Interim Financial Statements

1 January - 30 September 2011

Unaudited

Arion Bank
Borgartún 19
105 Reykjavík
Iceland

Reg. no. 581008 - 0150

Contents

Endorsement and Statement by the Board of Directors and the CEO

The Unaudited Interim Financial Statements of Arion Bank for the period ended 30 September 2011 include the Interim Financial Statements of Arion Bank and its subsidiaries, together referred to as "the Group".

Arion 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 and asset management and comprehensive wealth management for private banking clients.

Kaupskil ehf., a company owned by the creditors of Kaupthing Bank, holds 87% of the shares in Arion Bank. The remaining shareholding of 13% is held by the Icelandic State.

The number of full time equivalent positions at the Group was 1,168 at period end compared with 1,124 at 30 September 2010, thereof 870 positions were at Arion Bank compared with 965 at end of September 2010.

Operations during the period

Net earnings amounted to ISK 13,648 million for the period ended 30 September 2011. Total equity amounted to ISK 120,660 million at the end of the period, including share capital amounting to ISK 2,000 million. The capital adequacy ratio of the Group, calculated according to the Act on Financial Undertakings, was 21.8%. 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 were 36.0% and 16.0% respectively at the end of the period.

Arion Bank performed well during the period. Core banking activities continued to yield strong results as is the case with core subsidiaries. Substantial progress was made in reducing the Bank's currency imbalance during the period and the objective is to have the imbalance substantially closed before the end of 2011. The Bank continued to make good progress in the restructuring work on its loan book and other assets transferred from Kaupthing Bank. As a result the Bank's knowledge of the value of the Loan book is vastly improved. The recovery work is expected to be largely completed by year end.

On 30 June 2011 a Settlement and release of claims agreement was signed on behalf of Arion Bank and Kaupthing Bank to finalise a settlement of the Compensation Instrument and various other claims lodged against Kaupthing Bank by Arion Bank. Valuation changes in assets transferred from Kaupthing Bank at the establishment of Arion Bank and finalisation of loan restructuring and settlement of disputes made it possible to close the remaining balance of the Compensation Instrument. By signing the agreement the Compensation Instrument is terminated and neither Party shall have any payment obligations towards the other under the Instrument. The settlement was in the form of transfer of loans and claims from Kaupthing Bank to Arion Bank and loans from Arion Bank to Kaupthing Bank, which in most cases, results in the total exposure to the customers being held wholly by either Arion Bank or Kaupthing Bank.

The liquidity position of the Bank was very strong at the end of the period with deposits being in line with loans to customers. Regardless, the Banks' objective is to diversify its funding base.

Uncertainties continue to prevail regarding the legality of foreign currency loans to corporations as discussed in Note 52. At the same time the recovery of the Icelandic economy remains fragile. The Bank, however, is financially strong and well situated to meet challenges that may arise from the above. The Bank, furthermore, is in an ideal position to support the growth of the Icelandic economy over the coming years.

Endorsement and Statement by the Board of Directors and the CEO

Statement by the Board of Directors and the CEO

The Interim Financial Statements for the period ended 30 September 2011 have been prepared in accordance with International Financial Reporting Standard (IAS 34 *Interim Financial Reporting*) as adopted by the EU.

It is our opinion that the Interim Financial Statements give a true and fair view of the financial performance of the Group for the period ended 30 September 2011, its financial position as at 30 September 2011 and its cash flows for the period ended 30 September 2011.

The Board of Directors and the CEO of Arion Bank hereby confirm the Group's Interim Financial Statements for the period 1 January to 30 September 2011.

Reykjavík, 24 November 2011

Board of Directors

Monica Caneman
Chairman

Agnar Kofoed-Hansen

Jón G. Briem

Gudrún Björnsdóttir

Måns Höglund

Gudrún Johnsen

Chief Executive Officer

Höskuldur H. Ólafsson

Interim Statement of Comprehensive Income
for the Period from 1 January to 30 September 2011

	Notes	2011 1.1.-30.9.	2010 1.1.-30.9.	2011 1.7.-30.9.	2010 1.7.-30.9.
Interest income		34,672	41,127	11,052	12,342
Interest expense		(17,836)	(24,770)	(5,376)	(6,282)
Net interest income	10	16,836	16,357	5,676	6,060
Increase in book value of loans and receivables	11	29,795	11,832	457	3,131
Impairment of loans and receivables	12	(6,443)	(7,291)	(642)	(2,351)
Changes in compensation instrument	36	(19,593)	(3,422)	-	-
Net interest income less valuation changes on loans and receivables		20,595	17,476	5,491	6,840
Fee and commission income		12,300	5,543	3,921	1,697
Fee and commission expense		(4,726)	(1,429)	(1,446)	(435)
Net fee and commission income	13	7,574	4,114	2,475	1,262
Net financial income (expense)	14-17	348	(354)	386	(92)
Net foreign exchange gain (loss)	18	1,979	(1,816)	2	(3,485)
Share of profit or loss of associates	38	(1)	290	-	147
Other operating income	19	3,478	3,517	1,127	1,423
Operating income		33,973	23,227	9,481	6,095
Salaries and related expense	21	(8,221)	(6,386)	(2,705)	(1,934)
Administration expense		(5,400)	(4,599)	(1,632)	(1,668)
Depositors' and investors' guarantee fund	49	(875)	(271)	(318)	55
Depreciation and amortisation		(655)	(522)	(225)	(181)
Other operating expense	22	(624)	(851)	(126)	(500)
Earnings before tax		18,198	10,598	4,475	1,867
Income tax expense	24	(3,079)	(2,785)	(562)	(1,236)
Bank Levy	25	(684)	-	(238)	-
Net earnings from continuing operations		14,435	7,813	3,675	631
Net gain (loss) from discontinued operations net of tax	23	(787)	1,100	(219)	345
Net earnings		13,648	8,913	3,456	976
Attributable to:					
Shareholders of Arion Bank		13,046	8,957	3,221	1,098
Non-controlling interest		602	(44)	235	(122)
Net earnings		13,648	8,913	3,456	976
Other comprehensive income					
Exchange difference on translating foreign operations	47	112	(161)	(2)	13
Total comprehensive income for the period		13,760	8,752	3,454	989
Earnings per share					
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	26	6.52	3.94	1.61	0.55

The notes on pages 9 to 45 are an integral part of these Interim Financial Statements.

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Interim Statement of Financial Position
as at 30 September 2011

Assets	Notes	30.09.2011	31.12.2010	30.09.2010
Cash and balances with Central Bank	27	38,000	30,628	33,372
Loans and receivables to credit institutions	28-29	60,422	67,846	61,942
Loans and receivables to customers	30-31	444,074	451,219	445,440
Bonds and debt instruments	33-34	158,549	120,112	132,257
Shares and equity instruments with variable income	33	14,324	10,316	8,732
Derivatives	33,45	1,057	1,126	1,404
Securities used for hedging	33	365	3,213	3,413
Compensation instrument	36	-	24,188	30,059
Investment property	37	26,912	27,642	25,229
Investments in associates	38	2,756	2,713	6,274
Property and equipment		6,433	7,365	10,760
Intangible assets		4,681	4,352	2,987
Tax assets	39	377	295	732
Non-current assets and disposal groups held for sale	40	40,193	44,464	36,129
Other assets	41	24,909	17,136	20,925
Total Assets		823,052	812,615	819,655
Liabilities				
Due to credit institutions and Central Bank	33	30,209	95,646	105,181
Deposits	33	511,473	457,881	477,773
Financial liabilities at fair value	33	6,111	999	3,702
Tax liabilities	39	7,085	4,454	4,873
Non-current liabilities and disposal groups held for sale	40	11,901	13,514	14,980
Other liabilities	42	36,421	39,050	20,800
Borrowings	33,43	67,317	65,278	64,224
Subordinated liabilities	44	31,875	26,257	25,493
Total Liabilities		702,392	703,079	717,026
Equity				
Share capital	46	2,000	2,000	2,000
Share premium	46	73,861	73,861	73,861
Other reserves	47	1,637	1,525	2,355
Retained earnings		35,504	28,531	24,320
Total Shareholders' Equity		113,002	105,917	102,535
Non-controlling interest		7,658	3,619	94
Total Equity		120,660	109,536	102,629
Total Liabilities and Equity		823,052	812,615	819,655

The notes on pages 9 to 45 are an integral part of these Interim Financial Statements.

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Interim Statement of Changes in Equity
for the Period from 1 January to 30 September 2011

	Share capital and share premium	Other reserves	Retained earnings	**Total Share-holders' equity**	Non-controlling interest	**Total equity**
Changes in equity from 1 January to 30 September 2011:						
Equity 1 January 2011	75,861	1,525	28,531	105,917	3,619	109,536
Dividend paid			(6,073)	(6,073)		(6,073)
Total comprehensive income for the period attributable to the shareholders of Arion Bank		112	13,046	13,158		13,158
Total comprehensive income for the period attributable to the non-controlling interest					602	602
Disposal of non-controlling interests					3,437	3,437
Equity 30 September 2011	75,861	1,637	35,504	113,002	7,658	120,660
Changes in equity from 1 January to 30 September 2010:						
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 period attributable to the shareholders of Arion Bank		(161)	8,957	8,796		8,796
Total comprehensive income for the period attributable to the non-controlling interest					(44)	(44)
Transfer to statutory reserve		786	(786)	-		
Non-controlling interests acquired during the period					(18)	(18)
Equity 30 September 2010	75,861	2,355	24,320	102,535	94	102,629

The notes on pages 9 to 45 are an integral part of these Interim Financial Statements.

