)
<b>Total gain (loss) on foreign exchange</b> .....	<b>4,459</b>	<b>8,715</b>

# Notes to the Consolidated Financial Statements

## Other operating income

52. Other operating income is specified as follows:	2010	2009
Rental income from investment properties .....	2,050	1,183
Fair value changes on investment property .....	69	170
Realised gain on investment property .....	121	70
Earned premiums, net of reinsurance .....	851	822
Net gain on disposals of assets other than held for sale .....	578	44
Other income .....	1,508	1,100
<b>Other operating income</b> .....	<b>5,177</b>	<b>3,389</b>

53. Earned premiums, net of reinsurance:

Premium written .....	994	988
Outward reinsurance premiums .....	(99)	(96)
Change in the gross provision for unearned premiums .....	(44)	(70)
<b>Earned premiums, net of reinsurance</b> .....	<b>851</b>	<b>822</b>

## Personnel

54. The Bank's total number of employees is as follows:

Average number of full time equivalent positions during the year .....	1,201	1,177
Full time equivalent positions at the end of the year .....	1,260	1,157

Included in the average number of full time equivalent are Kaupthing Bank hf. employees, total of 33 in the year 2009. At the end of the year no Kaupthing banki hf. employee is included in the number of full time equivalent positions. During 2010 154 employees were added to the total number of employees from new subsidiaries.

Number of employees in core operations is as follows:

Average number of full time equivalent positions during the year .....	1,125	1,126
Full time equivalent positions at the end of the year .....	1,177	1,091

55. Salaries and related expense are specified as follows:

Salaries .....	7,269	6,489
Defined contribution pension plans .....	981	732
Salary related expense .....	1,022	852
<b>Salaries and related expense</b> .....	<b>9,272</b>	<b>8,073</b>

Included in the total amount of salaries and related expenses in 2009 are salaries of Kaupthing Bank hf. employees amounting to ISK 309 million.

# Notes to the Consolidated Financial Statements

## 56. Compensation of the key management personnel:

Salaries and related cost:

2010

	Position	Period	
Finnur Sveinbjörnsson .....	CEO .....	01.01. - 31.05.2010 .....	15.9
Höskuldur H. Ólafsson .....	CEO .....	01.06. - 31.12.2010 .....	30.0
Colin C. Smith .....	Director .....	20.05. - 30.09.2010 .....	1.6
Drífa Sigfúsdóttir .....	Director .....	01.01. - 18.03.2010 .....	0.4
Erna Bjarnadóttir, Chairman .....	Director .....	01.01. - 18.03.2010 .....	0.7
Guðrún Björnsdóttir .....	Director .....	18.03. - 31.12.2010 .....	0.4
Guðrún Johnsen .....	Director .....	18.03. - 31.12.2010 .....	5.0
Helga Jónsdóttir .....	Director .....	01.01. - 18.03.2010 .....	0.4
Jón G. Briem .....	Director .....	18.03. - 31.12.2010 .....	0.7
Jónína A. Sanders .....	Director .....	01.01. - 18.03.2010 .....	0.4
Kristján Jóhannsson .....	Director .....	18.03. - 31.12.2010 .....	3.3
Monica Caneman, Chairman .....	Director .....	18.03. - 31.12.2010 .....	6.6
Steen Hemmingsen .....	Director .....	18.03. - 10.11.2010 .....	2.7
Theodór S. Sigurbergsson .....	Director .....	18.03. - 31.12.2010 .....	3.3
Kaupthing Bank hf.* .....	Director .....	01.01. - 18.03.2010 .....	0.8
Five managing directors of the Bank's divisions .....			109.9

2009

Finnur Sveinbjörnsson .....	CEO .....	01.01. - 31.12.2009 .....	21.0
Audur Finnbogadóttir .....	Director .....	01.01. - 03.09.2009 .....	1.1
Drífa Sigfúsdóttir .....	Director .....	01.01. - 31.12.2009 .....	1.6
Erna Bjarnadóttir, Chairman .....	Director .....	01.01. - 31.12.2009 .....	2.1
Helga Jónsdóttir .....	Director .....	01.01. - 31.12.2009 .....	2.2
Hulda Dóra Styrmissdóttir, Chairman .....	Director .....	10.02. - 03.09.2009 .....	1.7
Jónína A. Sanders .....	Director .....	03.09. - 31.12.2009 .....	0.5
Magnús Gunnarsson, Chairman .....	Director .....	01.01. - 10.02.2009 .....	0.4
Kaupthing bank hf.* .....	2 Directors .....	03.09. - 31.12.2009 .....	1.2
Five managing directors of the Bank's divisions .....			80.1

The remuneration of the Chairman of the Board and the other directors of the Board was decided by a Shareholder's meeting on 8 January 2010.

Remuneration to the Chairman of the Board, CEO and other key management personnel consist of salary and other benefits.

All compensation to key management personnel were short term employee benefits.

\* Kaupthing bank hf. assigned two directors to the board of Arion banki hf., Theodór S. Sigurbergsson and Jóhannes Rúnar Jóhannesson for the period 03.09.2009 - 18.03.2010.

# Notes to the Consolidated Financial Statements

## Auditor's fee

57. Auditor's fee is specified as follows:

2010	Ernst & Young	KPMG	Total
Audit of the Financial Statements and other related audit service .....	124	76	200
Other service .....	0	8	8
<b>Auditor's fee .....</b>	<b>124</b>	<b>84</b>	<b>208</b>
2009			
Audit of the Financial Statements and other related audit service .....	60	38	98
Other service .....	18	28	46
<b>Auditor's fee .....</b>	<b>78</b>	<b>66</b>	<b>144</b>

## Other operating expense

58. Other operating expenses:	2010	2009
Direct operating expenses (including repairs and maintenance) arising on rental-earning investment properties .....	449	256
Claims incurred, net of reinsurance .....	274	315
<b>Other operating expenses .....</b>	<b>723</b>	<b>571</b>

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

59. Claims incurred, net of reinsurance:

Claims paid .....	279	317
Change in the provision for claims .....	117	(59)
Claims paid, net of reinsurers' share .....	(76)	97
Change in the provision for claims, reinsurers' share .....	(46)	(40)
<b>Claims incurred, net of reinsurance .....</b>	<b>274</b>	<b>315</b>

## Net gain (loss) from discontinued operations net of tax

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

Net earnings (loss) from legal entities .....	799	(705)
Impairment loss on remeasurement to fair value of legal entities .....	(2,629)	-
Impairment loss on real estates .....	(904)	(423)
Other assets .....	(286)	48
Effect of compensation instrument .....	2,017	-
<b>Net gain (loss) on non-current and disposal groups assets classified as held for sale .....</b>	<b>(1,003)</b>	<b>(1,080)</b>

Net earnings (loss) from legal entities comprises the revenues, expenses and income tax expense from operations of legal entities that were classified as held for sale by the end of 2010. Revenues, expenses and income tax expense of legal entities recognised as subsidiaries in 2009 (and included in relevant captions of the 2009 Consolidated Statement of Comprehensive Income) that were classified as held for sale during 2010 have been represented in the 2010 Consolidated Statement of Comprehensive Income within Net loss from legal entities for 2009 of amount ISK 705 million. The significant amounts represented were Other operating income of ISK 17,812 million; Other operating expense of ISK 15,708 million and Salaries expense of ISK 2,340 million.

# Notes to the Consolidated Financial Statements

## Tax expense

	2010	2009
61. Income tax recognised in the Consolidated Statement of Comprehensive Income are specified as follows:		
a) Current tax expense		
Current year .....	3,518	1,076
Deferred tax expense		
Changes in temporary differences .....	(37)	1,492
<b>Total income tax expense</b> .....	<b>3,481</b>	<b>2,568</b>

Reconciliation of effective tax rate:	2010		2009	
Earnings before income tax .....		17,331		16,519
Income tax using the Icelandic corporation tax rate .....	18.0%	3,120	15.0%	2,478
Non-deductible expense .....	0.3%	60	0.1%	9
Tax exempt revenues .....	(1.6%)	(283)	(0.8%)	(126)
Changes in deferred tax asset .....	4.7%	811	0.0%	-
Effect of increase in the income tax rate from 18% to 20% (2009; 15% to 18%) .....	0.4%	64	1.8%	297
Other changes .....	(1.7%)	(291)	(0.5%)	(89)
<b>Effective tax rate</b> .....	<b>20.1%</b>	<b>3,481</b>	<b>15.6%</b>	<b>2,569</b>

## b) Bank Levy

Bank levy is calculated according to law. The levy is 0,041% on total debt at year-end. Non-financial subsidiaries are exempt from this tax.

## Earnings per share

62. Earnings per share are specified as follows:	2010	2009
Net earnings attributable to the shareholders of Arion banki hf. ....	12,178	12,933
Weighted average share capital:		
Weighted average number of outstanding shares for the year, million .....	2,207	12,646
Basic earnings per share .....	5.52	1.02
Diluted earnings per share .....	5.52	1.02
Number of outstanding shares at the end of the year, million .....	2,000	12,646
Number of total shares at the end of the year, million, diluted .....	2,000	12,646

There were no instruments at year-end that could potentially dilute basic earnings per share that were not included in the calculation of diluted earnings per share.

# Notes to the Consolidated Financial Statements

## Notes to the Consolidated Statement of Financial Position

### Cash and balances with Central Bank

63. Cash and balances with Central Bank are specified as follows:	2010	2009
Cash on hand .....	9,609	3,536
Cash with Central Bank .....	13,250	28,521
Mandatory reserve deposits with Central Bank .....	7,769	9,849
<b>Cash and balances with Central Bank .....</b>	<b>30,628</b>	<b>41,906</b>

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

### Loans and receivables to credit institutions

64. Loans and receivables to credit institutions specified by types of loans:		
Bank accounts .....	57,707	24,037
Money market loans .....	1,294	4,733
Overdrafts .....	29	4,074
Other loans .....	10,175	6,353
Provision on loans and receivables .....	(1,359)	(727)
<b>Loans and receivables to credit institutions .....</b>	<b>67,846</b>	<b>38,470</b>

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

Balance at the beginning of the year .....	727	44
Provision for losses during the year .....	632	683
<b>Balance at the end of the year .....</b>	<b>1,359</b>	<b>727</b>

### Loans and receivables to customers

66. Loans and receivables to customers specified by types of loans:		
Overdrafts .....	37,390	31,673
Subordinated loans .....	499	17
Other loans and receivables .....	455,173	354,780
Provision on loans and receivables .....	(41,843)	(28,736)
<b>Loans and receivables to customers .....</b>	<b>451,219</b>	<b>357,734</b>

# Notes to the Consolidated Financial Statements

67. Loans and receivables to customers specified by sectors:	2010	2009
Individuals .....	24.7%	15.5%
Financial and insurance activities .....	14.1%	14.8%
Manufacturing, mining and other industry .....	13.3%	16.1%
Real estate activities .....	13.0%	17.4%
Agriculture, forestry and fishing .....	11.1%	11.8%
Wholesale and retail trades, transport, accommodation and food service activities .....	9.9%	4.3%
Business services .....	8.3%	12.2%
Construction .....	2.4%	5.3%
Public administration, defence, education, human health and social work activities .....	1.8%	1.3%
Other services .....	1.4%	1.3%
<b>Loans and receivables to customers .....</b>	<b>100.0%</b>	<b>100.0%</b>

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

Balance at the beginning of the year .....	28,736	18,905
Provision for losses and write-offs during the year .....	13,277	9,852
Payment of loans previously written off .....	(170)	(21)
<b>Balance at the end of the year .....</b>	<b>41,843</b>	<b>28,736</b>
Specific .....	39,083	28,736
Collective .....	2,760	-
	<b>41,843</b>	<b>28,736</b>

Further information about the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in note 111 c).

69. Impaired loans and receivables to customers by sector:	2010		2009	
	Impaired amount	Impaired loans	Impaired amount	Impaired loans
Individuals .....	5,472	35,118	1,201	8,058
Financial and insurance activities .....	4,673	24,228	6,934	20,990
Manufacturing, mining and other industry .....	2,136	19,095	2,466	18,207
Real estate activities .....	7,568	48,686	6,303	47,333
Agriculture, forestry and fishing .....	2,606	22,184	1,941	14,333
Wholesale and retail trades, transport, accommodation and food service activities .....	3,294	28,604	1,814	7,571
Business services .....	10,562	45,022	4,197	32,296
Construction .....	2,349	9,501	840	6,198
Public administration, defence, education, human health and social work activities .....	77	2,558	868	4,845
Other services .....	346	2,538	2,172	16,687
<b>Impairment on loans and receivables to customers .....</b>	<b>39,083</b>	<b>237,534</b>	<b>28,736</b>	<b>176,518</b>

# Notes to the Consolidated Financial Statements

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## **Renegotiated loans**

70. During 2009 and 2010 Arion banki hf. has engaged in financial restructuring of customers that are experiencing financial difficulties. For a detailed discussion of the Bank's recovery processes, see Note 108 b).

Starting in December 2009, the Bank has run a comprehensive program of standard solutions to assist individuals who have run into financial difficulties. These programs are now closed. Through the programs, the Bank reduced the debt level of 2346 individuals by an average of 27%.

Per an agreement between the government and lending institutions, the Bank participates in a coordinated effort to assist SMEs that are experiencing financial difficulties. The Bank engages companies on a case-by-case basis using a transparent set of standard procedures. To date, the debt restructuring of 270 companies has been finalized. The total nominal value post restructuring is 128 bn ISK, some of which is subordinated debt on which the Bank has taken a 23,5 bn ISK provision. In some instances the Bank has taken an equity stake in a company.

The Bank predicts that it will complete all of its restructuring activities in 2011.

# Notes to the Consolidated Financial Statements

## Financial assets and liabilities

71. Financial assets and liabilities are specified as follows:

2010	Loans and receivables	Designated Trading at fair value		Financial assets/ liabilities at amort. cost	Total
<i>Loans and receivables</i>					
Cash and balances with Central Bank .....	30,628	-	-	-	30,628
Loans to credit institutions .....	67,846	-	-	-	67,846
Loans to customers .....	451,219	-	-	-	451,219
<b>Loans and receivables .....</b>	<b>549,693</b>	-	-	-	<b>549,693</b>
<i>Bonds and debt instruments</i>					
Listed .....	-	4,731	41,833	-	46,564
Unlisted .....	-	20	73,528	-	73,548
<b>Bonds and debt instruments .....</b>	<b>-</b>	<b>4,751</b>	<b>115,361</b>	<b>-</b>	<b>120,112</b>
<i>Shares and equity instruments with variable income</i>					
Listed .....	-	12	2,062	-	2,074
Unlisted .....	-	612	5,451	-	6,063
Bond funds with variable income .....	-	360	1,819	-	2,179
<b>Shares and equity instruments .....</b>	<b>-</b>	<b>984</b>	<b>9,332</b>	<b>-</b>	<b>10,316</b>
<i>Derivatives</i>					
OTC derivatives .....	-	1,126	-	-	1,126
<b>Derivatives .....</b>	<b>-</b>	<b>1,126</b>	<b>-</b>	<b>-</b>	<b>1,126</b>
<i>Securities used for hedging</i>					
Bonds and debt instruments .....	-	3,213	-	-	3,213
<b>Securities used for hedging .....</b>	<b>-</b>	<b>3,213</b>	<b>-</b>	<b>-</b>	<b>3,213</b>
Compensation instrument .....	-	-	24,188	-	24,188
Other financial assets .....	-	-	-	16,688	16,688
<b>Financial assets .....</b>	<b>549,693</b>	<b>10,074</b>	<b>148,881</b>	<b>16,688</b>	<b>725,336</b>
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank .....	-	-	-	95,646	95,646
Deposits .....	-	-	-	457,881	457,881
Borrowings .....	-	-	-	65,278	65,278
Subordinated liabilities .....	-	-	-	26,257	26,257
<b>Liabilities at amortised cost .....</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>645,062</b>	<b>645,062</b>
<i>Financial liabilities at fair value</i>					
Short position in bonds held for trading .....	-	923	-	-	923
Derivatives held for trading .....	-	76	-	-	76
<b>Financial liabilities at fair value .....</b>	<b>-</b>	<b>999</b>	<b>-</b>	<b>-</b>	<b>999</b>
Other financial liabilities .....	-	-	-	34,048	34,048
<b>Financial liabilities .....</b>	<b>-</b>	<b>999</b>	<b>-</b>	<b>679,110</b>	<b>680,109</b>

# Notes to the Consolidated Financial Statements

71. cont.

2009	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
<i>Loans and receivables</i>					
Cash and balances with Central Bank .....	41,906	-	-	-	41,906
Loans to credit institutions .....	38,470	-	-	-	38,470
Loans to customers .....	357,734	-	-	-	357,734
<b>Loans and receivables</b> .....	<b>438,110</b>	-	-	-	<b>438,110</b>
<i>Bonds and debt instruments</i>					
Listed .....	-	4,221	4,614	-	8,835
Unlisted .....	-	-	164,647	-	164,647
<b>Bonds and debt instruments</b> .....	-	<b>4,221</b>	<b>169,261</b>	-	<b>173,482</b>
<i>Shares and equity instruments with variable income</i>					
Listed .....	-	709	429	-	1,138
Unlisted .....	-	1,464	3,380	-	4,844
Bond funds with variable income .....	-	320	776	-	1,096
<b>Shares and equity instruments</b> .....	-	<b>2,493</b>	<b>4,585</b>	-	<b>7,078</b>
<i>Derivatives</i>					
OTC derivatives .....	-	6	-	-	6
<b>Derivatives</b> .....	-	<b>6</b>	-	-	<b>6</b>
<i>Securities</i>					
Bonds and debt instruments .....	-	2,236	-	-	2,236
<b>Securities</b> .....	-	<b>2,236</b>	-	-	<b>2,236</b>
Compensation instrument .....	-	-	34,371	-	34,371
Other financial assets .....	-	-	-	9,230	9,230
<b>Financial assets</b> .....	<b>438,110</b>	<b>8,956</b>	<b>208,217</b>	<b>9,230</b>	<b>664,513</b>
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank .....	-	-	-	113,647	113,647
Deposits .....	-	-	-	495,465	495,465
Borrowings .....	-	-	-	11,042	11,042
<b>Liabilities at amortised cost</b> .....	-	-	-	<b>620,154</b>	<b>620,154</b>
<i>Financial liabilities at fair value</i>					
Derivatives held for trading .....	-	88	-	-	88
<b>Financial liabilities at fair value</b> .....	-	<b>88</b>	-	-	<b>88</b>
Other financial liabilities .....	-	-	-	15,262	15,262
<b>Financial liabilities</b> .....	-	<b>88</b>	-	<b>635,416</b>	<b>635,504</b>

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

# Notes to the Consolidated Financial Statements

72. Bonds and debt instruments designated at fair value specified by issuer:	2010	2009
Financial institutions .....	74,626	94,307
Public .....	40,393	73,048
Corporates .....	342	1,906
<b>Bonds and debt instruments designated at fair value .....</b>	<b>115,361</b>	<b>169,261</b>

The total amount of pledged bonds at 31 December 2010 was ISK 20,005 million (31 December 2009: Nil). Pledged bonds at year-end comprised Icelandic Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank.

## 73. Fair value hierarchy

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

Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;

Level 2: other techniques for which all inputs which have a significant effect on the recorded fair value are observable, either directly or indirectly; and

Level 3: techniques which use inputs which have a significant effect on the recorded fair value that are not based on observable market data.

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

2010	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL .....	3,063	119,962	1,668	124,693
Financial assets held for trading .....	7,956	2,098	20	10,074
Compensation instrument .....	-	-	24,188	24,188
	<u>11,019</u>	<u>122,060</u>	<u>25,876</u>	<u>158,955</u>
Financial liabilities held for trading .....	-	999	-	999
 2009				
Financial assets designated at FV through PL .....	2,215	168,953	2,678	173,846
Financial assets held for trading .....	7,166	1,790	-	8,956
Compensation instrument .....	-	-	34,371	34,371
	<u>9,381</u>	<u>170,743</u>	<u>37,049</u>	<u>217,173</u>
Financial liabilities held for trading .....	-	88	-	88

The classification of assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2009 is in consistency with the classification used in 2010.

The Compensation Instrument is classified within Level 3 as its value is based on the value of predefined loans for which market information is mostly unobservable. Valuation techniques used for the pool of assets involve estimation of future cash flow as explained in note 109 a. The contract provides Kaupthing the right to receive from the Bank 80% of the uplift of the predefined loans up to the initial value of the Compensation Instrument (ISK 38bn) and 50% of the uplift of the predefined loans thereafter up to a maximum amount of ISK 5 billion.

The Bank's fair value model takes into consideration the movement in the value of the pre-defined loans recognised in the current Consolidated Statement of Financial Position. The Bank estimates that the fair value attributable to future volatility in the predefined loan book valuation is not significant

# Notes to the Consolidated Financial Statements

73. cont.

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

	Transfers from Level 1 to Level 2	
	2010	2009
Financial assets		
Financial assets designated at FV through PL .....	1,146	24

The above financial assets were transferred from Level 1 to Level 2 as they have ceased to be actively traded during the year and fair values were consequently obtained using valuation techniques using observable market inputs. There have been no transfers from Level 2 to Level 1 in 2010 and 2009.

The fair value of a financial instrument is the amount at which the instrument 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 Bank to measure financial assets and financial liabilities. If quoted prices for a financial instrument 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 financial instrument 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 the financial instrument in Note 71 is used as an approximation for the fair value of the instrument. 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 Bank to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, such as commodities, the fair value is derived directly from the market prices. These instruments are disclosed under Bonds, Shares, Derivatives and Financial liabilities at fair value in the Consolidated Statement of Financial Position.

##### *Level 2: Fair value established using valuation techniques with observable market information*

For financial instruments, for which the market is not active, the Bank 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, 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 financial instruments for which quoted prices on active markets are not available, the fair values are 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.

The fair value for deposits with stated maturities was 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 Consolidated 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 financial instruments 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.

# Notes to the Consolidated Financial Statements

73. cont.

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.

Movements in level 3 financial instruments measured at fair value

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

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

	2010	2009
Balance at the beginning of the year.....	2,678	2,990
Gain (losses) recognised in consolidated statement of comprehensive income.....	(1,348)	(731)
Purchases.....	376	714
Sales.....	(18)	(295)
Balance at the end of the year.....	1,688	2,678

The following table shows the line items in the consolidated statement of comprehensive income where gain (losses) related to fair value measurements in Level 3 are recognised:

	2010	2009
Net interest income.....	18	24
Net financial income (expense).....	(1,223)	(878)
Net foreign exchange gain (loss).....	(143)	123
Gain (losses) recognised in the consolidated statement of comprehensive income.....	(1,348)	(731)

The following table presents the carrying amounts and fair values of financial assets and liabilities that are not carried at fair value in the financial statements. This table does not include the fair values of non-financial assets and non-financial liabilities.

	Carrying value	Fair value	Un-recognised gain (loss)
<b>Financial assets not carried at fair value</b>			
Cash and balances with Central bank .....	30,628	30,628	-
Loans and receivables to credit institutions .....	67,846	67,846	-
Loans and receivables to customers .....	451,219	451,219	-
Other financial assets .....	16,688	16,688	-
	566,381	566,381	-
<b>Financial liabilities not carried at fair value</b>			
Due to credit institutions and Central bank .....	95,646	95,646	-
Deposits .....	457,881	457,881	-
Borrowings .....	65,278	65,219	59
Subordinated loans .....	26,257	26,257	-
Other financial liabilities .....	34,048	34,048	-
	679,110	679,051	59
<b>Net unrecognised gain not recognised in the Consolidated Statement of Comprehensive Income .....</b>			<b>59</b>

As financial assets and financial liabilities predominantly bear interest at floating rates, the difference between book value and fair value of financial assets and financial liabilities is deemed to be immaterial.

# Notes to the Consolidated Financial Statements

## Compensation instrument

74. The compensation instrument is originated due to the difference in the fair value of the transferred assets, liabilities and contingent liabilities from Kaupthing Bank hf. to Arion banki hf. in accordance with the FME decision in 2008. The compensation instrument amounted to ISK 38,300 million and was denominated 50% in ISK and 50% in EUR and is subject to floating rates of interest. The maturity of this instrument is 30 June 2012 and is a priority claim against Kaupthing banki hf.

Compensation instrument is specified as follows:	2010	2009
Balance at the beginning of the year .....	34,371	41,156
Changes due to the Escrow and Contingent Value Rights Agreement		
Continuing operations .....	(11,604)	(10,556)
Discontinued operations .....	2,017	-
Accrued interest .....	1,256	2,398
Foreign exchange rate differences .....	(1,852)	1,373
<b>Balance at the end of the year .....</b>	<b>24,188</b>	<b>34,371</b>

Related to the compensation instrument is the Escrow and Contingent Value Rights Agreement where Kaupthing Bank hf. receives 80% of the appreciation of defined Arion banki hf. loans (the "ring-fenced assets"). The increase in value of the defined loans will decrease the value of the compensation instrument. If the compensation instrument is finally settled due to an increase in the aggregate value of the ring-fenced assets (such increase being 125% of the compensation instrument) then 50% of the increase in value of ring-fenced assets above the amount needed for closing the compensation instrument will be passed onto Kaupthing banki hf. up to a cap of ISK 5 billion.

During 2010 changes in those defined assets amounted to ISK 11,890 million, 80% of this increased value belonging to Kaupthing Bank hf., ISK 9,587 million as presented in the Consolidated Statement of Comprehensive Income, 20% belonging to Arion banki hf. as a part of the Consolidated Statement of Comprehensive Income. The total face value of the defined loans was approximately ISK 850,000 million and the book value was approximately ISK 225,000 million at year end.

The Bank holds a guarantee in specific assets of Kaupthing Bank hf. against the total balance of the compensation instrument. This guarantee is a priority claim against Kaupthing banki hf.

## Investment property

75. Investment property are specified as follows:	Investment		Total	2010	2009
	Investment properties	properties in progress			
Balance at the beginning of the year .....	18,069	4,878	22,947	12,079	
Acquisition through business combination .....	3,000	-	3,000	7,832	
Additions during the year .....	1,171	2,348	3,519	3,289	
Disposals during the year .....	(424)	(1,137)	(1,561)	(423)	
Fair value adjustments .....	(265)	2	(263)	170	
<b>Investment property .....</b>	<b>21,551</b>	<b>6,091</b>	<b>27,642</b>	<b>22,947</b>	

Investment properties were carried at estimated fair value at year-end in accordance with the accounting policy in note 19.

# Notes to the Consolidated Financial Statements

## Investments in associates

76. The Bank's interest in its principal associates are as follows:	2010	2009
Audkenni hf. Engjateigur 3, 105 Reykjavík, Iceland .....	20.0%	25.0%
Borgarland ehf., Egilsholt 1, 310 Borgarnes, Iceland .....	42.0%	-
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland .....	43.5%	-
Hótel Borgarnes hf., Egilsgata 16, 310 Borgarnes, Iceland .....	20.6%	-
KB ráðgjöf ehf. Hlíðarsmári 17, 201 Kópavogur, Iceland .....	43.1%	43.1%
Kríuvarp ehf., Borgartún 35, 105 Reykjavík, Iceland .....	25.0%	-
Reiknistofa Bankanna Kalkofnsvegur 1, 150 Reykjavík, Iceland .....	21.7%	18.0%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland .....	42.7%	42.7%
Ölgerðin Egill Skallagrímsson ehf., Grjótháls 7-11, 110 Reykjavík, Iceland .....	20.0%	-
Valitor holding hf., Laugavegur 77, 101 Reykjavík, Iceland .....	-	38.0%

Investment in associates are specified as follows:

Carrying amount at the beginning of the year .....	5,985	2,843
Acquisition through business combination .....	108	2
Additions during the year .....	7	2,941
Sold during the year .....	(54)	(153)
Transferred from associates due to step acquisition .....	(3,889)	(17)
Share of profit (loss) .....	556	369
<b>Carrying amount at the end of the year .....</b>	<b>2,713</b>	<b>5,985</b>

Summarised financial information in respect of the Bank's associates is set out below:

Total assets .....	113,296	71,238
Total liabilities .....	(95,176)	(58,953)
<b>Net assets .....</b>	<b>18,120</b>	<b>12,285</b>
Total revenue .....	13,116	4,178
Total profit in associates .....	2,489	763
<b>Bank's share of profit of associates .....</b>	<b>556</b>	<b>369</b>

# Notes to the Consolidated Financial Statements

## Property and equipment

	Real estate	Equip- ment	Total 2010	Total 2009
77. Property and equipment are specified as follows:				
Balance at the beginning of the year .....	7,774	4,034	11,808	7,752
Acquisitions through business combination .....	14	405	419	3,986
Additions during the year .....	-	381	381	208
Disposals during the year .....	(77)	(250)	(327)	(138)
Disposals through the sale of a subsidiary .....	-	(977)	(977)	-
Transfers to assets held for sale .....	(1,944)	(788)	(2,732)	-
Gross carrying amount at the end of the year .....	<u>5,767</u>	<u>2,805</u>	<u>8,572</u>	<u>11,808</u>
Accumulated depreciation at the beginning of the year .....	180	928	1,108	95
Depreciation during the year .....	122	583	705	1,019
Disposals during the year .....	(5)	(173)	(178)	(6)
Disposals through the sale of a subsidiary .....	-	(274)	(274)	-
Transfers to assets held for sale .....	-	(154)	(154)	-
Accumulated depreciation at the end of the year .....	<u>297</u>	<u>910</u>	<u>1,207</u>	<u>1,108</u>
<b>Property and equipment .....</b>	<u><b>5,470</b></u>	<u><b>1,895</b></u>	<u><b>7,365</b></u>	<u><b>10,700</b></u>

The official real estate value amounts to ISK 5,748 million at year end. The insurance value of real estate amounts to ISK 9,189 million at year end.

	2010	2009
78. Depreciation and amortisation in the Consolidated Statement of Comprehensive Income is specified as follows:		
Depreciation of property and equipment .....	705	617
Amortisation of intangible assets .....	114	142
<b>Depreciation and amortisation .....</b>	<u><b>819</b></u>	<u><b>759</b></u>

# Notes to the Consolidated Financial Statements

## Intangible assets

79. The intangible assets are related to different business segments in the Bank's operation. They comprise a credit card portfolio, insurance contract agreements, assets under management and custody contracts.