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Condensed Interim Statement of Cash Flows
for the Period from 1 January to 30 September 2011

	Notes	2011 1.1.-30.9.	2010 1.1.-30.9.
Net cash (used in) provided by operating activities:			
Earnings before income tax		18,198	13,383
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 adjustements		(1,377)	(1,448)
Changes in operating assets and liabilities		(15,893)	7,911
Income taxes paid		(544)	(101)
Net cash provided by operating activities	53	384	19,745
Net cash flow provided by (used in) investing activities		4,792	(604)
Net increase in cash and cash equivalents		5,176	19,141
Cash and cash equivalents at beginning of the period		72,797	56,094
Cash and cash equivalents acquired through business combinations		5	-
Effect of exchange rate changes on cash held		1,234	(5,201)
Cash and cash equivalents at end of the period		79,212	70,034
Cash and cash equivalents comprises			
Cash in hand and demand deposits		38,000	33,372
Due from credit institutions		49,001	44,597
Mandatory reserve with Central Bank		(7,789)	(7,935)
Total cash and cash equivalents		79,212	70,034
Non-cash investing and financing transactions:			
Tier II subordinated notes issued in settlement of dividend		(6,073)	-
Change in retained earnings for settlement of dividend with the Icelandic State		6,073	-
Loans and receivables received through changes in capitalization		-	112,824
Bonds and debt instruments delivered through changes in capitalization		-	(32,595)
Liabilities due to credit institutions and central bank transferred due to changes in capitalization		-	14,428
Borrowings transferred due to changes in capitalization		-	(61,252)
Subordinated loans transferred due to changes in capitalization		-	(29,543)
Net changes in equity due to changes in capitalization		-	(3,862)

The notes on pages 9 to 45 are an integral part of these Interim Financial Statements.

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Notes to the Interim Financial Statements

General information

1. Reporting entity

   Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The address of Arion banki hf. registered office is Borgartún 19, Reykjavík. The Interim Financial Statements for the period ended 30 September 2011 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

   The Interim Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 24 November 2011.

2. Basis of preparation

a) *Statement of compliance*

The Interim Financial Statements are condensed and consolidated and have been prepared in accordance with International Financial Reporting Standard IAS 34, Interim Financial Reporting as endorsed by the European Union. The Interim Financial Statements do not include all the information and disclosures required in the annual financial statements, and should be read in conjunction with Arion Banks' annual Financial Statements for the year 2010. The statements are available at Arion Banks' website www.arionbanki.is.

b) *Basis of measurement*

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

- Financial assets/liabilities held for trading are measured at fair value
- Financial assets/liabilities designated at fair value through profit and loss are measured at fair value
- Investment properties are measured at fair value
- 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 Interim Financial Statements are presented in Icelandic króna (ISK), which is the Parent Company's functional currency, rounded to the nearest million unless otherwise stated.

d) *Use of estimates and judgements*

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

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

Judgements made by management that have a significant effect on the Interim Financial Statements and estimates with a significant risk of material adjustment within the next financial year are discussed in Note 4 in these Interim Financial Statements and in the annual Financial Statements 2010.

Significant accounting policies

The accounting policies adopted in the preparation of these Interim Financial Statement are consistent with those followed in the preparation of the Group's annual Financial Statements for the year ended 31 December 2010.

3. Going concern assumption

   The Group's management has made an assessment of the ability to continue as a going concern and is satisfied that the Group has the resources to continue. The Statement of Financial Position of the Group 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 Bank 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 Group's stress testing has resulted in the Group management assessing that it is sufficiently capitalised to deal with market shocks, significant market shocks during the realignment period of the Group's risk profile, poses some uncertainty.

   The Group 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 Group's assets through the recovery process and a team of specialists was put together to work with defaulting customers. A favourable outcome from this process is already strengthening the Group's business. Further information on risk factors in the Group's operation are provided in the Risk Management Disclosures.

4. Critical accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities 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 Interim Financial Statements.

Key sources of estimation uncertainty

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

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

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

As set out in Note 40 of these Interim Financial Statements, 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.

Changes within the Group

5. Changes in ownership and capitalization of Arion Bank.

   There were no changes in the ownership and capitalization of Arion Bank during the period. The shareholders in Arion Bank during the period and at 30 September 2011 were Kaupskil ehf. with an 87% shareholding, and the Icelandic State with a 13% shareholding.

   During the period a special dividend amounting to ISK 6,500 million was settled with the Icelandic State. The dividend was deducted from retained earnings and settled following the fulfilment of certain conditions under the agreement with Arion Bank. The dividend payment was currency based and due to changes in the foreign exchange rate from the signing of the agreement the settlement amounted to ISK 6,074 million and was settled through the issuance of Tier II subordinated notes to the Icelandic State in March 2011.

6. Acquisition of subsidiaries

   On 8 April 2011 the Bank's shareholding in it's associate KB Rádgjöf ehf. increased from 43.1% to 100.0%, resulting in a change in classification as subsidiary and accounted for accordingly.

7. Disposal of subsidiaries.

   On 11 February 2011 the Bank sold 35.3% effective share in its subsidiary Hagar hf. The sale agreement includes a plan to list the company at Nasdaq OMX in Iceland. At end of September 2011 the Bank retained control of this entity holding 63.5% effective share in Hagar hf. The shareholding disposed of has been recognised as an increase in non-controlling interest. The legal entity was classified as non-current assets and disposal groups classified as held for sale at year end 2010.

   On 18 February 2011 the Bank sold its 100.0% shareholdings in Hekla ehf. and Hekla fasteignir ehf., subsidiaries of Hafrahlíd ehf. These legal entities were classified as non-current assets and disposal groups classified as held for sale at year end 2010.

   On 21 June 2011 the Bank sold its 100.0% shareholdings in Rekstrarfélagid tíu-ellefu ehf. The legal entity was classified as non-current assets and disposal groups classified as held for sale at year end 2010.

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

   On 25 May 2011 the Bank handed its 55.9% share in Menntaskóli Borgarfjardar to the non-controlling shareholder, the municipality Borgarbyggd.

   On 14 June 2011 all assets and liabilities of the Bank's subsidiary Kaupthing Advisory Company were transferred to the Bank. Following the subsidiary was liquidated.

Notes to the Interim Financial Statements

Operating Segment Reporting

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

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

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

   Business segments

   The Group comprises four 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.

   Asset Management and Private Banking manage financial assets for institutional, corporate and private clients. Asset Management is organised into three units: Alternative and Mutual Fund Management, Asset Management for Institutional Investors and Services for Institutional Investors. Private Banking consists of two units: Customer Relations and Portfolio Management.

   Corporate Finance is divided into two parts: Corporate Advisory and Recovery. Corporate Advisory which provides M&A advisory services and capital markets transaction services to corporate clients and investors. Recovery which is responsible for the financial restructuring of the numerous Icelandic corporates which are unable to meet their payment obligations towards the Bank following the recent crisis in the Icelandic economy.

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

9. Summary of the Group's business segments:

1.1.-30.9.2011	Corporate Banking and Capital Markets	Retail Banking	Asset Managem. and Private Banking	Corporate Finance	Other Divisions and Elimination	Total
Net interest income	9,008	9,298	1,065	(185)	(2,350)	16,836
Other income	8,478	3,605	1,631	726	2,697	17,137
Operating income	17,486	12,903	2,696	541	347	33,973
Operating expense	(1,907)	(9,777)	(1,339)	(190)	(2,562)	(15,775)
Earnings before tax	15,579	3,126	1,357	351	(2,215)	18,198
Net segment revenue from external customers	19,447	9,758	66	606	4,096	33,973
Net segment revenue from other segments	(1,961)	3,145	2,630	(65)	(3,749)	-
Operating income	17,486	12,903	2,696	541	347	33,973
Depreciation and amortisation	1	278	-	-	376	655
Total assets	258,454	220,276	3,720	20,930	319,672	823,052
Allocated equity	41,061	36,521	2,320	4,003	36,755	120,660

1.1.-30.9.2010						
Net interest income	11,312	6,623	1,182	(130)	(2,630)	16,357
Other income	2,349	2,691	1,594	246	(10)	6,870
Operating income	13,661	9,314	2,776	116	(2,640)	23,227
Operating expense	(1,447)	(6,501)	(1,059)	(523)	(3,100)	(12,630)
Earnings before tax	12,214	2,813	1,717	(407)	(5,740)	10,597
Net segment revenue from external customers	20,157	3,722	(387)	322	(587)	23,227
Net segment revenue from other segments	(6,496)	5,592	3,164	(206)	(2,054)	-
Operating income	13,661	9,314	2,777	116	(2,641)	23,227
Depreciation and amortisation	-	166	-	-	357	523
Total assets 31.12.2010	273,502	233,288	4,407	4,687	296,731	812,615
Allocated equity 31.12.2010	43,760	35,233	3,756	(359)	27,146	109,536