Intangible assets are specified as follows:

2010	Indefinite life		Total
	intangible assets	Software	
Balance at the beginning of the year .....	2,356	1,156	3,512
Acquisition through business combination .....	-	17	17
Additions during the year .....	2,124	121	2,245
Disposals through the sale of a subsidiary .....	(257)	(576)	(833)
Transfers to assets held for sale .....	-	(225)	(225)
Impairment .....	(250)	-	(250)
Amortisation .....	-	(114)	(114)
<b>Intangible assets .....</b>	<b>3,973</b>	<b>379</b>	<b>4,352</b>
2009			
Balance at the beginning of the year .....	2075	357	2,432
Acquisition through business combination .....	282	813	1,095
Additions during the year .....	24	128	152
Impairment .....	(25)	-	(25)
Amortisation .....	-	(142)	(142)
<b>Intangible assets .....</b>	<b>2,356</b>	<b>1,156</b>	<b>3,512</b>

The Bank performed its annual impairment test at 31 December 2010 of intangible assets with indefinite life. The recoverable amount of the largest intangible assets was determined based on a value in use calculation using cash flow projections from approved financial budgets covering a five year period. For Asset Management activities, the discount rate applied to cash flow projections was 10.8% (2009: 14.3%) and cash flows beyond the five-year period were extrapolated using a 5% growth rate (2009: 5%). As a result of this analysis no impairment was recognised for Asset Management in 2010. With regard to the Custody Service, due to a reduction in the scope of its activities, an impairment charge of ISK 250 million was recognised to fully impair the intangible asset. This is recorded within Administration expense in the Consolidated Statement of Comprehensive Income.

## Non-current assets and disposal groups held for sale

80. Non-current assets and disposal groups held for sale are specified as follows:	2010	2009
Legal entities .....	41,927	38,922
Real estates .....	2,456	2,570
Other assets .....	81	35
<b>Non-current assets and disposal groups held for sale .....</b>	<b>44,464</b>	<b>41,527</b>

The legal entities were acquired exclusively with view to resale and are classified as disposal groups held for sale in accordance with IFRS 5. At year-end the largest entities were BM Vallá ehf., Fram Foods hf., Hagar hf., Hafrahlið ehf. and subsidiaries, Langalína 2 ehf., Penninn á Íslandi ehf. and RE 10-11

Real estates and other assets classified as non-current assets are generally the result of foreclosures on companies and individuals. The official real estate value of real estates classified as non-current assets amounts to ISK 3.631 million at year end. The insurance value amounts to ISK 4.575 million.

Liabilities associated with the legal entities held for sale are as follows:	2010	2009
Legal entities, total liabilities .....	13,514	19,230

# Notes to the Consolidated Financial Statements

## Other assets

81. Other assets are specified as follows:	2010	2009
Unsettled securities trading .....	366	1,583
Accounts receivable .....	14,312	7,647
Accrued income .....	802	376
Prepaid expenses .....	448	341
Sundry assets .....	1,208	236
Other assets from subsidiaries acquired exclusively with view to resale .....	-	5,792
<b>Other assets</b> .....	<b>17,136</b>	<b>15,975</b>

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

## 82. Provision for other assets

During the year no impairment on accounts receivable and accrued income was made compared to ISK 940 million in 2009.

## Borrowings

83. Borrowings are specified as follows:	2010	2009
Bonds issued .....	7,156	-
Other loans .....	58,122	11,042
<b>Borrowings</b> .....	<b>65,278</b>	<b>11,042</b>

The Bank has not repurchased any of its own debt during the year (2009: Nil).

Interest of other loans is 3 month Libor +300 bps to the year 2015 and thereafter 3 month Libor +400 bps until 2019 when the loan expires.

The total book value of pledged loans at 31 December 2010 was ISK 74 billion (31 December 2009: Nil). Pledged loans at year-end comprised mortgage loans to individuals, loans to municipals and loans to state related entities (see Note 65) that were pledged against amounts borrowed.

## Subordinated liabilities

84. Subordinated liabilities are specified as follows:	2010	2009
Tier II capital .....	26,257	-
<b>Subordinated liabilities</b> .....	<b>26,257</b>	<b>-</b>

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

# Notes to the Consolidated Financial Statements

## Tax assets and tax liabilities

85. Tax assets and liabilities are specified as follows:

	2010		2009	
	Assets	Liabilities	Assets	Liabilities
Current tax .....	-	3,821	-	1,051
Deferred tax .....	295	633	1,415	1,790
<b>Tax assets and liabilities</b> .....	<b>295</b>	<b>4,454</b>	<b>1,415</b>	<b>2,841</b>

86. Deferred tax assets and liabilities are specified as follows:

2010

	Assets	Liabilities	Net
Balance at the beginning of the year .....	1,415	(1,790)	(375)
Income tax recognised in profit or loss .....	(1,120)	1,157	37
<b>Net tax assets and (liabilities)</b> .....	<b>295</b>	<b>(633)</b>	<b>(338)</b>

2009

Balance at the beginning of the year .....	551	(446)	105
Acquisition through business combination .....	1,005	-	1,005
Income tax recognised in profit or loss .....	39	(1,524)	(1,485)
Other changes .....	(180)	180	-
<b>Net tax assets and (liabilities)</b> .....	<b>1,415</b>	<b>(1,790)</b>	<b>(375)</b>

87. Changes in deferred tax assets and liabilities are specified as follows:

2010	At Jan. 1	Addition/ disposal during the year	Recognised in profit or loss	At Dec. 31
Foreign currency denominated assets and liabilities .....	(200)	-	(49)	(249)
Investment property and property and equipment .....	(16)	-	(123)	(139)
Other assets and liabilities .....	2	-	(39)	(37)
Deferred foreign exchange differences .....	(1,430)	-	892	(538)
Tax loss carry forward .....	1,269	-	(644)	625
<b>Change in deferred tax</b> .....	<b>(375)</b>	<b>-</b>	<b>37</b>	<b>(338)</b>

2009

Foreign currency denominated assets and liabilities .....	(136)	-	(64)	(200)
Investment property and property and equipment .....	18	-	(34)	(16)
Other assets and liabilities .....	(3)	-	5	2
Deferred foreign exchange differences .....	-	-	(1,430)	(1,430)
Tax loss carry forward .....	226	1,012	31	1,269
<b>Change in deferred tax</b> .....	<b>105</b>	<b>1,012</b>	<b>(1,492)</b>	<b>(375)</b>

# Notes to the Consolidated Financial Statements

88. Deferred tax assets and liabilities are attributable to the following:

	31.12.2010		31.12.2009	
	Assets	Liabilities	Assets	Liabilities
Deferred tax related to foreign exchange gain .....	5	(543)	-	(1,430)
Foreign currency denominated assets and liabilities .....		(249)	-	(200)
Investment property and property and equipment .....	10	(149)	144	(160)
Other assets and liabilities .....		(37)	2	-
Tax loss carry forward .....	625		1,269	-
	<u>640</u>	<u>(978)</u>	<u>1,415</u>	<u>(1,790)</u>
Set-off of deferred tax assets together with liabilities of the same taxable entities .....	(345)	345		
<b>Deferred tax assets and liabilities</b> .....	<u>295</u>	<u>(633)</u>	<u>1,415</u>	<u>(1,790)</u>

## Derivatives

89. Derivatives fair value are specified as follows:

	Fair value	
	Assets	Liabilities
2010		
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements .....	2	0
Interest rate and exchange rate agreements .....	1,100	-
	<u>1,102</u>	<u>0</u>
Bond derivatives:		
Bond swaps, agreements unlisted .....	24	75
<b>Derivatives</b> .....	<u>1,126</u>	<u>75</u>
2009		
Currency and interest rate derivatives, agreements unlisted:		
Interest rate and exchange rate agreements .....	-	71
	<u>-</u>	<u>71</u>
Bond derivatives:		
Bond swaps, agreements unlisted .....	6	17
<b>Derivatives</b> .....	<u>6</u>	<u>88</u>

## Other liabilities

90. Other liabilities are specified as follows:

	2010	2009
Accounts payable .....	24,704	1,524
Withholding tax .....	2,600	2,743
Deposit and investor guarantee fund .....	2,669	3,041
Insurance claim .....	1,992	1,847
Unsettled securities trading .....	110	1,134
Other liabilities from subsidiaries acquired exclusively with view to resale .....	-	6,557
Sundry liabilities .....	6,975	8,151
<b>Other liabilities</b> .....	<u>39,050</u>	<u>24,997</u>

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

# Notes to the Consolidated Financial Statements

## Equity

### Share capital and share premium

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

	Number		Number	
	(million)	2010	(million)	2009
Issued share capital				
At 1 January .....	12,646	72,000	12,646	72,000
Redeemed on 8 January .....	(12,386)	(62,139)		
Issued on 8 January .....	1,740	66,000		
	<u>2,000</u>	<u>75,861</u>	<u>12,646</u>	<u>72,000</u>

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

On 8 January 2010 the Annual Shareholders' Meeting approved a transfer of 87% shareholding from the Icelandic State to Kaupskil hf. The impacts due to this agreement are described in note 35.

### Other reserves

92. Other reserves are specified as follows:		2010	2009
Statutory reserve .....		1,637	1,637
Foreign currency translation reserve .....		(112)	92
<b>Other reserves</b> .....		<u>1,525</u>	<u>1,729</u>

## Off Balance Sheet information

### Obligations

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

		2010	2009
Guarantees .....		11,675	15,318
Unused overdrafts .....		40,896	36,152
Loan commitments .....		13,946	21,859

The Bank estimates possible loss of ISK 1,645 million in relation to guarantees transferred from Kaupthing Bank hf. Should any of the guarantees default, Kaupthing banki hf. will pay compensation up to ISK 3,000 million to Arion banki hf., agreement thereon was signed in September 2009.

94. Depositors' and Investors' Guarantee fund

According to Act No. 98/1999 on Deposit Guarantees and Investor Compensation Scheme the total assets of the Depositors' and Investors' Guarantee Fund shall amount to a minimum of 1% of the average amount of guaranteed deposits in the commercial bank concerned during the preceding year. In the event that total assets do not amount to the 1% minimum, all commercial banks shall contribute to the Fund an amount equivalent to 0.15% of the average of guaranteed deposits in the Bank during the preceding year. The Bank expensed ISK 324 million in 2010 and the liability to the Fund had a year-end balance of ISK 2,669 million, representing the net present value of the estimated future payments to the Fund over a five year period. The Bank has granted the Fund a guarantee for the total obligation amounting to ISK 3,364 million.

The Icelandic parliament is to discuss a bill on the Depositors' and Investors' Guarantee Fund which, if passed, would entail a substantial increase in the size of the fund and the banks' liabilities. There is still considerable uncertainty over what shape the proposed legislation will finally take and therefore a liability is not being recognised in the balance sheet. However, based on the current draft bill, Arion Bank's additional liability will be more than ISK 10 billion.

# Notes to the Consolidated Financial Statements

## Operating lease commitments

### 95. Bank as a lessee

The Bank 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 30 years. The majority of the contracts include renewal options for various periods of time.

	2010	2009
Less than one year .....	213	166
Over 1 year and up to 5 years .....	644	393
Over 5 years .....	1,108	408
<b>Minimum lease payments under non-cancellable leases .....</b>	<b>1,965</b>	<b>967</b>

### 96. Bank as a lessor

The Bank has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 30 years, with majority being non-cancellable agreements. The future minimum lease payments under non-cancellable leases are as follows:

	2010	2009
Less than one year .....	1,975	1,505
Over 1 year and up to 5 years .....	5,715	4,405
Over 5 years .....	4,269	2,949
<b>Minimum lease payments under non-cancellable leases .....</b>	<b>11,959</b>	<b>8,859</b>

## Assets under management and under custody

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

Assets under management .....	618,062	580,523
Assets under custody .....	1,745,384	2,129,518

## Contingent liabilities

### 98. Litigation is a common occurrence in the banking industry due to the nature of the business undertaken. Due to the current economic climate in Iceland the prospects of possible litigation against the Bank has become more likely. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Bank makes adjustments to account for any adverse effects which the claims may have on its financial standing. At year end, the Bank had several unresolved legal claims.

There are two significant legal claims against the Bank;

First, a major client of Kaupthing Bank has, in the course of the company's restructuring process, filed three rescission actions against Arion Bank hf. in the district court of Reykjavik relating to substantial transactions between the company and Kaupthing Bank. The claims are based on the argument that the company had in fact been bankrupt at the time of the payments and that Kaupthing Bank was a related party at the time. Arion banki hf. is of the opinion that the said claims have no substance and has opposed them in court. At the same time the Bank and the company are engaged in negotiations to end the dispute. The said claims have been filed recently and it is therefore very difficult to predict any outcome or developments. Should there be a ruling in favour of the company, the Bank intends to reclaim from Kaupthing Bank any amount it would be required to pay to the company on the basis of the said claims. Should there be a ruling in favour of the company, the Bank were to be deemed not to have a priority claim on the assets of Kaupthing Bank, then the losses for the Bank could be substantial. The Bank estimates the likelihood of this scenario to be minimal.

The other significant legal claim is in respect of a number of clients who have alleged that assets under management were improperly managed resulting in the clients suffering financial loss. Five of these claims have been taken to court of law but due to uncertainty of the court decision and amounts no provision for these claims has been made in these Consolidated Financial Statements.

# Notes to the Consolidated Financial Statements

## Notes to the Cash Flow Statement

99. Operational cash flows from interest and dividends:	2010	2009
Interest paid .....	30,809	53,337
Interest received .....	44,783	54,436
Dividend received .....	34	27

Interest paid includes interest credited to deposit accounts at 31 December 2010.

### 100. Non-cash items included in net earnings before income tax and other adjustments:

Increase in value of loans and receivables .....	(40,269)	(20,199)
Impairment on loans and other credit risk provisions .....	26,787	11,448
Compensation instrument, revaluation and accrued interest .....	8,331	8,158
Depreciation and amortisation .....	819	1,162
Impairment on other assets .....	250	25
Share of profit of associates .....	(557)	(369)
Investment property, fair value change .....	263	(170)
Indexation and foreign exchange difference .....	(4,458)	(10,205)
Net loss (gain) on financial assets and liabilities at fair value through profit or loss .....	3,132	(5,307)
Net loss (gain) on disposal of legal entities acquired exclusively with a view to resale .....	(579)	-
Net loss (gain) on disposal of property and equipment .....	39	(8)
Net loss (gain) on sale of associates .....	-	(39)
Net loss (gain) on non-current assets classified as held for sale .....	(144)	(375)
	<u>(6,386)</u>	<u>(15,879)</u>

### 101. Changes in operating assets and liabilities:

Mandatory reserve with Central Bank .....	2,080	(2,381)
Loans and receivables to credit institutions .....	520	21,215
Loans and receivables to customers .....	22,243	4,923
Financial assets measured at fair value .....	16,118	138
Shares and equity instruments with variable income .....	(1,280)	679
Derivatives .....	-	(6)
Securities used for hedging .....	(720)	-
Other assets .....	1,754	4,925
Due to credit institutions and Central Bank .....	(9,285)	(11,638)
Deposits .....	(20,511)	(52,622)
Borrowings .....	984	3,087
Subordinated loans .....	1,115	-
Financial liabilities at fair value .....	-	86
Other liabilities .....	(21,009)	(4,880)
	<u>(7,991)</u>	<u>(36,474)</u>

### 102. Cash and cash equivalents at the end of the year:

Cash in hand and demand deposits .....	30,628	41,906
Due from credit institutions .....	49,938	24,037
Mandatory reserve with Central Bank .....	(7,769)	(9,849)
<b>Cash and cash equivalents at year end .....</b>	<b>72,797</b>	<b>56,094</b>

# Notes to the Consolidated Financial Statements

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## Risk Management Disclosures

### Introduction

The Group faces various risks in its business activities, the most important being credit risk, liquidity risk and currency risk that are to the largest extent encountered within the parent company. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities. Managing risk is a core activity within the Group, the Group manages 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 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 management of risks encountered within subsidiaries is carried out within each subsidiary. Arion bank's risk management structure, strategy and risk exposures are addressed in the notes below.