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

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Notes to the Interim Financial Statements

Notes to the Interim Statement of Comprehensive Income

Net interest income

10. Interest income and expense is specified as follows:

1.1.-30.9.2011	Interest income	Interest expense	Net interest income
Cash and balances with Central Bank	381	-	381
Loans, receivables and deposits	28,036	14,243	13,793
Borrowings	-	1,966	(1,966)
Subordinated liabilities	-	1,404	(1,404)
Securities	5,722	-	5,722
Compensation instrument	322	-	322
Other	211	223	(12)
Interest income and expense	34,672	17,836	16,836
Interest income and expense from assets and liabilities at fair value	6,044	-	6,044
Interest income and expense from assets and liabilities not at fair value through profit or loss	28,628	17,836	10,792
Interest income and expense	34,672	17,836	16,836

1.1.-30.9.2010			
Cash and balances with Central Bank	927	-	927
Loans, receivables and deposits	28,789	22,309	6,480
Borrowings	-	1,558	(1,558)
Subordinated loans	-	872	(872)
Securities	9,751	-	9,751
Compensation instrument	931	-	931
Other	729	31	698
Interest income and expense	41,127	24,770	16,357
Interest income and expense from assets and liabilities at fair value	9,751	-	9,751
Interest income and expense from assets and liabilities not at fair value through profit or loss	31,376	24,770	6,606
Interest income and expense	41,127	24,770	16,357

Increase in book value of loans and receivables

11. The increase in book value of loans and receivables is determined in accordance with the accounting policy presented in the annual Financial Statements 2010. Increase in book value of loans and receivables consists of adjustment to reflect actual and estimated cash flows.

Impairment of loans and receivables

12. Impairment of loans and receivables is specified as follows:	2011 1.1.-30.9.	2010 1.1.-30.9.
Impairment of loans and receivables to credit institutions (reversed)	(40)	-
Impairment of loans and receivables to customers (reversed)	6,483	7,291
Impairment of loans and receivables	6,443	7,291

Arion Bank Interim Financial Statements 30 September 2011 15 Amounts are in ISK millions

Notes to the Interim Financial Statements

Net fee and commission income

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

	2011	2010
Fee and commission income	1.1.-30.9.	1.1.-30.9.
Asset management	1,921	2,005
Cards	7,486	885
Collection and payment services	907	781
Derivatives	139	126
Interbank clearing	512	488
Lending and guarantees	459	567
Security trading	192	133
Other fee and commission income	685	556
Fee and commission income	12,300	5,543
Fee and commission expense		
Asset management	57	182
Cards	3,810	441
Collection and payment services	21	23
Interbank clearing	531	529
Security trading	144	151
Other fee and commission expense	164	104
Fee and commission expense	4,726	1,429
Net fee and commission income	7,574	4,114

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

Net financial income

14. Net financial income is specified as follows:

	2011 1.1.-30.9.	2010 1.1.-30.9.
Dividend income	7	31
Net gain (loss) on financial assets and liabilities classified as held for trading	(879)	(848)
Net gain (loss) on financial assets and liabilities designated at fair value through profit or loss	1,220	463
Net financial income	348	(354)

15. Dividend income is specified as follows:

Dividend income on trading assets	4	2
Dividend income on assets designated at fair value through profit or loss	3	29
Dividend income	7	31

16. Net gain (loss) on trading portfolio is specified as follows:

Net gain (loss) on equity instruments and related derivatives	157	197
Net gain (loss) on interest rate instruments and related derivatives	(718)	(1,004)
Net gain (loss) on other derivatives	(318)	(41)
Net gain (loss) on trading portfolio	(879)	(848)

Arion Bank Interim Financial Statements 30 September 2011 16 Amounts are in ISK millions

Notes to the Interim Financial Statements

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

	2011 1.1.-30.9.	2010 1.1.-30.9.
Net gain (loss) on interest rate instruments designated at fair value	572	239
Net gain (loss) on equity instruments designated at fair value	648	224
Net gain (loss) on assets/liabilities designated at fair value through profit and loss	**1,220**	**463**

Net foreign exchange gain (loss)

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

FX gain (loss) of loans and receivables	5,410	(11,660)
FX gain (loss) on bank accounts	1,234	(5,201)
FX gain (loss) from deposits and borrowings	(4,455)	14,254
FX gain (loss) from subordinated liabilities	(725)	4,300
FX gain (loss) on bonds, equity and derivatives	58	(93)
FX gain (loss) from compensation instrument	325	(1,821)
FX gain (loss) on other assets and liabilities	132	(1,595)
Net foreign exchange gain (loss)	**1,979**	**(1,816)**

Other operating income

19. Other operating income is specified as follows:

Rental income from investment properties	1,706	1,497
Realised gain on investment property	-	172
Earned premiums, net of reinsurance	651	623
Net gain (loss) on disposals of assets other than held for sale	334	550
Other income	787	675
Other operating income	**3,478**	**3,517**

Personnel and salaries

20. The Group's total number of employees is as follows:	30.09.2011	30.09.2010
Average number of full time equivalent positions during the period	1,244	1,141
Full time equivalent positions at the end of the period	1,168	1,124

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

Average number of full time equivalent positions during the period	946	979
Full time equivalent positions at the end of the period	870	965

Arion Bank Interim Financial Statements 30 September 2011 17 Amounts are in ISK millions

	2011	2010
21. Salaries and related expense are specified as follows:	1.1.-30.9.	1.1.-30.9.
Salaries	6,529	4,973
Defined contribution pension plans	881	671
Salary related expense	811	742
Salaries and related expense	8,221	6,386

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

Salaries	4,859	4,192
Defined contribution pension plans	656	566
Salary related expense	640	660
Salaries and related expense	6,155	5,418

Other operating expense

22. Other operating expense:

Direct operating expense (including repairs and maintenance) arising on rental-earning investment properties	356	382
Fair value changes on investment property	-	241
Claims incurred, net of reinsurance	267	219
Other expense	1	9
Other operating expense	624	851

Net gain (loss) from discontinued operations net of tax

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

Net gain (loss) from legal entities	178	1,947
Impairment loss on remeasurement to fair value of legal entities	(2,027)	-
Net loss on revaluation and disposal of real estate	(34)	(725)
Other assets	(166)	(122)
Effect of compensation instrument	1,262	-
Net gain (loss) from discontinued operations net of tax	(787)	1,100

Net gain (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 the period.

Revenues, expenses and income tax expense of legal entities recognised as subsidiaries at 30 September 2010 (and included in relevant captions of the 2010 Statement of Comprehensive Income) that were classified as held for sale in the fourth quarter 2010 have been represented in the 2010 comparative figures within Net gain from legal entities for 2010. The significant amounts represented were Other operating income of ISK 14,264 million; Other operating expense of ISK 10,802 million and Salaries expense of ISK 2,600 million.

Arion Bank Interim Financial Statements 30 September 2011 18 Amounts are in ISK millions

Tax expense

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

	2011 1.1.-30.9.	2010 1.1.-30.9.
Current tax expense		
Current year	2,525	3,742
Deferred tax expense		
Changes in temporary differences	554	(957)
Total income tax expense	3,079	2,785

Reconciliation of effective tax rate:	1.1.-30.9.2011		1.1.-30.9.2010	
Earnings before income tax		18,198		10,598
Income tax using the Icelandic corporation tax rate	20.0%	3,640	18.0%	1,908
Non-deductible expense	0.1%	9	0.1%	11
Tax exempt revenues	(0.3%)	(52)	(0.3%)	(36)
Changes in deferred tax asset	0.0%	-	7.7%	811
Tax incentives not recognised in the Income Statement	(1.3%)	(243)	0.0%	-
Other changes	(1.5%)	(275)	0.9%	92
Effective tax rate	16.9%	3,079	26.4%	2,786

25. Bank Levy

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

Earnings per share

26. Earnings per share are specified as follows:

	2011 1.1.-30.9.	2010 1.1.-30.9.
Net earnings attributable to the shareholders of Arion Bank	13,046	8,957
Weighted average share capital:		
Weighted average number of outstanding shares for the period, million	2,000	2,276
Basic earnings per share	6.52	3.94
Diluted earnings per share	6.52	3.94
Number of outstanding shares at the end of the period, million	2,000	2,000
Number of total shares at the end of the period, million, diluted	2,000	2,000

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

Arion Bank Interim Financial Statements 30 September 2011 19 Amounts are in ISK millions

Notes to the Interim Financial Statements

Notes to the Interim Statement of Financial Position

Cash and balances with Central Bank

27. Cash and balances with Central Bank are specified as follows:	30.09.2011	31.12.2010
Cash on hand	2,846	9,609
Cash with Central Bank	27,365	13,250
Mandatory reserve deposits with Central Bank	7,789	7,769
Cash and balances with Central Bank	38,000	30,628

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

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

Bank accounts	49,001	57,707
Money market loans	8,897	1,294
Overdrafts	17	29
Other loans	3,042	10,175
Provision on loans and receivables	(535)	(1,359)
Loans and receivables to credit institutions	60,422	67,846

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

Balance at the beginning of the period	1,359	727
Provision for losses during the period (reversed)	(40)	632
Write-offs during the period	(784)	-
Balance at the end of the period	535	1,359

Loans and receivables to customers

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

Overdrafts	41,886	37,390
Subordinated loans	554	499
Other loans and receivables	444,876	455,173
Provision on loans and receivables	(43,242)	(41,843)
Loans and receivables to customers	444,074	451,219

The total book value of pledged loans at 30 September 2011 was ISK 74 billion (31 December 2010: 74). Pledged loans at period end comprised mortgage loans to individuals, loans to municipals and loans to state related entities that were pledged against amounts borrowed.

Arion Bank Interim Financial Statements 30 September 2011 20 Amounts are in ISK millions

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

	30.09.2011	31.12.2010
Balance at the beginning of the period	41,843	28,736
Provision for losses during the period	12,380	20,655
Write-offs during the period	(11,393)	(7,718)
Payment of loans previously written off	412	170
Balance at the end of the period	43,242	41,843
Specific	36,439	39,083
Collective	6,803	2,760
	43,242	41,843

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

Renegotiated loans

32. Since 2009 Arion Bank has engaged in financial restructuring of customers that are experiencing financial difficulties. For a detailed discussion of the Group's recovery processes, see Note 108 b) in the annual Financial Statements 2010.

Starting in December 2009, the Group has run a comprehensive program of standard solutions designed by the Bank and in conjunction with the government to assist individuals who have run into financial difficulties. As of 1 July 2011 all such programs are suspended. Through the programs, the Group reduced the debt level of 5,126 families by an average of 24.1%.

As per an agreement between the government and lending institutions, the Group participates in a coordinated effort to assist SMEs that are experiencing financial difficulties. The Group engages companies on a case-by-case basis using a transparent set of standard procedures. Until the closing day of the programme on 1 July the debt restructuring of over 470 companies was finalized. The procedures result in senior debt for which full performance is anticipated and subordinated debt which is initially non-performing and on which the Group has taken significant provisions. In some instances the Group has taken an equity stake in a company.

The Group predicts that it will complete its restructuring activities in 2011.

Arion Bank Interim Financial Statements 30 September 2011 21 Amounts are in ISK millions

Financial assets and liabilities

33. Financial assets and liabilities are specified as follows:

30.09.2011	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
Cash and balances with Central Bank	38,000	-	-	-	38,000
Loans to credit institutions	60,422	-	-	-	60,422
Loans to customers	444,074	-	-	-	444,074
Loans and receivables	542,496	-	-	-	542,496
Bonds and debt instruments					
Listed	-	5,694	50,235	-	55,929
Unlisted	-	20	102,600	-	102,620
Bonds and debt instruments	-	5,714	152,835	-	158,549
Shares and equity instruments with variable income					
Listed	-	44	1,237	-	1,281
Unlisted	-	589	8,903	-	9,492
Bond funds with variable income	-	1,819	1,732	-	3,551
Shares and equity instruments	-	2,452	11,872	-	14,324
Derivatives					
OTC derivatives	-	1,057	-	-	1,057
Derivatives	-	1,057	-	-	1,057
Securities used for hedging					
Bonds and debt instruments	-	313	-	-	313
Shares and equity instruments	-	52	-	-	52
Securities used for hedging	-	365	-	-	365
Other financial assets	-	-	-	24,120	24,120
Financial assets	542,496	9,588	164,707	24,120	740,911
Liabilities at amortised cost					
Due to credit institutions and Central Bank	-	-	-	30,209	30,209
Deposits	-	-	-	511,473	511,473
Borrowings	-	-	-	67,317	67,317
Subordinated liabilities	-	-	-	31,875	31,875
Liabilities at amortised cost	-	-	-	640,874	640,874
Financial liabilities at fair value					
Short position in bonds held for trading	-	5,400	-	-	5,400
Derivatives held for trading	-	711	-	-	711
Financial liabilities at fair value	-	6,111	-	-	6,111
Other financial liabilities	-	-	-	30,816	30,816
Financial liabilities	-	6,111	-	671,690	677,801

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33. cont.

31.12.2010	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
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
Loans and receivables	549,693	-	-	-	549,693
Bonds and debt instruments					
Listed	-	4,731	41,833	-	46,564
Unlisted	-	20	73,528	-	73,548
Bonds and debt instruments	-	4,751	115,361	-	120,112
Shares and equity instruments with variable income					
Listed	-	12	2,062	-	2,074
Unlisted	-	612	5,451	-	6,063
Bond funds with variable income	-	360	1,819	-	2,179
Shares and equity instruments	-	984	9,332	-	10,316
Derivatives					
OTC derivatives	-	1,126	-	-	1,126
Derivatives	-	1,126	-	-	1,126
Securities used for hedging					
Bonds and debt instruments	-	3,213	-	-	3,213
Securities used for hedging	-	3,213	-	-	3,213
Compensation instrument	-	-	24,188	-	24,188
Other financial assets	-	-	-	16,688	16,688
Financial assets	549,693	10,074	148,881	16,688	725,336
Liabilities at amortised cost					
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
Liabilities at amortised cost	-	-	-	645,062	645,062
Financial liabilities at fair value					
Short position in equity held for trading	-	923	-	-	923
Derivatives held for trading	-	76	-	-	76
Financial liabilities at fair value	-	999	-	-	999
Other financial liabilities	-	-	-	34,048	34,048
Financial liabilities	-	999	-	679,110	680,109

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

Arion Bank Interim Financial Statements 30 September 2011 23 Amounts are in ISK millions

34. Bonds and debt instruments designated at fair value specified by issuer:	30.09.2011	31.12.2010
Financial institutions	73,704	74,626
Public	71,923	40,393
Corporates	7,208	342
Bonds and debt instruments designated at fair value	152,835	115,361

No pledged bonds were held at period end (31.12.2010: ISK 20,005 million). 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.

35. Fair value hierarchy

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

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

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

30.09.2011	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL	4,727	158,091	1,889	164,707
Financial assets held for trading	6,103	3,465	20	9,588
	10,830	161,556	1,909	174,295
Financial liabilities held for trading	-	6,111	-	6,111

31.12.2010	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
	11,019	122,060	25,876	158,955
Financial liabilities held for trading	-	999	-	999

The classification of assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2010 is in consistency with the classification used in 2011.

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	
Financial assets	30.09.2011	31.12.2010
Financial assets designated at FV through PL	854	1,146

The above financial assets were transferred from Level 1 to Level 2 as they have ceased to be actively traded during the period and fair values were consequently obtained using valuation techniques using observable market inputs. There have been no transfers from Level 2 to Level 1 in 2011 and 2010.

Arion Bank Interim Financial Statements 30 September 2011 24 Amounts are in ISK millions

35. cont.

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):

	30.09.2011	31.12.2010
Balance at the beginning of the period	1,688	2,678
Gains (losses) recognised in Statement of Comprehensive Income	729	(1,348)
Purchases	84	376
Sales	(592)	(18)
Balance at the end of the period	1,909	1,688

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

	30.09.2011	31.12.2010
Net interest income	136	18
Net financial income (expense)	528	(1,223)
Net foreign exchange gain (loss)	65	(143)
Gains (losses) recognised in the Statement of Comprehensive Income	729	(1,348)

Compensation instrument

36. The compensation instrument was originated due to the difference in the fair value of the transferred assets, liabilities and contingent liabilities from Kaupthing Bank to Arion Bank in accordance with the FME decision in 2008. The compensation instrument amounted to ISK 38,300 million and was originally denominated 50% in ISK and 50% in EUR and subject to floating rates of interest.

Related to the compensation instrument was the Escrow and Contingent Value Rights Agreement (ECVRA) where Kaupthing Bank received 80% of the appreciation of defined Arion Bank loans (the "ring-fenced assets"). The increase in value of the defined loans should decrease the balance of the compensation instrument. If the compensation instrument was 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 would be passed onto Kaupthing Bank up to a cap of ISK 5 billion.

On 30 June 2011 a special agreement called Settlement and release of claims agreement was signed on behalf of Arion Bank and Kaupthing Bank to finalise a settlement of the ECVRA and various other claims lodged against Kaupthing Bank by Arion Bank. By signing the agreement the ECVRA is terminated and neither Party shall have any payment obligations towards the other under the ECRVA.

During the first half 2011 changes in those defined assets amounted to ISK 22,519 million, 80% of this increased value belonging to Kaupthing Bank, ISK 18,015 million as presented in the Statement of Comprehensive Income, 20% belonging to Arion Bank as a part of the Statement of Comprehensive Income. The total face value of the defined loans was approximately ISK 474,000 million and the book value was approximately ISK 210,000 million the end of June 2011

The net effect for the recognition of items per the settlement and release of claims agreement was expensed through the Interim Statement of Comprehensive Income.