#### 103. Risk management structure

##### Board of Directors

The Board of Directors is ultimately responsible for the Group's risk management framework and ensuring that satisfactory risk management processes and policies for controlling the Group's risk exposure are in place. The Board of Directors allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board of Directors set the Risk Appetite. The Risk Appetite is translated into exposure limits and targets that are monitored by the Bank's Risk Management department, which reports its findings regularly to 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 are also responsible for the Bank's Internal Capital Adequacy Assessment Process (ICAAP).

##### CEO

The Chief Executive Officer is responsible for sustaining an effective risk management framework, policies and control as well as maintaining a high level of risk awareness among the Bank's employees, making risk everyone's business.

The CEO of Arion banki hf. and all members of the Arion banki hf. Board of Directors are subject to a fit and proper examination by the FME.

##### Committee structure

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 ICAAP. The BARC regularly reviews reports on the Bank's risk exposures. The Asset and Liability Committee (ALCO), chaired by the CEO, is responsible for managing asset-liability mismatch, liquidity risk, market risk, interest rate risk and capital management. The Bank operates four credit committees. The highest authority in credits is the Board Credit Committee which decide on all major credit risk exposures. The next highest credit granting authority is the Arion Bank Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's capital. The ACC is chaired by the CEO. Corporate Banking and Retail Banking operate their individual credit committees with tighter credit granting limits. The Bank also operates two temporary recovery committees that are focused on recovery cases, one for Corporate banking and the other for Retail banking. The recovery committees have authority to approve credit and write-offs, within their limits, in connection with recovery.

##### Risk Management

The Bank's Risk Management Department is headed by the CRO. It is independent and centralized and reports directly to the CEO. The CEO and the Board of Directors are responsible for defining and articulating a Risk Appetite for the Bank's operations. The CRO and Risk Management are responsible for monitoring that the Bank is operating according to the Risk Appetite.

##### Internal Audit

The Bank's Internal Audit conducts independent reviews of the Bank's operations, risk management framework, processes, policies and measurements. Internal Audit examines 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. Internal Audit discusses its results with management and reports its findings and recommendations to the Board Audit and Risk Committee.

#### 104. Organization of the Risk Management Department

The Risk Management Department is divided into five units: Credit Control, which monitors credit exposures on a customer-by-customer basis; Credit Analysis, which supports and monitors the credit granting process; Portfolio Risk, which monitors liquidity risk and risks in the Bank's Assets and Liabilities at the portfolio level; Economic Capital, which is responsible for the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and Operational Risk which monitors risks associated with the daily operation of the Bank.

# Notes to the Consolidated Financial Statements

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## 105. High level discussion of the consequences of the crash

The Bank faces numerous challenging risks related to the circumstances leading to the Bank's foundation on 22 October 2008, following the failure of the North European bank, Kaupthing Bank hf. The Bank acquired assets, liabilities and contingent liabilities in accordance with the decision of the FME which resulted in significant mismatching of FX, interest rate and liquidity in the Consolidated Statement of Financial Position. An asset shortfall of ISK 38.300 million resulted in a priority claim on Kaupthing Bank hf., see Note 74.

During 2009 and 2010, the Icelandic economy has been living with the consequences of the crash and the ensuing recession. With the collapse of the Icelandic currency, inflation linked and foreign currency denominated debt became unmanageable for corporates and households alike. Icelandic banks must restructure this debt in order for their loan portfolios to become performing.

## 106. Overview of the most material risks

The Consolidated Statement of Financial Position of Arion banki hf. presents significant asset-liability management challenges. A considerable portion of the transferred assets are denominated in low interest rate foreign currencies. The assets are predominantly funded with on demand deposits denominated in Icelandic króna, a high interest rate currency. Liquidity risk, as well as risks related to imbalances in currency, duration and the interest rate base are discussed below.

The asset portfolio transferred from Kaupthing Bank hf. presents additional challenges. Assets were transferred at fair value, where the distressed nature of the Icelandic economy and the funding cost were taken into account. A conservative approach was taken to the asset valuation, which has reduced the Bank's downside risk. Nevertheless, much risk is related to the accuracy of the asset valuation and assumptions about the performance of the assets. These risks and credit concentration risks are discussed below.

The Bank faces legal risk related to a recent court judgements on foreign currency loans, see Note 117.

During 2010 the Bank has made progress toward lowering its currency imbalance. The imbalance will continue to decrease during 2011 with redenomination of foreign currency loans to individuals into ISK as well as actions taken to encourage companies with limited foreign currency income to redenominate their loans into ISK. Concentration in the Bank's loan book has declined during 2010, the total sum of large exposures at year-end was 70% of risk capital, down from 143% at end 2009. The Bank has seen an increase in political risk. During 2010 the government made an agreement with all parties of the banking industry to address the debt situation of Icelandic households. Central to the agreement is the write-off of mortgage debt exceeding 110% of property value. Agreements have also been made to fast-track debt restructuring of small companies with loans up to 1 billion ISK. In a standardized scheme, loans are converted to an indexed ISK loan according to the operational capacity to service debt. Remaining debt is converted to a low interest, subordinated junior loan, up to 100% of the value of assets. Debt exceeding the value of assets is written off. Prior to the agreement, the Bank had made excellent progress using the same restructuring methodology.

In addition to the aforementioned, the Bank faces the traditional types of risks related to its business as a financial institution arising from its day to day operations. Management devotes a significant portion of its time to the management of these risks. The mainstays of effective risk management are the identification of significant risk, the quantification of the risk exposure, actions to limit risk and the constant monitoring of risk. The most significant of these risks are discussed below.

# Notes to the Consolidated Financial Statements

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## Credit Risk

### 107. Credit Risk

Credit Risk is the risk that the Bank will incur a loss because its customers or counterparties fail to discharge their contractual obligations. The Bank manages and controls Credit risk by setting limits on the amount of risk it is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits.

Credit risk arises anytime the Bank commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance.

### 108. Credit Risk Strategy

The Bank has a two pronged strategy for credit risk. In the near term, emphasis will be placed on recovering value from the portfolio of impaired assets which was acquired from Kaupthing Bank hf. To this end, the Bank has expanded its Recovery department and defined a complete set of procedures which outline how value will be maximized without compromising transparency. The Bank has in 2010 refined its internal classification system to provide early identification of possible changes in the creditworthiness of counterparties. This has helped the Bank to improve monitoring of the loan portfolio quality and streamline the process for transferring problem loans into Recovery.

Longer term, the Bank recognizes that carefully monitored credit risk is a base for stable profits. Undertaking credit risk is a cornerstone in the Bank's strategy for maintaining the future profitability of the Bank. The main asset of the Bank is its loan portfolio, and therefore managing and analyzing the loan portfolio is of utmost importance. The emphasis is on keeping a high quality credit portfolio, by seeking business with strong parties, maintaining a strict credit process, critically inspecting loan applications, identifying and reacting to possible problem loans at an early stage and actively monitoring the credit portfolio.

#### a) Credit Granting Process

A fundamental requirement is to have a comprehensive structure for credits which is coherent across the Bank. This structure applies both for the granting of new credits and for the restructuring of impaired credits. The highest authority in credits is the Board Credit Committee (BCC). The next highest credit granting authority is the Arion Bank Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's capital. Corporate Banking and Retail Banking operate their individual credit committees with tighter credit granting limits. The principle of central management of risk is maintained by having the Bank's CEO as a member of the BCC and the ACC, and by having the Managing Director of Risk Management, or his representative, attend the meetings of the ACC with the power to escalate decisions to the BCC. The CEO is responsible for maintaining the Bank's exposures within legal and policy limits.

The pricing of each new credit granted and the credits arising from the impaired loan restructuring process should reflect the risk taken. The client's interests must be protected at all times and there must be a high likelihood that the client will be able to repay a given loan. In particular, the quality of collateral can never be the sole reason for a positive credit decision.

It is the aim of the credit strategy that, in the long run, write-offs should be less than 5% of net interest income. Aspects of the credit process have been designed and implemented with this long term goal in mind.

Provisions for losses reflect the expected loss, both for loans for which specific provisions exist as well as for portfolios of performing loans. The collective assessment of such portfolios is based on default predictions and loss-given-default parameters.

The Bank 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.

#### b) Recovery Process

The Bank has implemented numerous solutions to assist customers that are experiencing payment difficulties. Members of the recovery team lead the restructuring work with support from Corporate Banking, Retail Banking and Legal. Restructuring of individuals and small companies is predominantly carried out by Retail Banking with assistance from the recovery team. Restructuring of larger companies is carried out by the recovery team. During 2009 and in early 2010 the recovery work focused on the largest recovery cases and individuals. From mid-year 2010 the Bank's focus has shifted to restructuring small and medium sized companies. The Bank estimates that the majority of the restructuring cases will be completed before end 2011.

The recovery strategy is based on identifying clusters of similar customers and implementing standardised solutions for those customers. Custom solutions are tailored to the needs of larger, more complex companies. The Bank structures its solutions in accordance with Act No. 107/2009 and the industry standard rules for the financial restructuring of companies, as issued by the Icelandic Financial Services Association. The rules are based on an agreement between the government and financial institutions around restructuring of individuals and small companies.

# Notes to the Consolidated Financial Statements

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108. cont.

## Solutions for individuals

Solutions are structured according to the severity of the individual's financial difficulties:

- Temporary payment relief, such as payment holidays, payment of a fixed amount of 5,000 ISK pr. million borrowed and shifting from a consumer price index or currency exchange rate to a national salary index.
- Temporary redenomination incentives for foreign currency loans at a September 2008 exchange rate (currently closed).
- Writing down mortgage loans to 110% of the market value of the underlying property, up to a limit of 4 million ISK pr. individual. If interest and instalments payments exceed 20% of the customer total income the write-off amount can be up to 15 million ISK pr. individual.
- Special debt adjustment to those with serious financial difficulties and negative equity position. Payments are adjusted to the customers ability to pay. The loan can be written down up to 70% of the market value of the underlying property. The difference between 70% and 100% of assets is restructured into a three year subordinated junior loan with no interest. Debt exceeding 100% of assets is written off.

## Solutions for corporates

The corporate recovery portfolio is separated into two main clusters, Corporate recovery and Retail recovery for smaller corporates. Further sub-clustering includes refinements to address the special needs of Fisheries and Agriculture.

- Retail Recovery: Standardised solution is applied for retail recovery. Indexed investment loans and business loans are offered up to the amount which maximises the operational capacity to service debt, loans are at standard market terms with standard payment schedule. Subordinated junior loan is then applied up to 100% of the asset value, terms are below market terms and payment schedule varies by sector and underlying collateral. No equity position is taken. Debts to the Bank exceeding the asset value are written off.
- Corporate Recovery: Tailor-made solutions are applied as each case is unique. An independent business review is applied for larger more complex cases. Alternatives evaluated are: debt restructuring, consensual deal with current owners/management regarding joint ownership, writing down debt against equity injection, seizing the company and/or its assets and liquidation of the company.

Seized assets are transferred to one of the Bank's specialized subsidiaries with the aim of divesting them as soon as is practical and economically viable.

## c) Quantification and Rating model description

The basic elements for the quantification of credit risk are the probability of default, the loss given default, and exposure at default. These quantities need to be measured with an effective and accurate credit rating system. Information, both quantitative and qualitative, must be gathered, both specifically in regard to the counterparty and to its general economic situation in order to estimate its creditworthiness. Furthermore, a facility rating should be performed to determine the loss parameters in case of a default.

The Bank uses an internal rating system to rate corporate loans and loans to individuals. The rating model for larger corporates bases its rating both on qualitative factors and quantitative factors. The rating model for smaller corporates and individuals are purely quantitative models. Internal rating is used in a credit quality classification to distinguish between performing, watch, sub-performing and non-performing customers in addition to other parameters, see Note 109 b).

The policy of the Bank is to continue to use credit models to monitor credit risk. These credit models will however not come into play in the application of the Basel II standardized approach to capital requirements calculations but they will be the basis for a future application of an internal rating based approach. Therefore, further development, implementation and application of these models is carried out in accordance with Basel II requirements. The credit models will become an integral component in the Bank's Internal Capital Adequacy Assessment Process (ICAAP) strategy.

# Notes to the Consolidated Financial Statements

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108. cont.

*d)* Loan provisioning

The Bank's loan book consists of loans which were acquired from Kaupthing Bank hf. at fair value. However, the maximization of the value of the loan book requires that the Bank continue to service it on a face value basis.

In a face value treatment of the loan book an allowance for credit losses is established if there is objective evidence that the Bank will be unable to collect all amounts due on a claim, i.e. a loan, commitment, guarantee etc., according to the original contractual terms or the equivalent value. An allowance for credit losses is reported as a reduction of the carrying value of a claim on the Consolidated Statement of Financial Position, whereas for an off balance sheet item such as a commitment a provision for credit loss is reported in other liabilities. Additions to the allowances and provisions for credit losses are made through impairment on loans.

When considering loans at face value, allowances and provisions for credit losses are evaluated at a counterparty specific level and a collective basis, based on the principles described below.

Meanwhile, the carrying value of the loan takes into account impairment for credit loss and counterparty specific provision is not considered unless the impairment of the loan is believed to exceed the difference between the face value and amortised cost value. Loans which were priced as a homogeneous pool (retail loans to individuals and SMEs) are excluded from counterparty specific provisioning. This is because the homogeneous pool pricing methodology fully accounts for loan impairment. Therefore, special consideration of loans which have impairment beyond the pool average would be inappropriate, without corresponding consideration of loans which have objective evidence of recovery above the pool average. Efforts are underway to discontinue the homogeneous pool methodology in favor of traditional specific provisioning on a loan-by-loan basis.

#### Individually assessed allowances

A claim is considered impaired when there is objective evidence that it is probable that the Bank will not be able to collect all amounts due according to the original contractual terms or the equivalent value. Individual credit exposures are evaluated based upon the borrower's character, overall financial condition, resources and payment record; the prospects for support from any financially responsible guarantors; and, where applicable, the realizable value of any collateral.