Compensation instrument is specified as follows:	30.09.2011	31.12.2010
Balance at the beginning of the period	24,188	34,371
Changes due to the Escrow and Contingent Value Rights Agreement		
Continuing operations	(19,593)	(11,604)
Discontinued operations	1,578	2,017
Accrued interest	322	1,256
Foreign exchange rate differences	325	(1,852)
Assets and liabilities upon settlement	(6,820)	-
Balance at the end of the period	-	24,188

Arion Bank Interim Financial Statements 30 September 2011 25 Amounts are in ISK millions

Investment property

37. Investment property is specified as follows:	Investment property	Investment property in progress	Total 30.09.2011	Total 31.12.2010
Balance at the beginning of the period	21,550	6,092	27,642	22,947
Acquisition through business combination	-	-	-	3,000
Additions during the period	598	-	598	3,519
Disposals during the period	-	(2,088)	(2,088)	(1,561)
Transferred from property and equipment	760	-	760	-
Fair value adjustments	-	-	-	(263)
Investment property	22,908	4,004	26,912	27,642

Investments in associates

38. The Group´s interest in its principal associates are as follows:	30.09.2011	31.12.2010
Audkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20.0%	20.0%
Borgarland ehf., Egilsholt 1, 310 Borgarnes, Iceland	-	42.0%
Exista ehf., Ármúli 3, 108 Reykjavík, Iceland	44.9%	-
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	43.5%	43.5%
Hótel Borgarnes hf., Egilsgata 16, 310 Borgarnes, Iceland	20.6%	20.6%
KB Rádgjöf ehf., Hlídarsmári 17, 201 Kópavogur, Iceland	-	43.1%
Kríuvarp ehf., Borgartún 35, 105 Reykjavík, Iceland	25.0%	25.0%
Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland	21.7%	21.7%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42.7%	42.7%
Sementsverksmidjan ehf., Mánabraut 20, 300 Akranes, Iceland	23.6%	-
SMI ehf., Smáratorg 3, 210 Kópavogur, Iceland	39.1%	-
Ölgerdin Egill Skallagrímsson ehf., Grjótháls 7-11, 110 Reykjavík, Iceland	20.0%	20.0%

Investments in associates are specified as follows:

Carrying amount at the beginning of the period	2,713	5,985
Acquisition through business combination	-	108
Additions during the period	2,579	7
Transferred to held for sale assets	(2,525)	(54)
Transferred from associates due to step acquisition	(10)	(3,889)
Share of profit (loss)	(1)	556
Carrying amount at the end of the period	2,756	2,713

Tax assets and tax liabilities

39. Tax assets and liabilities are specified as follows:	30.09.2011		31.12.2010	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	5,971	-	3,821
Deferred tax	377	1,114	295	633
Tax assets and liabilities	377	7,085	295	4,454

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Non-current assets and disposal groups held for sale

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

	30.09.2011	31.12.2010
Legal entities	37,185	41,927
Real estates	2,800	2,456
Other assets	208	81
Non-current assets and disposal groups held for sale	40,193	44,464

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 period end the largest entities were BM Vallá ehf., Fram Foods ehf., Hagar hf., Penninn á Íslandi ehf. and the Bank's associate company N1 hf.

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

Liabilities associated with the legal entities held for sale are as follows:

	30.09.2011	31.12.2010
Legal entities, total liabilities	11,901	13,514

Other assets

41. Other assets are specified as follows:

Unsettled securities trading	2,254	366
Accounts receivable	20,405	14,312
Accrued income	529	802
Prepaid expenses	744	448
Sundry assets	977	1,208
Other assets	24,909	17,136

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

Other liabilities

42. Other liabilities are specified as follows:

Accounts payable	18,375	24,704
Withholding tax	443	2,600
Depositors' and investors' guarantee fund	3,024	2,669
Insurance claim	2,001	1,992
Unsettled securities trading	1,272	110
Sundry liabilities	11,306	6,975
Other liabilities	36,421	39,050

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

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Borrowings

43. Borrowings are specified as follows:	30.09.2011	31.12.2010
Bonds issued	6,834	7,156
Other loans	60,483	58,122
Borrowings	67,317	65,278

The Group has not repurchased any of its own debt during the period (2010: 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.

Subordinated liabilities

44. Subordinated liabilities are specified as follows:	30.09.2011	31.12.2010
Tier II capital	31,875	26,257
Subordinated liabilities	31,875	26,257

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

Derivatives

45. Derivatives at fair value are specified as follows:

	Fair value	
30.09.2011	Assets	Liabilities
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	440	218
Interest rate and exchange rate agreements	536	396
	976	614
Bond derivatives:		
Bond swaps, agreements unlisted	78	97
Options - purchased agreements	3	-
Derivatives	1,057	711

31.12.2010		
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	2	-
Interest rate and exchange rate agreements	1,100	-
	1,102	-
Bond derivatives:		
Bond swaps, agreements unlisted	24	75
Derivatives	1,126	75

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Equity

Share capital and share premium

46. 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.

Issued share capital	Number (million)	30.09.2011	Number (million)	31.12.2010
At 1 January	2,000	75,861	12,646	72,000
Redeemed on 8 January			(12,386)	(62,139)
Issued on 8 January			1,740	66,000
	2,000	75,861	2,000	75,861

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

Other reserves

47. Other reserves are specified as follows:

	30.09.2011	31.12.2010
Statutory reserve	1,637	1,637
Foreign currency translation reserve	-	(112)
Other reserves	1,637	1,525

Off Balance Sheet information

Obligations

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

	30.09.2011	31.12.2010
Guarantees	7,768	11,675
Unused overdrafts	34,193	40,896
Loan commitments	15,519	13,946

49. Depositors' and Investors' Guarantee fund

According to a provisional amendment to Act No. 98/1999 on Deposit Guarantees and Investor Compensation Scheme the payments to a new division within the Depositors' and Investors' Guarantee Fund shall amount to a minimum of 0.3% of the amount of guaranteed deposits in the commercial bank concerned. Payment shall be made on a quarterly basis or 0.075% each quarter. In addition to the minimum fee the commercial bank concerned shall pay a variable fee based on risk indicator with value between zero and one as defined by the FME. The Group expensed ISK 875 million in the period January to September 2011 for the amounts required under the provisional amendment. Due to uncertainty of the shape of final legislation on the Depositors' and Investors' Guarantee Fund the liability brought forward from previous year is not changed from the balance of ISK 2,669 million. The Bank has granted the Fund a guarantee for obligations amounting to ISK 3,364 million.

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund which, if passed, would entail a substantial increase in the size of the fund and related payments.

Assets under management and under custody

50. Assets under management and assets under custody are specified as follows:	30.09.2011	31.12.2010
Assets under management	632,587	618,062
Assets under custody	1,686,055	1,745,384

Contingent liabilities

51. 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 Group has become more likely. The Group has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Group makes adjustments to account for any adverse effects which the claims may have on its financial standing. At period end, the Group had several unresolved legal claims.

One significant court case is a case between Drómi and the Bank. By means of a decision issued by the Icelandic Financial Supervisory Authority (FME) on 21 March 2009, the Bank acquired the deposits of SPRON. According to the decision the resolution committee of SPRON should establish a specific limited liability company owned by SPRON, later Drómi, designed to receive all the assets of the savings banks and all security interests, including all liens, guarantees and other comparable interests linked to SPRON's claims. The subsidiary was then supposed to take over all SPRON's obligations to the Bank relating to the acquisition of SPRON's deposits obligations and was supposed to issue a bond to the Bank as compensation for the deposit obligations. Such obligation to the Bank was documented with an agreement on repaying the debt. The agreement states that the interest rate on the debt principal shall be determined by the FME at any given time. The FME decided that the debt should bear a given annual interest rate plus an interest premium from that time until the debt has been paid in full. It was also specified that the FME was permitted to review the decision upon request by the parties every six months. In a letter dated 2 December 2009 Drómi insisted that the FME review its former interest rate decision. On 4 February 2011 the FME decided that the debt should bear annual interest rate which should be the original given interest rate plus the original given interest premium from the takeover date until 30 June 2010, but without an interest premium from that time until the debt has been paid in full. The Bank has brought legal action against the FME and Drómi in an attempt to annul the FME's decision of 4 February 2011. On 4 May 2011 Drómi brought legal action against the FME and the Bank. Drómi principally demands the annulment of all decisions by the FME on interest rates and secondly demanding a different interest rate from the outset.

A number of clients alleged that assets under management were improperly managed resulting in the clients suffering financial loss. Five of these claims were taken to court of law. On May 13 2011 all of these claims were dismissed by the district court. On June 15 2011 the appellate court, i.e. the Supreme Court of Iceland, upheld the previous decision of the district court.

There are also a number of court cases, to which the Bank is a party, whereby the legality of the Bank's FX loans are called into question. In some of the cases, the interest rate which is used in the recalculation of said loans is called into question, and also if the Bank is obligated to reimburse borrowers because of foreign currency linked loans which the borrower had repaid in full before the Bank was founded in October 2008. If the Courts side with the borrowers, and state that recalculated loans should bear the interest stipulated in each loan document, rather than the interest stipulated in Act No 151/2010 (on recalculation of loans), i.e. non-indexed interest rate for the Icelandic krona posted by the Central Bank, or state that the Bank is obligated to reimburse borrowers which had repaid before the Bank was founded, the impact on the Bank's loan portfolio would be significant.