The estimated recoverable amount is the present value, using the loan's original effective interest rate, of expected future cash flows, which may result from restructuring or liquidation. Impairment is measured and allowances for credit losses are established for the difference between the carrying amount and the estimated recoverable amount.

Upon impairment, the accrual of interest income based on the original terms of the claim is discontinued, but the increase of the present value of impaired claims due to the passage of time is reported as interest income.

Impaired claims are reviewed and analyzed at least every three months. Any subsequent changes to the amounts and timing of the expected future cash flows compared to the prior estimates will result in a change in the allowances for credit losses and be charged or credited through impairment on loans.

An allowance for impairment is reversed only when the credit quality has improved such that there is reasonable assurance of improved collection of principal and interest.

A write-off is made when all or part of a claim is deemed uncollectible or forgiven. Write-offs are charged against previously established allowances for credit losses or directly to credit loss expense and reduce the principal amount of a claim.

#### Collective assessed allowances

All loans for which no impairment is identified on a counterparty specific level are grouped into economically homogeneous portfolios to collectively assess whether impairment exists within a portfolio. Allowances from collective assessment of impairment are recognized as credit loss expense and result in an offset to the loan position. As the allowance cannot be allocated to individual loans, interest is accrued on all loans according to contractual terms.

#### *Special provisioning for currency exchange rate impairment of certain loans to individuals and corporates*

The loan book transferred from Kaupthing Bank hf. contains a category of loans which requires special consideration. These are loans in foreign currency to Icelandic companies and individuals whose income is primarily in ISK. When the ISK depreciates against the foreign currency, the ISK value of the loan increases. However, since the borrower's ability to pay does not increase, the increase in loan value is considered unrecoverable. Provisions are made for this unrecoverable value increase. Conversely, when the ISK appreciates (as occurred in 2010) and the ISK value of the loan decreases, there is a reversal of loan impairment due to the borrower's increased ability to repay.

# Notes to the Consolidated Financial Statements

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108. cont.

## e) Sources of Credit Risk

### Loan portfolio

The main assets of the Bank are its loans. To maintain and further improve the quality of the loan portfolio it is imperative to constantly monitor loans, both individually and at the portfolio level. However, it is not the policy of the Bank to solely issue credit of very low risk but it is important that the price of issued credit reflects both risk and costs incurred. This means that a detailed assessment of individual customers, their financial position and the collateral is a prerequisite for granted credits.

### Commitments and guarantees

The Bank often commits itself to and ensures that funds are available to customers as required. The most common commitments to extend credit are in the form of limits on checking accounts, credit cards and credit lines. Potential loss on these accounts is equal to the amount of the limits although they may only be partly used at any one time. In practice, the potential loss is less severe since many of these commitments can be recalled immediately by the Bank in case the clients do not meet credit standards.

Guarantees carry the credit risk to the full amount similar as loans, since they represent irrevocable assurances that the Bank will make payments in the event that a customer cannot meet its obligations to third parties.

### Derivatives trading

The Bank offers financial derivatives instruments to professional investors, including, interest rate swaps and options and forwards on Treasury notes and housing financing bonds. Value-changes are in response to changes in interest rates and security prices. Credit risk arising from derivative financial instruments is, at any time, limited to those with positive fair values. The Bank uses limits on total exposure and on the positive fair value net of collateral to control the Bank's risk towards these instruments. These limits are generally client specific and may refer specifically to different categories of contracts. Generally, collateral is required to cover potential losses on a contract. Acceptable collateral for margin accounts is cash or Treasury bills. Should the net-negative position of the contract fall below a certain level, a call is made for added collateral. If extra collateral is not supplied within a tightly specified deadline, the contract is closed. This process is closely monitored within the Bank.

### Master netting agreements

Frequently, exposure to credit losses is reduced by entering into master netting agreements with client counterparties that have significant and/or diverse credit related business with the Bank. Master netting agreements do not generally result in an offset in the Consolidated Statement of Financial Position of assets and liabilities, as transactions are usually settled on a gross basis. However, the credit risk associated with favourable contracts is reduced by these types of agreements since in the case of default all amounts of the counterparty are terminated and settled on a net basis.

# Notes to the Consolidated Financial Statements

## 109. Credit Risk Disclosures

The valuation that occurred as the Bank's assets were transferred from Kaupthing Bank hf. attempted to account for all realized and foreseen losses, which greatly reduces traditional credit risk in the Bank's loan portfolio. Nevertheless, the Bank is exposed to credit-type risks through the loan portfolio that are related to the accuracy of the transfer valuation, the performance of the loan book and the success of the restructuring of non-performing loans. There is also risk associated with the credit concentration to a few customer names and to business sectors.

### a) Asset valuation

Asset valuation risk is the risk that the assets in the Consolidated Statement of Financial Position of the Bank are overvalued. This includes assets that were transferred as part of the Bank's opening balance sheet and the assets which were transferred as part of the 8 January 2010 Kaupthing capitalization. Different valuation methods are used depending on the nature of the underlying assets and collateral. In the table below, the loan portfolio has been categorized in accordance with the valuation methods, shown by book value. Additionally, retail assets are assessed for impairment on a homogeneous pool basis.

Asset valuation is subject to on-going revision as additional information about company performance and the Icelandic economy emerges. Valuation methods for some loans have changed in 2010 compared to prior years as additional information has become available, and this has had a material impact on valuations. In particular, as a clearer picture of corporate finances has emerged, a greater emphasis has been placed on valuation by EV/EBITDA multiples.

Category: Description (D) / Valuation method (V):	2010 % of loans to customer	2009* % of loans to customer
<b>Higher discount factor:</b>		
D: Loans where Arion banki hf. expects full recovery and the contractual cash flow is used.		
V: Present value of discounted contractual cash flows at market interest rates at date of transfer.	39%	40%
<b>Collateral value:</b>		
D: Loans where the underlying collateral value is greater than the value of future expected cash flow.		
V: Assessment of underlying collateral.	18%	21%
<b>Real estate companies (those valued based on collateral value):</b>		
D: Real estate companies.		
V: The Iceland Property Registry rate or an appraised value	6%	17%
<b>EV/EBITDA multiples:</b>		
D: Operating companies that generate positive cash flow, but are currently unable or are estimated to be unable to service their debt, and estimated value is greater than underlying collateral value.	29%	21%
V: EV/EBITDA multiples.		
<b>Currently in recovery:</b>		
D: Borrowers that are currently in a recovery and restructuring process.		
V: Individual assessment using discounted cash flows, collateral value, multiples and other methods available.	8%	1%
	100%	100%

\* The 31.12.2009 numbers were restated due to error in consolidating the loans to overtaken subsidiaries with view to resale.

60% of loans to customers are assessed for impairment using the methods in the table. The remainder of loans to customers are loans which have been valued as a homogeneous pool and, to a very small degree, loans granted after the establishment of the Bank. The homogeneous pool includes individuals and SMEs.

A discussion of the main sources of valuation risk follows:

Impaired loans valued based on EV/EBITDA multiples comprise approximately 17% of loans to customers (29% of 60%). These loans are not cause for major concern because the experience of the loans in the category since 22 October 2008 has been that the valuation has been conservative. Furthermore, the valuation method is based on a diverse set of valuation multiples as opposed to the value being driven any specific economic parameter.

Among the risk parameters in the Collateral Value category are loans whose value has been linked to the price of fishing quotas. The Bank conservatively discounts the price of fishing quotas by 25% compared to market prices due to inactive prices, in order to perform the valuation of these loans. It is estimated that approximately 4% of loans to customers are directly sensitive to the price of fishing quotas. "Directly sensitive" refers to the fact that the loan is valued based on the collateral value. Consequently, an additional 20% reduction in the price of fishing quotas would translate into a 0.8% drop in the value of loans to customers.

# Notes to the Consolidated Financial Statements

109. cont.

Another risk parameter of concern is the price of real estate. The valuation of the real estate related loans was based on a forecast of the real estate market by the Central Bank of Iceland and the official real estate values. Real estate prices affect value in the Collateral Value and the real estate company categories. 3.3% of loans to customers are estimated to be directly sensitive to the real estate-price parameter. Thus, a 20% additional reduction in real estate price would lead, approximately, to a 0.7% reduction in loans to customers. It is observed that mortgage loans to individuals with LTV > 100% are also sensitive to real estate value depreciation, but according to agreements between banks and the government, the Bank will write off mortgage amounts in excess of 110% and provisions have already been taken for this eventuality.

A large contribution to the value of the loan book is the category referred to as Higher Discount Factor. This category was applied to loans to companies with an ability to service debt. The discounted value of these loans was based on the Bank's higher cost of funding. The valuation risk is that the cost of funding is even greater than was assumed during the valuation. Each 1.0% increase in the funding cost of the Bank, compared to the valuation assumptions would lead to a 1.3% reduction in this portion of the portfolio, for a 0.4% reduction of the value loans to customers.

To put the aforementioned sensitivity study into perspective, it must be taken into consideration that each 1.0% loss in value of loans to customers would correspond to approximately 0.5% point reduction in the Bank's Tier 1 capital ratio.

## b) Non-performing loans

The sharp depreciation of the ISK in the autumn of 2008 and the following inflation left many borrowers with foreign currency and Icelandic indexed linked loans unable to service their loans. Payment holidays were offered to all customers, regardless of their ability to pay, as a temporary solution. In December 2009 the Bank announced a set of programs to assist individuals who have run into financial difficulties. The programs were offered during 2010. A substantial portion of the Bank's loan book entered into restructuring during 2009 and continued during year 2010.

The Bank is highly focused on the performance of the loan book. The Bank enhanced its classification during 2010 to capture the changes in the creditworthiness of counterparties as early as possible as well as streamlining the process for problem loans into Recovery. Former classification was based on classifying the loan portfolio into Performing, Stressed and Non-performing. The current classification is based on classifying the loan portfolio into Performing, Watch, Sub-performing and Non-performing.

Current classification is based on:

Status	Provision	Days in default	Debt/EBITDA /LTV	Equity Ratio*	Credit Rating	Covenant breach
Performing.....	No	<30 days	< 4-5 / < 75%-90%	> 15-30%	≥ B	None
Watch.....	No	30 - 90 days	4-6 / < 75%-90%	10-30%	CCC+	Minor
Sub-Performing.....	No	> 90 days	> 5-6 / 90%-100%	<10-20%	< CCC+	Serious
Non Performing.....	Yes	> 90 days	> 5-6 / >100%	<10-20%	< CCC+	Serious
< 100 million ISK.....	x	x	x		x	

\*For debt/EBITDA, LTV and equity ratios the condition varies based on industry sector and the underlying collateral type.

The classification is made on a customer basis, all conditions must be met for a customer to be able to be classified as performing. Only customers with sufficient collateral to cover existing loan can be classified into Sub-Performing if the loan is more than 90 days in default. Customers with less than 100 million ISK of loans are classified based on provisioning, days in default, LTV and credit rating.

It is important to note that the classification is predominately based on contractual loan terms and does not fully consider that some loans are deeply discounted. For instance, the debt and equity ratios do not take into account that the banks are holding the borrowers debt at a discount. Also, a borrower who is making irregular payments may be in default relative to the contractual terms, but may be fulfilling the obligations anticipated for the discounted loan. Many more loans would be classified as Performing if this weaker standard was applied.

The following table shows a breakdown of the loan book based on these categories:

	2010
Performing .....	38%
Watch .....	10%
Sub-performing .....	15%
Non-performing .....	37%
	<u>100%</u>

# Notes to the Consolidated Financial Statements

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109. cont.

The 2010 and 2009 classifications are not directly comparable, but the "Performing" categories can be compared and the "Non-performing" category from the 2009 classification could be considered analogous to the "Non-performing" and "Sub-performing" categories from the 2010 classification.

Former classification classified all loans as performing that were not Stressed or Non-performing. Non-performing were loans where:

- the loan had been more than 90 days in default.
- the borrower was in recovery.
- specific provisions had been made against the loan.
- the borrower had taken advantage of payment holidays of both principal and interest payments.

Stressed loans were those that were:

- between 30 and 90 days in default.
- the borrower has taken advantage of payment holidays, paying only interests.

The following table shows the 2009 breakdown of the loan book based on the earlier categories:

	2009
Performing .....	38%
Stressed .....	10%
Non-performing .....	52%
<b>Total</b> .....	<b>100%</b>

# Notes to the Consolidated Financial Statements

109. cont.

c) Maximum exposure to Credit Risk and credit concentration by industry sectors

The Bank seeks proper diversification in the granting of all new credits. Nevertheless, the loan portfolio which was transferred to Arion banki hf. from Kaupthing Bank hf. suffers from material credit concentrations because only Icelandic assets were transferred to the Bank and assets were transferred at fair value resulting in a very different loan portfolio make-up.

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 reporting period before the effect of mitigation due to collateral agreements or other credit enhancements. The Bank uses ISAT 08 standard classification for its industry classification. ISAT 08 is based on the NACE Rev. 2 classification standard.

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

2010

	I	II	III	IV	V	VI	VII	Total
Cash & balances w/ Central Bank .....	-	-	30,628	-	-	-	-	30,628
Loans & receivables to cr.inst. ....	-	-	67,846	-	-	-	-	67,846
Loans & receivables to customers .....	111,354	69,637	63,484	59,829	44,713	50,229	51,973	451,219
Overdrafts.....	12,315	2,289	14,831	1,711	2,274	780	3,190	37,390
Subordinated loans.....	-	-	-	-	493	-	6	499
Other loans.....	99,039	67,348	48,653	58,118	41,946	49,449	48,777	413,330
Bonds and debt instruments .....	-	223	74,635	11	27	-	45,216	120,112
Listed.....	-	-	1,384	11	27	-	45,143	46,565
Unlisted.....	-	223	73,251	-	-	-	73	73,547
Derivatives .....	10	-	14	732	-	-	370	1,126
Bonds & debt instrum., hedging .....	-	-	-	-	-	-	3,213	3,213
Listed.....	-	-	-	-	-	-	3,213	3,213
Unlisted.....	-	-	-	-	-	-	-	-
Compensation instrument .....	-	-	24,188	-	-	-	-	24,188
Other assets with credit risk .....	274	331	15,075	267	27	20	694	16,688
Total on balance sheet maximum exposure to credit risk .....	111,638	70,191	275,870	60,839	44,767	50,249	101,466	715,020

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

Financial guarantees .....	407	2,825	1,958	724	1,693	920	3,148	11,675
Unused overdrafts .....	23,068	734	9,358	1,405	1,895	287	4,149	40,896
Loan Commitments .....	443	-	454	2,331	1,256	3,216	6,246	13,946
Total off balance sheet maximum exposure to credit risk .....	23,918	3,559	11,770	4,460	4,844	4,423	13,543	66,517

I: Individuals

II: Real estate activities and construction

III: Financial and insurance activities

IV: Manufacturing, mining and other industry

V: Wholesale and retail trades, transport, accommodation and food service activities

VI: Agriculture, forestry and fishing

VII: Services\*

\*Includes Business services, Public administration, defence, education, human health and social work activities and Other Service.

# Notes to the Consolidated Financial Statements

109. cont.

2009	I	II	III	IV	V	VI	VII	Total
Cash & balances w/ Central Bank .....	-	-	41,906	-	-	-	-	41,906
Loans & receivables to cr.inst. ....	-	-	38,470	-	-	-	-	38,470
Loans & receivables to customers .....	55,366	81,362	52,768	57,635	15,508	42,152	52,943	357,734
Overdrafts .....	9,989	3,227	523	1,520	2,463	1,114	12,837	31,673
Subordinated loans .....	-	-	-	-	-	-	17	17
Other loans .....	45,377	78,135	52,245	56,115	13,045	41,038	40,089	326,044
Bonds and debt instruments .....	-	232	94,307	373	41	-	78,529	173,482
Listed .....	-	-	1,603	371	41	-	6,820	8,835
Unlisted .....	-	232	92,704	2	-	-	71,709	164,647
Derivatives .....	-	0	6	-	-	-	-	6
Bonds & debt instrum., hedging .....	-	-	-	-	-	-	2,236	2,236
Listed .....	-	-	-	-	-	-	2,236	2,236
Compensation instrument .....	-	-	34,371	-	-	-	-	34,371
Other assets with credit risk .....	118	586	8,471	14	-	-	41	9,230
Total on balance sheet maximum exposure to credit risk .....	55,484	82,180	270,299	58,022	15,549	42,152	133,749	657,435

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

Financial guarantees .....	334	6,491	1,796	1,006	1,824	83	3,784	15,318
Unused overdrafts .....	26,743	345	4,643	1,201	138	338	2,744	36,152
Loan Commitments .....	-	-	8,780	3,981	645	357	8,096	21,859
Total off balance sheet maximum exposure to credit risk .....	27,077	6,836	15,219	6,188	2,607	778	14,624	73,329

I: Individuals

II: Real estate activities and construction

III: Financial and insurance activities

IV: Manufacturing, mining and other industry

V: Wholesale and retail trades, transport, accommodation and food service activities

VI: Agriculture, forestry and fishing

VII: Services\*

\*Includes Business services, Public administration, defence, education, human health and social work activities and Other Service.

The majority of the revenues from external customers were attributable to Iceland.

# Notes to the Consolidated Financial Statements

109. cont.

d) 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:

- For retail lending, mortgages over residential properties
- For corporate lending, charges over real estate properties, fixed and current assets, inventory and trade receivables
- For derivative exposure, cash or treasury bills

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.

e) Credit quality by class of financial assets

The table below shows the credit quality of financial assets.

	Neither past due nor impaired	Past due but not impaired	Individu- ally impaired	Total
At 31 December 2010				
Loans and receivables to credit institutions .....	63,451	-	4,395	67,846
Loans and receivables to customers				
Loans to corporate .....	119,655	51,405	168,805	339,865
Loans to individuals .....	67,127	14,581	29,646	111,354
Total .....	<u>250,233</u>	<u>65,986</u>	<u>202,846</u>	<u>519,065</u>

Past due but not impaired loans by class of financial assets

	Less than 30 days	31 to 60 days	61 to 90 days	More than 91 days	Total
At 31 December 2010					
Loans and receivables to credit institutions .....	-	-	-	-	-
Loans and receivables to customers					
Loans to Corporate .....	6,063	949	7,112	37,280	51,404
Loans to individuals .....	2,594	3,237	1,792	6,958	14,581
Total .....	<u>8,657</u>	<u>4,186</u>	<u>8,904</u>	<u>44,238</u>	<u>65,985</u>

The majority of the loans have been acquired at discount and are in process of being restructured or in a recovery process.

Allowance for impairment losses on loans and advances to customers as discussed in Note 108 d).

At 31 December 2010 the value of collateral that the Bank holds relating to loans individually determined to be impaired amounts to 104,556 million ISK. The collateral consists of cash, securities and residential and commercial real estate.

# Notes to the Consolidated Financial Statements

109. cont.

f) Collateral repossessed

During the year, the Bank took possession of real estates with the carrying value of 1,749 million ISK and other assets with the value of 46 million ISK, all which the Bank is in the process of selling, see Note 80.

g) Large Exposure Disclosures

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

The legal maximum for individual large exposures is 25% of risk capital and the sum of all large exposures cannot exceed 800% of risk capital.

The loan book which was transferred from Kaupthing banki hf. to Arion banki hf. contained loans which, while appropriately sized in Kaupthing Bank hf.'s large Consolidated Statement of Financial Position, has led to high counterparty concentration on Arion banki hf.'s more modest Consolidated Statement of Financial Position. The maximum exposure to a group of connected clients as of 31 December 2010 was 36 billion ISK (2009: 36 billion ISK) before taking account of eligible collateral, excluding claim on Drómi and Kaupthing Bank. The Bank has seven large exposures (2009: eight exposures) net of eligible collateral. The table below shows all gross exposures exceeding 10% of capital.

no.	2010		2009	
	Gross	Net	Gross	Net
1 .....	57%	1%	114%	1%
2 .....	28%	19%	41%	29%
3 .....	18%	0%	40%	40%
4 .....	19%	18%	33%	33%
5 .....	16%	16%	21%	20%
6 .....	13%	13%	17%	17%
7 .....	12%	8%	14%	14%
8 .....	11%	11%	0%	0%
9 .....	10%	8%	17%	13%
Sum of exposure gross > 10% .....	184%	94%	297%	167%

No large exposure exceed the legal limit of 25% at end 2010. The Ministry of Finance has pledged that Arion banki hf. will be held harmless from the exposure due to the bond claim on Drómi ehf. listed nr. 1 in the table above. The FME has ruled that the Bank can use the hold harmless statement as an credit enhancement towards the claim on Drómi ehf. Consequently, the Bank finds that the net exposure on Drómi ehf. is zero, or 1% when taking into consideration financial related parties.

The Bank reports large exposures among all assets. Thus the Kaupthing Bank hf. compensation instrument (see Note 74) is also listed as a large exposure, nr. 3 in the table. The compensation instrument fell below the 25% legal limit mid year 2010 and the net exposure at the end of 2010 is zero, due to a cash pledge provided by Kaupthing Bank.

The sum of all large exposures is 86% before collateral mitigation or 76% net of eligible collateral, which is well below the 800% legal maximum and the Bank's internal 150% limit net of collateral.

# Notes to the Consolidated Financial Statements

## Market risk

### 110. 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 Bank'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.

### 111. Market Risk Strategy

The Bank's strategy towards market risk is to limit the risk exposure due to imbalances in the Bank's balance sheet but accept limited risk in its trading book. The Bank keeps firm track of the market risk and separates its exposure to market risk into trading book and non-trading book i.e. banking book. The market risk in the trading book arises from proprietary trading activities. Market risk in the banking book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. The market risk in the trading book and in the banking book are managed separately by Treasury and monitored by Risk Management.

Fair value of financial instruments is disclosed in Note 73.

#### Market risk - trading book

In the case of proprietary trading the CEO decides the total market risk exposure of the book and per asset class, expressed as maximum overnight exposure. The Bank trading book's main exposures are listed Icelandic Treasury notes and bonds and Housing Fund bonds and to a very limited extent listed equities.

Fair values of bonds and debt instruments, and share and equity instruments are disclosed in Note 72.

#### Derivatives

The Bank's use of derivatives is through derivative sales and trading portfolios. The types of derivative currently offered by the Bank are interest rate swaps and options and forwards on Treasury notes and housing financing bonds.

The Bank is not materially exposed to derivative instruments at year end 2010.

#### Market risk - banking book

##### a) Interest rate Risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments. The Bank's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities. These mismatches are characterized by a large maturity gap between assets and liabilities where a large amount of liabilities is on demand but the duration of interest bearing assets are much higher resulting in a yield curve 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.

#### Interest rate Risk Strategy

The Bank's strategy for managing its interest rate risk to strive for an interest rate balance between assets and liabilities by offering deposit incentives and by targeted lending practices.

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

		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
2010						
CPI Indexed linked .....	ISK	486	(160)	(673)	(10,833)	(78)
Non Indexed linked .....	ISK	(73)	(577)	(376)	(364)	(67)
	EUR	(65)	(26)	-	-	-
	Other	(584)	(40)	-	-	-
2009						
CPI Indexed linked .....	ISK	304	356	(160)	(836)	(726)
Non Indexed linked .....	ISK	(100)	(48)	(52)	(162)	(38)
	EUR	4	(36)	-	-	-
	Other	(8)	-	-	-	-

# Notes to the Consolidated Financial Statements

111. cont.

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

2010	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
<b>Assets</b>							
Cash and balances with Central Bank .....	30,628	22,859	-	7,769	-	-	-
Due from banks .....	67,846	49,572	15,372	691	1,803	408	-
Loans and receivables to customers .....	451,219	-	8,155	43,902	236,701	162,461	-
Bonds and debt instruments .....	120,112	6,467	-	32	73,984	39,629	-
Shares and equity instruments .....	10,316	-	-	-	-	-	10,316
Derivatives .....	1,126	-	44	262	820	-	-
Assets leg .....	5,687	-	2,447	538	2,702	-	-
Liabilities leg .....	(4,561)	-	(2,403)	(276)	(1,882)	-	-
Securities used for hedging .....	3,213	3,213	-	-	-	-	-
Compensation instrument .....	24,188	-	-	-	24,188	-	-
Investment property .....	27,642	-	-	-	-	-	27,642
Investments in associates .....	2,713	-	-	-	-	-	2,713
Property and equipment .....	7,365	-	-	-	-	-	7,365
Intangible assets .....	4,352	-	-	-	-	-	4,352
Tax assets .....	295	-	-	-	-	-	295
Non-current assets held for sale .....	44,464	-	-	-	-	-	44,464
Other assets .....	17,136	368	2,915	13,220	186	-	447
<b>Total assets 31.12.2010 .....</b>	<b>812,615</b>	<b>82,479</b>	<b>26,486</b>	<b>65,876</b>	<b>337,682</b>	<b>202,498</b>	<b>97,594</b>
<b>Liabilities</b>							
Due to credit inst. and Central Bank .....	95,646	58,985	3,508	5,153	28,000	-	-
Deposits .....	457,881	327,824	27,974	78,307	18,823	4,953	-
Borrowings .....	65,279	600	501	32	4,349	59,796	-
Subordinated liabilities .....	26,257	-	-	-	-	26,257	-
Financial liabilities at fair value .....	999	923	76	-	-	-	-
Assets leg .....	(4,283)	-	(4,283)	-	-	-	-
Liabilities leg .....	5,282	923	4,359	-	-	-	-
Tax liabilities .....	4,454	-	-	-	-	-	4,454
Non-current liabilities held for sale .....	13,514	-	-	-	-	-	13,514
Other liabilities .....	39,050	110	31,644	-	1,970	-	5,326
<b>Total liabilities 31.12.2010 .....</b>	<b>703,079</b>	<b>388,442</b>	<b>63,703</b>	<b>83,492</b>	<b>53,142</b>	<b>91,006</b>	<b>23,294</b>
<b>Off balance sheet items</b>							
Guarantees .....	11,675	67	1,029	2,173	7,347	1,059	-
Unused overdraft .....	40,896	40,896	-	-	-	-	-
Loan commitments .....	13,946	13,946	-	-	-	-	-
<b>Total off balance sheet items .....</b>	<b>66,517</b>	<b>54,909</b>	<b>1,029</b>	<b>2,173</b>	<b>7,347</b>	<b>1,059</b>	<b>-</b>
<b>Net interest sensitivity gap .....</b>	<b>43,018</b>	<b>(360,872)</b>	<b>(38,246)</b>	<b>(19,789)</b>	<b>277,193</b>	<b>110,433</b>	<b>74,298</b>

# Notes to the Consolidated Financial Statements

111. cont.

2009	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
<b>Assets</b>							
Cash and balances with Central Bank .....	41,906	41,906	-	-	-	-	-
Due from banks .....	38,470	24,024	3,244	5,463	5,124	615	-
Loans and receivables to customers .....	357,734	-	13,534	48,013	193,376	102,811	-
Unpaid share capital .....	-	-	-	-	-	-	-
Bonds and debt instruments .....	173,482	5,969	474	1,127	93,562	72,350	-
Shares and equity instruments .....	7,078	-	-	-	-	-	7,078
Derivatives .....	6	-	6	-	-	-	-
Assets leg .....	1,024	-	1,024	-	-	-	-
Liabilities leg .....	(1,018)	-	(1,018)	-	-	-	-
Securities used for hedging .....	2,236	2,236	-	-	-	-	-
Compensation instrument .....	34,371	-	-	-	34,371	-	-
Investment property .....	22,947	-	-	-	-	-	22,947
Investments in associates .....	5,985	-	-	-	-	-	5,985
Property and equipment .....	10,700	-	-	-	-	-	10,700
Intangible assets .....	3,512	-	-	-	-	-	3,512
Tax assets .....	1,415	-	-	-	-	-	1,415
Non-current assets held for sale .....	41,527	-	-	-	-	-	41,527
Other assets .....	15,975	1,583	1,486	5,999	1,114	1	5,792
<b>Total assets 31.12.2009 .....</b>	<b>757,344</b>	<b>75,718</b>	<b>18,744</b>	<b>60,602</b>	<b>327,547</b>	<b>175,778</b>	<b>98,956</b>
<b>Liabilities</b>							
Due to credit inst. and Central Bank .....	113,647	104,571	3,431	5,645	-	-	-
Deposits .....	495,465	448,307	16,461	14,127	14,842	1,728	-
Borrowings .....	11,042	348	-	-	-	10,694	-
Subordinated liabilities .....	-	-	-	-	-	-	-
Financial liabilities at fair value .....	88	45	17	-	26	-	-
Assets leg .....	(6,229)	(227)	(3,855)	-	(2,147)	-	-
Liabilities leg .....	6,317	272	3,872	-	2,173	-	-
Tax liabilities .....	2,841	-	-	-	-	-	2,841
Non-current liabilities held for sale .....	19,230	-	-	-	-	-	19,230
Other liabilities .....	24,997	1,134	13,457	333	1,696	675	7,702
<b>Total liabilities 31.12.2009 .....</b>	<b>667,310</b>	<b>554,405</b>	<b>33,366</b>	<b>20,105</b>	<b>16,564</b>	<b>13,097</b>	<b>29,773</b>
<b>Off balance sheet items</b>							
Guarantees .....	15,318	12	2,330	3,100	8,403	1,473	-
Unused overdraft .....	36,152	36,152	-	-	-	-	-
Loan commitments .....	21,859	21,859	-	-	-	-	-
<b>Total off balance sheet items .....</b>	<b>73,329</b>	<b>58,023</b>	<b>2,330</b>	<b>3,100</b>	<b>8,403</b>	<b>1,473</b>	<b>-</b>
<b>Net interest sensitivity gap .....</b>	<b>16,705</b>	<b>(536,710)</b>	<b>(16,951)</b>	<b>37,397</b>	<b>302,579</b>	<b>161,208</b>	<b>69,183</b>

# Notes to the Consolidated Financial Statements

111. cont.