One case is a claim based on an agreement from 2001 on the use of guarantees for individual debts. The guarantor claims that the bank did not adhere to the rules, which put the responsibility on the lender to provide the guarantor with a credit valuation of the debtor to be signed by the guarantor. The disputed amount in this case is not material for the bank but could affect the validity of guarantees held by the bank for a number of other loans to individuals.

The EFTA Surveillance Authority (ESA) has opened a formal investigation into the purchases of the assets of money market funds in the autumn of 2008. The investigation aims to clarify whether the purchase by Arion Bank of assets from the funds can be seen as government support in the understanding of Article 61 of the EEA Agreement. Stefnir hf. has communicated its remarks to the Ministry of Finance and a result is expected in the year 2011.

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

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The uncertainty regarding the book value of Foreign currency lending

52. 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 has now finished recalculating all mortgage loans for personal residents in foreign currency to individuals. Over 60% of the number of foreign currency loans to individuals was affected and as of March 2011 the book value of the loans reflected the result of the calculations.

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

    Even though no foreign currency indexed ISK loans made by the Bank have been deemed illegal by the Supreme Court, the Bank has decided and announced on 15 June 2011 that recent rulings made by the Supreme Court provide a precedent for the Bank to follow, and that the loans that fall under the conditions set forth by the Supreme Court in its rulings will be recalculated into ISK denominated loans. The Bank estimates that around 2,000 loans, to both individuals and businesses, will have to be recalculated. The Bank has taken adequate provisions for this pending recalculation.

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

Notes to the Interim Statement of Cash Flow

53. Changes in operating assets and liabilities specify as follows:

	30.09.2011	30.09.2010
Mandatory reserve with Central Bank, net change	(20)	1,914
Loans and receivables to credit institutions	6,767	(2,912)
Loans and receivables to customers	34,758	16,169
Bonds and debt instruments	(38,936)	7,865
Shares and equity instruments	(884)	(1,233)
Derivatives	69	(1,439)
Securities used for hedging	2,811	(1,177)
Other assets	3,303	(2,102)
Due to credit institutions and central bank	(1,234)	7,962
Deposits	(17,666)	(5,438)
Borrowings	1,639	(8,070)
Subordinated loans	(1,181)	-
Financial liabilities at fair value	698	3,614
Other liabilities	(6,017)	(7,242)
	(15,893)	7,911

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Risk Management Disclosures

Further information regarding risk management is available in the annual Financial Statements 2010.

Credit risk

54. Credit risk

The valuation that occurred as the Bank's assets were transferred from Kaupthing Bank 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) The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, including derivatives, before the effect of mitigation through the use of collateral agreements or other credit enhancements.

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

	30.09.2011	31.12.2010
Cash and balances with Central Bank	38,000	30,628
Loans and receivables to credit institutions	60,422	67,846
Loans and receivables to customers	444,074	451,219
Overdrafts	41,887	37,390
Subordinated loans	554	499
Other loans	402,183	413,330
Bonds and debt instruments	158,549	120,112
Listed	55,929	46,565
Unlisted	102,620	73,547
Derivatives	1,057	1,126
Bonds and debt instruments, hedging	365	3,213
Listed	313	3,213
Compensation instrument	-	24,188
Other assets with credit risk	24,120	16,688
Total on balance sheet maximum exposure to credit risk	726,587	715,020

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

	30.09.2011	31.12.2010
Financial guarantees	7,768	11,675
Unused overdrafts	34,193	40,896
Loan Commitments	15,519	13,946
Total off balance sheet maximum exposure to credit risk	57,480	66,517
Maximum exposure to credit risk	784,067	781,537

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54. cont.

b) 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.

c) Non-performing loans

The Bank uses following classification to capture the changes in the creditworthiness of counterparties as early as possible as well as streamlining the process for problem loans into Recovery.

Classification conditions:

Status	Provision	Days in default	Debt/EBITDA /LTV	Equity Ratio*	Credit Rating	Covenant breach
Performing	No	<30 days	< 4-5 / < 75%-90%	> 15-25%	≥ B	None
Watch	No	30 - 90 days	4-6 / < 75%-90%	10-25%	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 where conditions differ between sectors. 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 total loan exposure less than 100 million ISK 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:

	30.09.2011	31.12.2010
Performing	47%	38%
Watch	16%	10%
Sub-performing	16%	15%
Non-performing	21%	37%
Total	100%	100%

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54. cont.

d) Credit quality by class of financial assets

The table below shows the credit quality of financial assets:

30.09.2011	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Loans and receivables to credit institutions	60,422	-	-	60,422
Loans and receivables to customers				
Loans to corporates	250,129	23,661	61,534	335,324
Loans to individuals	89,372	14,113	5,265	108,750
Total	399,923	37,774	66,799	504,496

31.12.2010	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Loans and receivables to credit institutions	63,451	-	4,395	67,846
Loans and receivables to customers				
Loans to corporates	119,655	51,404	168,805	339,864
Loans to individuals	67,127	14,581	29,646	111,354
Total	250,233	65,985	202,846	519,064

Restructuring of loans to customers is now finalised for the major part of the loan book which makes it possible for the bank to look at impairment on loans on a loan basis rather than customer basis, which was the method used until now. For these two reasons individually impaired loans are considerably lower than before. Different method and progress made in the restructuring of loans also affects the figure for Neither Past due nor impaired which is considerably higher than at year end 2010.

e) Past due but not impaired loans by class of financial assets:

30.09.2011	Less than 30 days	31 to 60 days	61 to 90 days	More than 91 days	Total
Loans to corporates	9,436	658	400	13,167	23,661
Loans to individuals	5,797	865	966	6,485	14,113
Total	15,233	1,523	1,366	19,652	37,774

31.12.2010	Less than 30 days	31 to 60 days	61 to 90 days	More than 91 days	Total
Loans to corporates	6,063	949	7,112	37,280	51,404
Loans to individuals	2,594	3,237	1,792	6,958	14,581
Total	8,657	4,186	8,904	44,238	65,985

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

f) Collateral repossessed

During the period, the Bank took possession of real estates with the carrying value of 1,289 million ISK and other assets with the value of 176 million ISK, all which the Bank is in the process of selling, see Note 40.

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54. cont.

g) Loans and receivables to customers specified by sectors:

	30.09.2011	31.12.2010
Individuals	24.4%	24.7%
Financial and insurance activities	16.9%	14.1%
Manufacturing, mining and other industry	9.4%	13.3%
Real estate activities	12.0%	13.0%
Agriculture, forestry and fishing	13.3%	11.1%
Wholesale and retail trades, transport, accommodation and food service activities	11.7%	9.9%
Business services	7.1%	8.3%
Construction	2.1%	2.4%
Public administration, defence, education, human health and social work activities	1.6%	1.8%
Other services	1.5%	1.4%
Loans and receivables to customers	100.0%	100.0%

h) Impaired loans and receivables to customers by sector:

	30.09.2011		31.12.2010	
	Impaired amount	Impaired loans	Impaired amount	Impaired loans
Individuals	6,807	12,072	5,472	35,118
Financial and insurance activities	5,583	17,761	4,673	24,228
Manufacturing, mining and other industry	1,912	8,461	2,136	19,095
Real estate activities	6,800	14,615	7,568	48,686
Agriculture, forestry and fishing	2,760	9,713	2,606	22,184
Wholesale and retail trades, transport, accommodation and food service activities	2,421	13,149	3,294	28,604
Business services	6,280	14,504	10,562	45,022
Construction	3,462	10,184	2,349	9,501
Public administration, defence, education, human health and social work activities	152	1,738	77	2,558
Other services	262	1,041	346	2,538
Impairment on loans and receivables to customers	36,439	103,238	39,083	237,534

i) Large Exposure Disclosures

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

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

The maximum exposure to a group of connected clients at period end was 35 billion ISK (31.12.2010: 36 billion) before taking account of eligible collateral, excluding claim on Drómi. The Group has seven large exposures at period end (31.12.2010: seven exposures) net of eligible collateral.

No large exposure exceeds the legal limit of 25% of the group's risk capital at period end. The Ministry of Finance has pledged that Arion Bank will be held harmless from the exposure due to the bond claim on Drómi. The FME has ruled that the Group can use the hold harmless statement as a credit enhancement towards the claim on Drómi ehf. Consequently, the Group finds that the net exposure on Drómi is zero, or 1% when taking into consideration financial related parties.

The sum of all large exposures is 109% before collateral mitigation or 105% net of eligible collateral, which is well below the 800% legal maximum and the Group's internal 150% limit net of collateral.

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Liquidity risk

55. Liquidity risk

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

Secured Liquidity

The Group 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 Group 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 Group’s liabilities are primarily short term or on-demand deposits while the contractual maturity of the assets is much higher. The Group actively monitors its liquidity reserves and has made excellent progress in understanding and modelling the behaviour of its deposit base. The ratios during the period were as follows:

	Liquidity ratio	Cash ratio
Period-end	36%	16%
Maximum	37%	18%
Minimum	29%	12%
Average	34%	15%

Deposit Stickiness

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

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

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

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55. cont.