*b)* Inflation risk

The Bank is exposed to inflation risk when there is a mismatch between inflation linked assets and liabilities. The total amount of indexed assets amount to ISK 106.4 billion (2009: 70.7 billions) and the total amount of indexed liabilities amount to ISK 87.8 billions (2009: 85.4 billions)

2010	Up to 1 year	1 to 5 years	Over 5 years
Assets - CPI indexed linked			
Loans and receivables to customers .....	202	33,824	68,404
Bonds and debt instruments .....	-	-	1,867
<b>Total</b> .....	<b>202</b>	<b>33,824</b>	<b>70,271</b>
Liabilities - CPI indexed linked			
Deposits .....	56,296	27,360	4,091
<b>Total</b> .....	<b>56,296</b>	<b>27,360</b>	<b>4,091</b>
Net on balance sheet position .....	(56,094)	6,464	66,180
Net off balance sheet position .....	-	2,115	-
<b>Total CPI Balance</b> .....	<b>(56,094)</b>	<b>8,579</b>	<b>66,180</b>

*c)* Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is primarily exposed to currency risk through a currency mismatch between assets and liabilities. The liabilities of the Bank are predominantly ISK denominated deposits whereas the Bank's assets consist largely of foreign currency denominated loans to customers.

Currency Risk strategy

The Bank's strategy for reducing its currency imbalance is twofold: The systematic ISK redenomination of foreign currency loans to customers which have ISK income (the naturally hedged currency imbalance), and hedging of its real currency imbalances through agreements with the Central Bank of Iceland and through currency swaps with Icelandic customers. The task of redenominating loans to customers with ISK income was hampered by the uncertain legal status of foreign currency loans. The legislation regarding the treatment of foreign currency loans to individuals has resolved the uncertainty and rapid redenomination will ensue in Q1 2011. Net exposures per currency are monitored centrally in the Bank.

# Notes to the Consolidated Financial Statements

111. cont.

The following table shows the breakdown of assets and liabilities by currency

2010

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash with Central Bank .....	20,734	2,718	4,295	377	1,256	186	1,062	30,628
Loans to credit institutions .....	27,144	5,968	10,450	255	4,654	1,014	18,361	67,846
Loans and receivables to customers ..	172,339	81,321	39,704	66,026	14,564	53,015	24,250	451,219
Unpaid share capital .....	-	-	-	-	-	-	-	-
Bonds and debt instruments .....	119,087	996	29	-	-	-	-	120,112
Shares and equity instruments .....	6,430	2,302	916	-	1	-	667	10,316
Derivatives .....	393	126	607	-	-	-	-	1,126
Securities used for hedging .....	3,213	-	-	-	-	-	-	3,213
Compensation instruments .....	22,214	1,974	-	-	-	-	-	24,188
Investment property .....	27,642	-	-	-	-	-	-	27,642
Investments in associates .....	2,590	123	-	-	-	-	-	2,713
Property and equipment .....	7,365	-	-	-	-	-	-	7,365
Intangible assets .....	4,352	-	-	-	-	-	-	4,352
Tax assets .....	295	-	-	-	-	-	-	295
Non-current assets held for sale .....	40,897	3,567	-	-	-	-	-	44,464
Other assets .....	16,083	623	365	-	23	-	42	17,136
<b>Total assets 31.12.2010 .....</b>	<b>470,778</b>	<b>99,718</b>	<b>56,366</b>	<b>66,658</b>	<b>20,498</b>	<b>54,215</b>	<b>44,382</b>	<b>812,615</b>
<b>Liabilities</b>								
Due to credit inst. and Central Bank ..	62,613	8,005	3,622	1,760	522	462	18,662	95,646
Deposits .....	409,368	25,290	5,720	536	5,664	319	10,984	457,881
Borrowings .....	8,807	12,674	23,118	8,658	6,323	5,698	-	65,278
Subordinated liabilities .....	-	26,257	-	-	-	-	-	26,257
Financial liabilities at fair value .....	44	0	-	297	-	658	-	1,000
Tax liabilities .....	4,454	-	-	-	-	-	-	4,454
Non-current liabilities held for sale ....	11,575	1,939	-	-	-	-	-	13,514
Other liabilities .....	35,542	1,584	887	1	93	45	898	39,051
Equity .....	109,536	-	-	-	-	-	-	109,536
<b>Total liabilities 31.12.2010 .....</b>	<b>641,939</b>	<b>75,749</b>	<b>33,347</b>	<b>11,252</b>	<b>12,602</b>	<b>7,182</b>	<b>30,544</b>	<b>812,616</b>
Net on balance sheet position .....	(171,160)	23,971	23,018	55,405	7,896	47,034	13,836	
Net off balance sheet position .....	897	126	-	(296)	-	(407)	(320)	
Net position 2010 .....	(170,263)	24,097	23,018	55,109	7,896	46,627	13,516	
Net position 2009 .....	(190,666)	43,493	32,687	53,497	5,505	33,573	21,910	
Loans to customers with ISK income	121,707	(32,914)	(11,771)	(37,110)	(3,787)	(30,658)	(5,466)	
Net real position 2010 .....	(48,556)	(8,817)	11,247	17,999	4,109	15,969	8,050	
Net real position 2009 .....	(49,623)	13,513	17,258	11,057	566	1,074	6,155	

# Notes to the Consolidated Financial Statements

111. cont.

The table below indicates the currencies to which the Bank had significant exposure at 31 December 2010. 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).

Currency	2010	
	-10%	+10%
EUR .....	882	-882
USD .....	(1,125)	1,125
CHF .....	(1,800)	1,800
GBP .....	(411)	411
JPY .....	(1,597)	1,597
Other .....	(805)	805

#### A natural hedge for currency risk

The currency risk is mitigated by the specific nature of foreign currency loans to customers with ISK income. The Bank refers to this as a natural hedge because the loans do not generate profit and loss for small to moderate fluctuations in the exchange rate. These loans were purchased from Kaupthing Bank hf. at a fair value which is based on the customer's ability to repay the loan, which is largely unaffected by changes in the exchange rate. IFRS accounting rules stipulate that the depreciation of the ISK against the loan currency be classified as an impairment event rather than a gain in the loan value if the borrower's ability to repay the loan remains unchanged. Conversely, an appreciation of the ISK is an impairment reversal and that this reversal may be made in certain situations up to the gross value of the loan, which may be significantly higher than the fair value at which the loan was transferred to Arion banki hf. The Bank has modelled the effect of this mitigating effect and has presented the relevant authorities with its measure of the effective currency risk which is attributed to this portfolio of loans. The year end 2010 values of the foreign currency imbalance are shown in the following table with year end 2009 values by comparison. The book value refers to the value of the imbalance without accounting for the natural hedge whereas the effective value takes into consideration the mitigating effect of the natural hedge, as modelled by the bank. This strength of the natural hedge is different at different times. Previously, the natural hedge effect was applied on a portfolio level, but is now applied on a loan-by-loan basis.

	2010		2009	
	Book value	Effective value	Book value	Effective value
FX imbalance due to customers with FX income .....	48,556	48,556	49,623	49,623
FX imbalance due to customers with ISK income .....	121,707	48,683	141,043	33,850
Total .....	170,263	97,239	190,666	83,473

The effective FX imbalance due to customers with ISK income during 2010 and 2009 was 40% and 24% respectively, whereas the effective FX imbalance due to customers with FX income is always 100%.

The relevant authorities have granted temporary dispensation from rules regarding the currency imbalance.

#### Equity Price risk

Equity price 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 Bank's assets i.e. restructuring of troubled companies which the Bank has taken over. For information on assets seized and held for sale, see Note 80.

#### Prepayment risk

Prepayment risk is the risk that the Bank 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 Bank is not materially exposed to prepayment risk at year end 2010.

# Notes to the Consolidated Financial Statements

## Liquidity risk

### 112. Liquidity risk

Liquidity risk is defined as the risk that the Bank will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources. The funding liquidity risk limit is quantified by secured liquidity ratio as well as applying stress tests to identify scenarios of possible liquidity strain.

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

### 113. Liquidity Risk strategy

The Bank's strategy is to lengthen the maturity profile on the liability side, making it comparable to other Nordic banks and strengthening the Bank's liquidity reserve. The Bank has made significant process in converting on-demand deposits to term deposits. At 31 December 2009 over 90% the Bank's deposits were on-demand compared to 70% at 31 December 2010.

#### Secured Liquidity

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

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

	Liquidity ratio	Cash ratio
Year-end .....	24.8%	11.2%
Maximum .....	34.5%	15.9%
Minimum .....	23.9%	6.1%
Average .....	27.9%	11.0%

# Notes to the Consolidated Financial Statements

113. cont.

## c) Deposit Stickiness

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

- Capital controls: Deposits from customers believed to be waiting for the lifting of capital controls
- Resolution process: Deposits from customers in a resolution process
- Investors: Deposits from investors who may withdraw when other investment opportunities appear or competitor offers higher deposits rate
- Deposits - legal entities: Deposits from legal entities with no other business relationship with the bank and not quantified as an active investor
- Deposits - retail individual: Deposits from retail individual with no other business relationship with the bank and not quantified as an active investor
- Deposits - legal entities with business relationship: Deposits from legal entities with business relationship with the bank
- Deposits - retail individual: Deposits from retail individual with business relationship with the bank

The table below shows the split between different levels of the Bank's deposit stickiness at year end 2010, according to the Bank's classification. The rating 7 means the stickiest deposits and the rating 1 the least sticky. The Bank adopted new classification for the deposit stickiness in the year 2010.

% of deposit base:

Stickiness rating	2010	2010	2009	2009
	%	Amount	%	Amount
1 Capital controls .....	7%	39,932	6%	36,547
2 Resolution process .....	9%	48,718	12%	73,093
3 Investors .....	29%	160,437	25%	152,278
4 Deposits - legal entities .....	9%	49,817	9%	54,820
5 Deposits - retail individuals .....	12%	66,423	13%	79,185
6 Deposits - legal entities with business relationship .....	17%	94,100	15%	91,367
7 Deposits - retail individuals with business relationship .....	17%	94,100	20%	121,822
Total .....	100%	553,527	100%	609,112

The Bank's stress tests are primarily focused on the effect of lifting the capital controls in Iceland on the deposit base and its liquidity buffer. A stress test below shows the effect on the secured liquidity and cash ratios if unpledged deposit in stickiness's categories Capital Controls and Resolution Process are withdrawn immediately taking into account expected cashflow from assets and expenses.

Liquidity stress test for the year 2011

	Jan	Feb	Mar	Apr	May	Jun	Jul
Secured liquidity ratio.....	18.2%	18.3%	18.6%	18.8%	19.2%	19.3%	19.8%
Cash ratio.....	0.2%	0.3%	0.8%	1.0%	1.4%	1.5%	2.2%

# Notes to the Consolidated Financial Statements

## Operational risk

### 114. Operational risk

Operational risk is the risk of loss, resulting from inadequate or failed internal processes, human and system error, or from external events that affect the Bank's operations and can result in direct losses. The risk is present in all five core business areas and in the ancillary divisions.

Operational Risk is inherent in every activity undertaken within the Bank, in outsourced activities and in all interaction with external parties. The Bank aims to reduce the frequency and impact of operational risk events in a cost effective manner. The Bank can reduce its exposure to operational risk with selection of internal control and quality management, well educated and qualified staff. The Bank can choose to transfer operational risk through outsourcing the activity or to transfer the financial consequences through insurance programs.

### 115. Operational risk strategy

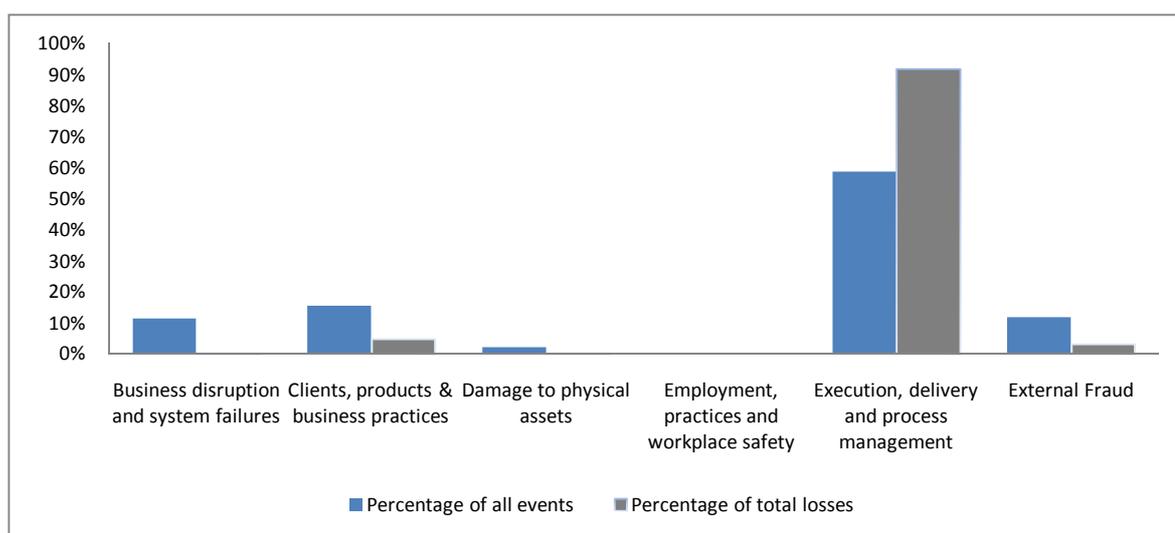
The Bank keeps a firm track of the operational risk that the Bank is exposed to. Identification and measurements are made by the means of Control and Risk Self Assessment, registration of loss events, near misses and quality deficiencies and by monitoring potential risk indicators and other early warning signals. Operational risk is reduced through staff training, process redesign and enhancement of the control environment.

The Bank aims to maintain an open, no blame, operational risk culture and to seek to get to the point of no surprises by utilizing the Bank's operational tools and processes to the fullest extent possible. The Bank operates no tolerance policy for internal fraud.

The Bank has elected to use the Basel II basic indicator approach to the calculation of Risk Capital requirements for Operational Risk but managed it in accordance with the Standardized Approach. Risk Capital for Operational Risk is measured 15% of the average over three years of the sum of net interest income and net non interest income, outlined in the Capital Requirements Directive (CRD). As Arion banki hf. does not have three years of operation, the 15% is of the sum of net interest income and net non interest income.

The Bank's losses due to operational risk are registered in the Bank's loss database. Loss events are analyzed to understand the cause of the event, control failure and amendments made where applicable to reduce the risk of the event happening again.

Losses of ISK 391 million were registered in the loss database for the year 2010. The majority of the loss events were due to mistakes in processing. The largest single loss of ISK 291 million accounted for 78% of the total loss amount. This event was due to a duplicate settlement of an asset management transaction during the collapse of the banking system. It has not been resolved whether the total loss amount will be realized in full by the Bank or by a third party. The largest amount of total losses is due to Asset Management whereas the largest number of loss events are registered by Retail Banking.



# Notes to the Consolidated Financial Statements

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## Capital Adequacy and ICAAP Strategy

116. The Group's capital policy is to maintain a strong capital base to support business development and to meet regulatory capital requirements, even in times of stress. Long term capital planning for the Group is currently based on a benchmark minimum Core Tier 1 capital ratio of 12% and a Capital Adequacy ratio of 16%. On the 8th of January 2010 additional capital was injected by the Ministry of Finance as Tier 2 capital in the form of a subordinated loan, at the discretion of the FME. FME supervises the Bank, receives information on the capital adequacy of, and sets capital requirements for, the Bank as a whole.