% of deposit base:

Stickiness rating		30.09.2011		31.12.2010
1 Capital controls	8%	42,649	7%	39,932
2 Resolution process	10%	55,046	9%	48,718
3 Investors	28%	151,091	29%	160,437
4 Deposits - legal entities	14%	76,380	9%	49,817
5 Deposits - retail individuals	11%	58,098	12%	66,423
6 Deposits - legal entities with business relationship	13%	71,330	17%	94,100
7 Deposits - retail individuals with business relationship	16%	87,088	17%	94,100
Total	100%	541,682	100%	553,527

Market risk

56. Market risk

a) Interest rate risk

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

		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
30.09.2011						
CPI Indexed linked	ISK	(60)	(941)	(792)	(10,609)	(474)
Non Indexed linked	ISK	(688)	(273)	(224)	(158)	(57)
	EUR	(78)	(3)	-	-	-
	Other	(113)	(720)	-	-	-
31.12.2010						
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)	-	-	-

Notes to the Interim Financial Statements

56. cont.

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

30.09.2011 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	38,000	30,211	-	7,789	-	-	-
Due from banks	60,422	49,028	9,164	784	1,156	290	-
Loans and receivables to customers	444,074	-	7,862	42,286	233,696	160,230	-
Bonds and debt instruments	158,549	6,523	513	30,373	81,282	39,858	-
Shares and equity instruments	14,324	-	-	-	-	-	14,324
Derivatives	1,057	-	252	-	7	-	798
Assets leg	18,244	-	13,545	-	297	-	4,402
Liabilities leg	(17,187)	-	(13,293)	-	(290)	-	(3,604)
Securities used for hedging	365	313	-	-	-	-	52
Investment property	26,912	-	-	-	-	-	26,912
Investments in associates	2,756	-	-	-	-	-	2,756
Property and equipment	6,433	-	-	-	-	-	6,433
Intangible assets	4,681	-	-	-	-	-	4,681
Tax assets	377	-	-	-	-	-	377
Non-current assets held for sale	40,193	-	-	-	-	-	40,193
Other assets	24,909	2,258	20,449	565	707	7	923
Total assets 30.09.2011	823,052	88,333	38,240	81,797	316,848	200,385	97,449
Liabilities							
Due to credit inst. and Central Bank	30,209	27,432	216	-	2,561	-	-
Deposits	511,473	369,769	54,545	33,792	48,254	5,113	-
Financial liabilities at fair value	6,111	5,400	315	-	396	-	-
Assets leg	(28,005)	-	(27,325)	-	(680)	-	-
Liabilities leg	34,116	5,400	27,640	-	1,076	-	-
Tax liabilities	7,085	-	-	-	-	-	7,085
Non-current liabilities held for sale	11,901	-	-	-	-	-	11,901
Other liabilities	36,421	1,271	26,826	900	1,819	-	5,605
Borrowings	67,317	-	700	579	4,351	61,687	-
Subordinated liabilities	31,875	-	-	-	-	31,875	-
Total liabilities 30.09.2011	702,392	403,872	82,602	35,271	57,381	98,675	24,591
Off balance sheet items							
Guarantees	7,768	102	863	1,069	4,600	1,134	-
Unused overdraft	34,193	848	9,908	8,677	14,690	70	-
Loan commitments	15,519	-	3,592	9,339	1,738	850	-
Total off balance sheet items	57,480	950	14,363	19,085	21,028	2,054	-
Net interest sensitivity gap	63,180	(316,489)	(58,725)	27,441	238,439	99,656	72,858

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56. cont.

31.12.2010 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	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
Total assets 31.12.2010	812,615	82,479	26,486	65,876	337,682	202,498	97,594
Liabilities							
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	-
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
Borrowings	65,278	600	501	32	4,349	59,796	-
Subordinated liabilities	26,257	-	-	-	-	26,257	-
Total liabilities 31.12.2010	703,079	388,442	63,703	83,492	53,142	91,006	23,294
Off balance sheet items							
Guarantees	11,675	67	1,029	2,173	7,347	1,059	-
Unused overdraft	40,896	40,896	-	-	-	-	-
Loan commitments	13,946	13,946	-	-	-	-	-
Total off balance sheet items	66,517	54,909	1,029	2,173	7,347	1,059	-
Net interest sensitivity gap	43,019	(360,872)	(38,246)	(19,789)	277,193	110,433	74,300

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56. cont.

b) Inflation risk

The Group is exposed to inflation risk when there is a mismatch between inflation linked assets and liabilities. The total amount of indexed assets amount to ISK 115.1 billions (31.12.2010: 106.0 billions) and the total amount of indexed liabilities amount to ISK 100.7 billions (31.12.2010: 87.8 billions).

30.09.2011	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets - CPI indexed linked				
Loans and receivables to customers	(173)	36,062	70,651	106,540
Bonds and debt instruments	(10)	2,059	4,287	6,336
Off balance sheet position	-	2,190	-	2,190
Total	(183)	40,311	74,938	115,066
Liabilities - CPI indexed linked				
Deposits	55,143	33,270	3,213	91,626
Borrowings	-	6,288	2,801	9,089
Total	55,143	39,558	6,014	100,715
Net on balance sheet position	(55,326)	753	68,924	14,351
Net off balance sheet position	-	2,190	-	2,190
Total CPI Balance	(55,326)	2,943	68,924	16,541
Total CPI Balance 31.12.2010	(56,094)	8,579	66,180	18,665

c) Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Group is primarily exposed to currency risk through a currency mismatch between assets and liabilities. The liabilities of the Group are predominantly ISK denominated deposits whereas the Group'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 continue in third quarter 2011. Net exposures per currency are monitored centrally in the Bank.

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

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash with Central Bank	13,525	957	6,908	676	9,910	2,169	3,855	38,000
Loans to credit institutions	22,989	10,270	9,343	770	3,762	820	12,468	60,422
Loans and receivables to customers	265,162	48,147	20,910	39,299	10,392	33,561	26,603	444,074
Bonds and debt instruments	148,578	341	9,630	-	-	-	-	158,549
Shares and equity instruments	10,715	2,131	867	-	139	-	472	14,324
Derivatives	1,047	-	10	-	-	-	-	1,057
Securities used for hedging	365	-	-	-	-	-	-	365
Investment property	26,912	-	-	-	-	-	-	26,912
Investments in associates	2,755	1	-	-	-	-	-	2,756
Property and equipment	6,433	-	-	-	-	-	-	6,433
Intangible assets	4,681	-	-	-	-	-	-	4,681
Tax assets	377	-	-	-	-	-	-	377
Non-current assets held for sale	35,999	4,194	-	-	-	-	-	40,193
Other assets	22,123	1,163	616	13	296	145	553	24,909
Total assets 30.09.2011	561,661	67,204	48,284	40,758	24,499	36,695	43,951	823,052
Liabilities								
Due to credit inst. and Central Bank	25,266	2,283	1,223	7	751	13	666	30,209
Deposits	422,934	31,537	12,360	6,295	7,513	4,786	26,048	511,473
Financial liabilities at fair value	3,843	-	231	178	13	1,846	-	6,111
Tax liabilities	7,085	-	-	-	-	-	-	7,085
Non-current liabilities held for sale	9,251	2,650	-	-	-	-	-	11,901
Other liabilities	31,203	2,454	1,711	6	570	-	477	36,421
Borrowings	7,213	3,078	19,129	20,230	6,511	10,559	597	67,317
Subordinated loans	-	25,844	2,359	-	3,672	-	-	31,875
Equity	120,660	-	-	-	-	-	-	120,660
Total liabilities 30.09.2011	627,455	67,846	37,013	26,716	19,030	17,204	27,788	823,052
Net on balance sheet position	(65,794)	(642)	11,271	14,042	5,469	19,491	16,163	
Net off balance sheet position	(134)	128	(4)	9	2	150	(151)	
Net position 30.09.2011	(65,928)	(514)	11,267	14,051	5,471	19,641	16,012	
Net position 31.12.2010	(170,263)	24,097	23,018	55,109	7,896	46,627	13,516	
Loans to customers with ISK income	43,093	(8,603)	(2,492)	(15,272)	(251)	(14,573)	(1,901)	
Net real position 30.09.2011	(22,835)	(9,117)	8,775	(1,221)	5,220	5,068	14,111	
Net real position 31.12.2010	(48,556)	(8,817)	11,247	17,999	4,109	15,969	8,049	

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56. cont.

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 Group 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 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 Bank. The Group 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 30 September 2011 values of the foreign currency imbalance are shown in the following table with year end 2010 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 group. 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.