It is the policy of the Bank to refrain from paying dividends, divesting shares and conducting share buy-backs for 3 years after its initial capitalisation i.e. 21st of October 2008. This policy will only be altered in cooperation with the FME and only if the Bank and the FME jointly determine that a sustainable turnaround of the Icelandic Economy has been achieved.

### a) Capital adequacy

Capital Requirements according to Pillar 1 are based on the sum of risk weighted assets ("RWA") for credit risk, market risk and operational risk, computed using formulas from the EU's Capital Requirements Directive (CRD). The CRD offers different approaches for calculating RWA for these risk types:

#### *Credit Risk*

Standard approach, Foundation IRB approach, and Advanced IRB approach.

#### *Market Risk*

Standardised approach and Internal value at risk model.

#### *Operational Risk*

Basic indicator approach, Standardised approach, and AM approach.

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 different books. Banking book 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. Banking book off balance sheet items giving rise to credit, foreign exchange or interest rate risk are assigned risk weights appropriate to the category of the counterparty, again accounting for eligible collateral or guarantees. Trading book risk weighted assets are determined by taking into account market related risks such as foreign exchange, interest rate and equity position risks, and counterparty risk.

Approaches used for capital requirement calculations:

The Bank uses the:

- Standardized approach to calculate the capital requirements for credit risk.
- Standardized method to calculate the capital requirements for market risk.
- Basic indicator approach for operational risk.

Arion banki hf. will use the Basel II standardized method to calculate the capital requirements for credit risk under Pillar 1.

The Bank uses credit rating models for its corporate and retail portfolio but will be focusing on recalibrating those models for the post-crisis business environment and deploying them in its internal risk capital management and ICAAP. When the consistent fidelity of the credit rating models can be demonstrated they will be submitted to the FME as part of an application to use the Foundation Internal Ratings Based (FIRB) approach to calculating the capital requirements for credit risk.

The Bank has implemented methods and tools for operational risk management based on the minimal requirements for the standardised approach. The Bank will continue refining these tools and methods as part of its internal management of operational risk and is using them within its ICAAP.

Internal Capital Adequacy Assessment Process:

The internal capital adequacy assessment process (ICAAP) is an ongoing process that ensures 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 ensure that the Bank has sufficient capital in accordance to its risk profile.

# Notes to the Consolidated Financial Statements

116. cont.

To measure the Pillar 2 capital requirement the Bank uses an internal capital model (economic capital model). This model is based on Pillar 1 calculations, using internal models for credit risk calculations, and takes into consideration risks that are not covered under Pillar 1, e.g. concentration risk, residual risk, country risk, settlement risk, fx risk, liquidity risk, interest rate risk in the banking book, reputation risk, legal and compliance risk, business risk and strategic risk.

The Bank has implemented methods to calculate, for Pillar 2, concentration risk for single name concentration and sector concentration in addition the Bank is applying methods to include valuation risk, interest rate risk in the banking book, legal risk and business risk. Methods for evaluating other Pillar 2 risks will be developed in line with further development of the Bank's economic capital model.

Stress tests are an important part of the ICAAP and show how the Bank's capital could be affected by sharp macro economic changes, downswings in the Bank's core business or other major events. The Bank is currently running, under the ICAAP, stress testing scenarios on its business plan and planned capital needs.

## b) Capital Adequacy Disclosures

Capital base at 31 December 2010 amounts to ISK 131.146 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 19.0%, exceeding the minimum legal requirement of 8%.

The Group, parent company and subsidiaries that are subjected to capital requirements rules comply in full with imposed capital requirements (2009: the same)

A remark about capital requirements for currency imbalance is in order. As indicated in the discussion about currency risk, there exists a risk mitigation in the form of a natural hedge when the imbalance is due to an FX loan to a borrower with ISK income. The effect of this natural hedge is reflected in the RWA for market risk where the 40% effective contribution of the corresponding portion of the FX imbalance has been accounted for at year end 2010 (2009: 24%).

The table shows the Bank's RWA calculations for 31 December of 2010 and the RWA for the end of the year 2009.

Capital Base	2010	8.1.2010	2009
Share capital .....	2,000	2,000	12,646
Share premium .....	73,861	73,862	59,354
Statutory reserve .....	1,525	1,729	1,729
Retained earnings .....	28,531	16,150	16,150
Non-controlling interests .....	3,619	155	155
Total Equity .....	109,536	93,896	90,034
Deduction from Tier 1 capital .....	4,647	3,050	2,843
Total Tier 1 capital .....	104,889	90,846	87,191
Tier 2 capital .....	26,257	29,543	-
Total Capital base .....	131,146	120,389	87,191
Risk weighted assets	2010	2010	2009
Credit risk .....	513,328	574,943	480,374
Market risk FX .....	97,657	94,366	89,233
Market Risk Other .....	20,397	14,844	14,849
Operational risk .....	57,267	51,055	51,055
Total Risk weighted assets .....	688,649	735,208	635,511
Tier 1 ratio .....	15.2%	12.4%	13.7%
Capital adequacy ratio .....	19.0%	16.4%	13.7%

## Pillar 2

The Bank is exposed to relatively high concentration in the loan portfolio. According to the Bank's ICAAP, single name concentration and sector concentration lead to an add-on of 1.8% and 1.9% respectively, on top of the capital requirement for credit risk. Add-on due to interest rate risk in the banking book is 2%, other add-ons applied are due to political and legal risk and sensitivity in valuation techniques. FME is currently conducting its supervisory review and evaluation process of the Bank's ICAAP.

No Pillar 2 adjustments are made for FX risk, because we feel that the effects of the natural hedge on the FX risk are adequately and appropriately addressed in Pillar 1.

# Notes to the Consolidated Financial Statements

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## Other information

### The uncertainty regarding the book value of currency-linked lending

117. By two very similar judgments on 16 June 2010, the Supreme Court of Iceland stated that two car loans were in fact loans in Icelandic krona indexed to a foreign currency exchange rate (rather than loan agreements denominated in foreign currency) and that Act No. 38/2001 on Interest and Price Indexation made such indexation illegal. These judgments were mainly based on the wording of the respective loan documents.

By a judgment on 16 September 2010, the Supreme Court of Iceland stated that a loan agreement, which was ruled to be in Icelandic krona indexed to a foreign currency exchange rate, should bear the non-indexed Icelandic krona interest rate posted by the Central Bank of Iceland.

On 18 December 2010, the Icelandic Parliament passed an act (Act No. 151/2010) removing legal uncertainty on how to recalculate interest on loans in Icelandic krona indexed to a foreign currency exchange rate. According to the law, the principal of such loans shall be recalculated from the start date bearing the non-indexed interest rate for the Icelandic krona posted by the Central Bank. Furthermore, the law requires that banks recalculate foreign-currency mortgage loans for personal residents before 28 March 2011. As applicable, the loan principal shall be adjusted to the outcome of the recalculation or if the borrower has overpaid, the amount shall be reimbursed.

In accordance with the act, the Bank is now in the process of recalculating all mortgage loans for personal residents in foreign currency to individuals. Over 60% of the number of foreign currency loans to individuals is affected and the book value of the loans at end 2010 reflects the result of the calculations.

The Supreme Court has not yet ruled on the legitimacy of any of the Bank's own loan agreements in foreign currency. Therefore, the legitimacy of loans to corporates and individuals not addressed by Act No. 151/2010 is still not clear. However, based on an opinion of legal counsel to the FME, provided last summer, an important category of the Bank's corporate loan documents has been classified as having no risk from court rulings.

As a worst case scenario, if all the Bank's vulnerable foreign currency loans are ruled illegitimate, they will be recalculated according to Act No. 151/2010 with a considerable loss to the Bank. After taking into account provisions and a mitigation of credit risk and currency imbalance, the Bank estimates that its capital ratio will remain above the 16% limit which is currently stipulated by the FME.

By two very similar judgments on 14 February 2011, the Supreme Court stated that two foreign currency loans from Frjálsi Fjárfestingabankinn to small SMEs were in fact loans in Icelandic krona and indexed to a foreign currency exchange rate. Therefore, these loans were in breach of Act No. 38/2001 on Interest and Price Indexation. These judgments mean that the legitimacy of loans to corporates and individuals not addressed by Act No. 151/2010 is not entirely clear. However, the Supreme Court upheld the interest calculation scheme specified in the judgment of 16 September 2010 and subsequently in Act No. 151/2010

# Notes to the Consolidated Financial Statements

## Related parties

118. The Bank has a related party relationship with Kaupskil ehf., Kaupthing Bank hf., the Bank's associates, the Board of Directors of Arion banki hf., the key management personnel of the Bank and close family members of individuals referred to above. Loans to related parties are reported in the Consolidated Statement of Financial Position.

For compensation to the key management personnel, see Note 56.

No unusual transactions took place with related parties in the year of 2010. 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 than the one related to the compensation instrument as disclosed in Note 74.

The following table shows outstanding balances with related parties at year end, the corresponding interest and other income during the year:

2010

Balance with related parties:

	Assets	Liabilities	Net balance
Shareholders with significant influence over the Bank .....	42,605	65,170	(22,565)
Board of Directors and key Management personnel .....	348	903	(555)
Associates and other related parties .....	20,603	2,416	18,187
	<u>63,556</u>	<u>68,489</u>	<u>(4,933)</u>

Transactions with related parties:

	Interest income	Interest expenses	Commission income	Commission expenses	Change in compens. instrum.
Shareholders with significant influence over the Bank .....	1,256	2,088	23	-	9,587
Board of Directors and key Management personnel .....	45	32	-	-	-
Associates and other related parties .....	1,444	108	499	263	-
	<u>2,745</u>	<u>2,228</u>	<u>522</u>	<u>263</u>	<u>9,587</u>

# Notes to the Consolidated Financial Statements

118. cont.

2009

Balance with related parties:

	Assets	Liabilities	Net balance
Shareholders with significant influence over the Bank .....	46,420	64,525	(18,105)
Board of Directors and key Management personnel .....	193	480	(287)
Associates and other related parties .....	10,260	1,754	8,506
	<u>56,873</u>	<u>66,759</u>	<u>(9,886)</u>

Transactions with related parties:

	Interest income	Interest expenses	Comm- mission income	Comm- mission expenses	Change in compens. instrum.
Shareholders with significant influence over the Bank .....	0	6,688	41	-	10,556
Board of Directors and key Management personnel .....	34	37	-	-	-
Associates and other related parties .....	310	52	672	404	-
	<u>344</u>	<u>6,777</u>	<u>713</u>	<u>404</u>	<u>10,556</u>

Comparative balances at 31 December 2009 were revised during the year to include related party balances of associates that had previously been omitted. The effect of this change is to decrease the net liability due to related parties at 31 December 2009 by ISK 11,924 million.

## Offsetting agreement between Arion banki hf. and Kaupthing Bank hf.

119. According to the FME decision of 22 October 2008, the customers of Kaupthing Bank hf. are allowed to offset their debt against assets transferred to Arion banki hf. The claim registration period for customers of Kaupthing banki hf. ended on 30 December 2009. The amount of possible set off is still unknown but the effect on the Consolidated Statement of Financial Position will principally be a reclassification of assets from Loans and receivables to Accounts receivable within Other assets. Although the claim registration period is due the customers of Kaupthing banki hf. still have the right to request set off, thus the amounts are unknown.

An agreement signed on 3 September 2009 relating to certain aspects of the financial settlement between the banks sets out the way guarantees, shared collateral and claims subject to set off are treated. There is uncertainty regarding compensation for interest recognised on the transferred asset from Kaupthing Bank hf. from the time the transaction took place until the set off process is finalized. The amount for interest recognised in 2009 and 2010 is considered immaterial in these financial statements.

## Events after the Balance Sheet date

120.

### a) Sale of subsidiaries

The Bank sold Hekla ehf., a subsidiary of Hafrahlíd ehf. in the first quarter of 2011 as further described in Note 37.

An agreement to sell 34% share of Hagar hf., a retail-chain, was signed in February 2011. The agreement includes plans to list the company at the Nasdaq OMX in Iceland. Condition for the sale is the approval by Competition authorities.

### b) Currency-linked lending

In February 2011 the Supreme Court of Iceland pronounced two judgments on currency-linked loans to companies. The court decided that the loans were illegal in the same way as it had in the 2010 judgments which led to new legislation on mortgage loans to individuals. The new judgments create certain doubt over currency-linked loans to smaller companies if such loans were taken to the courts. The Bank has already allowed for exchange rate adjustment in its accounts in relation to the aforementioned agreement with the other banks and the authorities. However, if the corporate loans are largely deemed illegal the Bank will suffer substantial losses but this will not jeopardize the 16% capital ratio requirement.

# Notes to the Consolidated Financial Statements

## Subsidiaries

121. Shares in subsidiaries are specified as follows:

Company:	Country	Currency	Activity <sup>1</sup>	Equity interest accum. %
AB-fjárfestingar ehf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	OD	100.0
AFL - sparisjóður, Adalgata 34, 580 Siglufjörður .....	Iceland	ISK	RB	94.5
Arion Verðbréfavarsla hf., Ármúli 13, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Drög ehf., Pósthólf 878, 121 Reykjavík .....	Iceland	ISK	OD	82.1
Eignabjarg ehf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	OD	100.0
Ekort ehf., Gardatorg 5, 210 Gardabær .....	Iceland	ISK	RB	100.0
ENK 1 ehf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	OD	100.0
G-7 ehf., Grjóthálsi 7-11, 110 Reykjavík .....	Iceland	ISK	OD	100.0
Gen hf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	OD	100.0
GIR Fund Management Ltd., Walker House Mary Street, George Town. ....	Cayman Isl.	ISK	OD	100.0
Kaupthing Advisory Company S.A., 35a, avenue J.F. Kennedy .....	Luxemb.	EUR	OD	100.0
Kaupthing Management Comp S.A., 35a, avenue J.F. Kennedy .....	Luxemb.	EUR	OD	100.0
Landey ehf., Sudurlandsbraut 22, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Landfestar ehf., Sudurlandsbraut 22, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Landsel ehf., Sudurlandsbraut 22, 108 Reykjavík .....	Iceland	ISK	OD	100.0
Menntaskóli Borgarfjarðar ehf., Borgarbraut 54, 310 Borgarnes .....	Iceland	ISK	OD	55.9
Nidurskógur ehf., Digranesgata 2, 310 Borgarnes .....	Iceland	ISK	OD	100.0
Okkar líftryggingar hf., Sóltún 26, 105 Reykjavík .....	Iceland	ISK	OD	100.0
Sparisjóður Ólafsfjardar, Adalgata 14, 625 Ólafsfjörður .....	Iceland	ISK	RB	100.0
SPM ehf., Digranesgata 2, 310 Borgarnes .....	Iceland	ISK	RB	100.0
Stefnir hf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	OD	100.0
Valitor Holding hf., Laugavegi 77, 101 Reykjavík .....	Iceland	ISK	RB	52.9
Vesturland hf., Borgartún 19, 105 Reykjavík .....	Iceland	ISK	OD	100.0

1. RB: Retail Banking, OD: Other Divisions.