	30.09.2011		31.12.2010	
	Book value	Effective value	Book value	Effective value
FX imbalance due to customers with FX income	22,835	22,837	48,556	48,556
FX imbalance due to customers with ISK income	43,093	23,867	121,707	48,683
Total	65,928	46,704	170,263	97,239

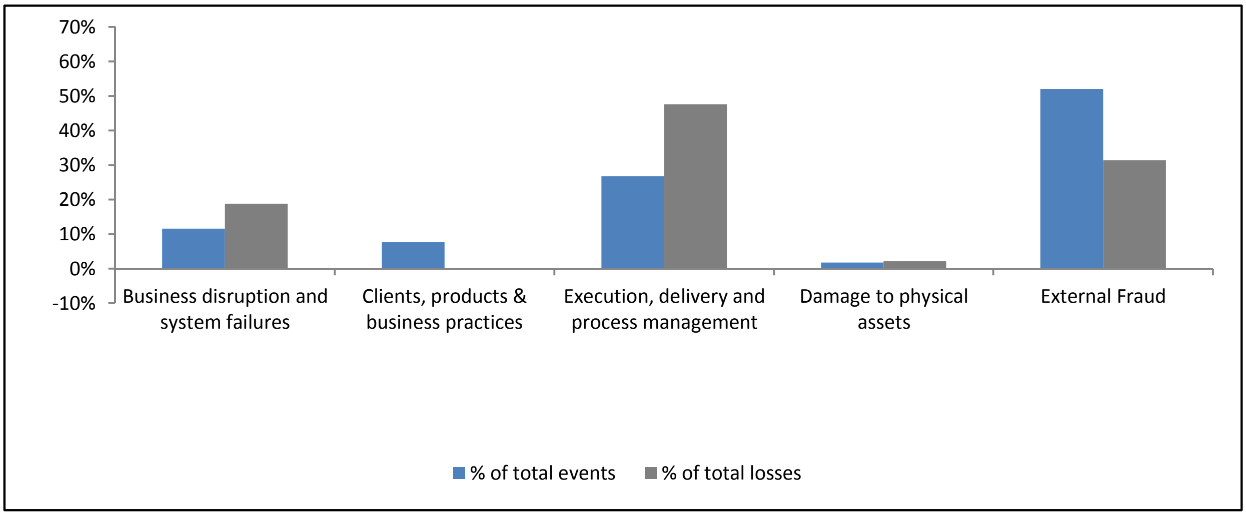
The effective FX imbalance due to customers with ISK income during the period was 46% (31.12.2010: 40%), whereas the effective FX imbalance due to customers with FX income is always 100%.

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

Operational risk

57. Operational risk

Losses of ISK 48.4 million were registered in the Bank’s loss database for the first nine months. The Bank experienced a number of external fraud risk events such as credit card fraud, which accounted for 31% of total loss amount. The largest single loss of ISK 9.6 million accounted for 19.8% of the total loss amount. The largest amount of total losses is due to Asset Management whereas the largest number of loss events are registered by Retail Banking.



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Capital Adequacy

58. Capital Adequacy Disclosures

Capital base at 30 September 2011 amounts to ISK 147,476 million. The capital base and capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 144,255 million and 21.8% respectively, exceeding the minimum legal requirement of 8%. The difference being the unaudited profit for the period.

The Group, Parent company and subsidiaries that are subjected to capital requirements rules comply in full with imposed capital requirements (2010: 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 46% effective contribution of the corresponding portion of the FX imbalance has been accounted for at period end (31.12.2010: 40%).

The table shows the Group's RWA calculations:

Capital Base	30.09.2011	31.12.2010
Share capital	2,000	2,000
Share premium	73,861	73,861
Statutory reserve	1,637	1,525
Retained earnings*	35,504	28,531
Non-controlling interests	7,658	3,619
Total Equity	120,660	109,536
Deduction from Tier 1 capital	5,059	4,647
Total Tier 1 capital	115,601	104,889
Tier 2 capital	31,875	26,257
Total Capital base	147,476	131,146
Risk weighted assets		
Credit risk	526,499	513,328
Market risk FX	46,704	97,657
Market Risk Other	30,281	20,397
Operational risk	57,267	57,267
Total Risk weighted assets	660,751	688,649
Tier 1 ratio	17.5%	15.2%
Capital adequacy ratio	22.3%	19.0%
Official Tier 1 ratio	17.0%	15.2%
Official Capital adequacy ratio	21.8%	19.0%

*Retained earnings and reserves based on unaudited figures.

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Other information

Related parties

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

No unusual transactions took place with related parties during the period. 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 other than the one related to the compensation instrument as disclosed in Note 36.

The following table shows outstanding balances with related parties:

30.09.2011	Assets	Liabilities	Net balance
Shareholders with significant influence over the Group	16,094	70,361	(54,267)
Board of Directors and key Management personnel	273	457	(184)
Associates and other related parties	38,711	18,733	19,978
	55,078	89,551	(34,473)
31.12.2010			
Shareholders with significant influence over the Group	36,440	65,170	(28,730)
Board of Directors and key Management personnel	348	903	(555)
Associates and other related parties	20,603	2,416	18,187
	57,391	68,489	(11,098)

Comparative balances at 31 December 2010 were revised during the period to exclude related party balances of shareholders with significant influence that had previously been included. The effect of this change was to increase the net liability amount due to shareholders with significant influence at 31 December 2010 by ISK 6,165 million.

Events after Balance Sheet date

60. Events after Balance Sheet date

Verdis hf.

In March 2011 Arion Bank and Landsbanki Íslands hf. signed a letter of intent whereby Landsbanki Íslands hf. intended to purchase new equity issued by Verdis hf. (the name was changed from Arion verdbréfavarsla hf.), currently a wholly owned subsidiary of Arion Bank. After the issuance of new equity Arion Bank should hold 75.5% share in Verdis hf. The letter of intent was signed with the notice of a due diligence and an approval by Competition authority was pending. On 17 October 2011 the Competition authority revoked the agreement.

N1 hf.

On 28 September 2011 an agreement to sell the Banks 38,9% shareholding in its associate N1 hf. was signed. Following the agreement the shareholding in N1 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 Interim Financial Statements. An approval by the Competition authority is pending.

B.M. Vallá ehf.

On 4 October 2011 Eignabjarg ehf. sold its 100.0% shareholding in B.M. Vallá ehf. The agreement was signed with the notice of an approval by Competition authorities. B.M. Vallá ehf. is classified as non-current assets and disposal groups held for sale in these Interim Financial Statements.

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60. cont.

Sparisjódur Ólafsfjardar and AFL - sparisjódur

One offer was received for Arion Bank's shareholdings in the savings banks Sparisjódur Ólafsfjardar and AFL - sparisjódur which has branches in Siglufjördur and Saudárkrókur. Arion Bank owns almost the entire guarantee capital in both savings banks and advertised it for sale in September. The offer was non-binding and discussions with the offeror have been ceased. The bank is now working on other solutions in the operation and ownership of the two savings banks.

Hagar hf.

In February 2011 the Bank sold 35.3% effective share in its subsidiary Hagar hf. to Búvellir slhf. The sale agreement included option for the buyer to purchase additional 10% share in Hagar hf. Búvellir slhf. has confirmed that it will exercise the option and the transaction will take place on 23 November 2011.

HB Grandi hf.

In October the Bank acquired a 33% shareholding of HB Grandi hf. as a part of Kjalar´s ehf. debt settlement with the Bank. The Bank aims is to sell the shareholding in HG Grandi hf. as soon as market conditions allow for an agreeable sale.

Subsidiaries

61. Shares in subsidiaries are specified as follows:

Company:	Country	Currency	Activity[1]	Equity interest accum. %
AB-fjárfestingar ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0
AFL - sparisjódur, Adalgata 34, 580 Siglufjördur	Iceland	ISK	RB	94.5
Drög ehf., Hátún 2B, 105 Reykjavík	Iceland	ISK	OD	100.0
EAB 1 ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0
Eignabjarg ehf., Borgartún 26, 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
Gen hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0
GIR Fund Management Ltd., Walker House Mary Street, George Town.	Cayman Isl.	ISK	AM	100.0
Kaupthing Management Company S.A., 35a, avenue J.F. Kennedy	Luxemb.	EUR	AM	100.0
KB Rádgjöf ehf., Hlídasmári 17, 201 Kópavogur	Iceland	ISK	OD	100.0
Landey ehf., Hátún 2b, 105 Reykjavík	Iceland	ISK	OD	100.0
Landfestar ehf., Borgartún 26, 105 Reykjavík	Iceland	ISK	OD	100.0
Nidurskógur ehf., Digranesgata 2, 310 Borgarnes	Iceland	ISK	OD	100.0
Okkar líftryggingar hf., Sóltún 26, 105 Reykjavík	Iceland	ISK	RB	100.0
Sparisjódur Ólafsfjardar, Adalgata 14, 625 Ólafsfjördur	Iceland	ISK	RB	100.0
SPM ehf., Digranesgata 2, 310 Borgarnes	Iceland	ISK	OD	100.0
Stefnir hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	AM	100.0
Valitor Holding hf., Laugavegur 77, 101 Reykjavík	Iceland	ISK	RB	52.9
Verdis hf., Ármúli 13, 108 Reykjavík	Iceland	ISK	OD	100.0
Vesturland hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0

1. AM: Asset Management and Private Banking, RB: Retail Banking, OD: Other Divisions.

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