Arion Bank

Press release, 29 August 2013

ARION BANK'S H1 2013 FINANCIAL RESULTS

Arion Bank reported net earnings of ISK 5.9 billion for the first half of 2013, compared with ISK 11.2 billion for the same period in 2012. Return on equity was 8.9%, compared with 18.8% in the same period of 2012. Return on equity based on regular operations was 8.1%, compared with 11.8% in the same period of 2012. Total assets amounted to ISK 929.0 billion, compared with ISK 900.7 billion at the end of 2012.

Net earnings for the second quarter of 2013 amounted to ISK 4.5 billion, compared with ISK 6.8 billion in the same period in 2012. Return on equity in the second quarter was 13.5%, compared with 22.7% in the same period in 2012. Return on equity based on regular operations in the second quarter was 9.9%, compared with 11.4% in the same period of 2012.

The Bank's capital ratio at the end of the period was 24.3%, the same figure as at the end of 2012.

Highlights of the interim financial statement:

- Net earnings of ISK 5.9 billion, compared with ISK 11.2 billion during the same period of 2012.
- Earnings during the second quarter of 2013 of ISK 4.5 billion, compared with ISK 6.8 billion during the same period in 2012.
- Earnings from regular operations of ISK 5.4 billion, compared with ISK 7.0 billion during the same period of 2012.
- Operating income decreased between years to ISK 20.8 billion from ISK 24.9 billion in the same period of 2012. The main reason for this is the decrease in the interest-rate differential related to an increase in term deposits, bond issues and lower valuation changes in the loan portfolio.
- Net interest income of ISK 12.7 billion, slightly lower than the same period in 2012 as a result of lower inflation.
- Net valuation change on loans of ISK 0.1 billion, mostly as a result of write-downs relating to court judgments on currency-linked loans and written off loans totalling ISK 6.8 billion and an increase in the valuation of loans, primarily to corporate clients, of ISK 6.7 billion.
- Return on equity was 8.9%, compared with 18.8% in the same period of 2012. Return on equity based on regular operations was 8.1%, compared with 11.8% in the same period of 2012.
- The interest-rate differential as a percentage of average interest-bearing assets was 3.1% during the period, compared with 3.4% during the same period of 2012.
- The cost-to-income ratio was 62.4%, compared with 52.0% during the same period of 2012. The high ratio is partly explained by provisions relating to the fine imposed on Valitor by the Competition Authority and lower operating income than in the same period of 2012. The cost-to-income ratio on regular operations was 60.3%, compared with 52.8% during the same period of 2012.
- Loans to customers of ISK 567.3 billion at the end of the period, which is virtually unchanged from the beginning of the year.

- Total assets of ISK 929.0 billion, compared with ISK 900.7 billion at the end of 2012.
- Shareholders’ equity at the end of the period of ISK 136.8 billion, compared with ISK 130.9 billion at the end of 2012.

Höskuldur H. Ólafsson, CEO of Arion Bank:

“The Bank’s second quarter financial results are in line with our expectations. The Bank continues to consolidate its position, thanks to the improved quality of the loan portfolio and greater diversity in the funding base, both areas on which we have placed great emphasis recently. The Bank’s capital ratio and liquidity ratios remain robust.

Despite the positive results in the second quarter, the six-month results are clearly affected by the first quarter results which fell short of expectations, largely as a result of unfavourable exchange rates and provisions made for a one-off expense related to a subsidiary of the Bank.

We have registered a 60% increase in demand for new loans in the first six months of the year compared with last year, a pleasing development. As we emerge from a period of economic stagnation, we would naturally like to see an even greater growth in loans, but a change in demand does indicate more intense economic activity.

The Bank’s operations continue to be fundamentally stable, although volatile areas do remain in the Bank’s external environment, such as the high costs relating to court judgments on currency-linked loans this year just as in past years. Nevertheless the impact of irregular items on the Bank’s operations is decreasing and we expect this trend to continue."

For further information please contact Haraldur Gudni Eidsson of Arion Bank's Communications division at haraldur.eidsson@arionbanki.is, or tel. +354 856 7108.

Income statement – highlights

Income Statement				
In ISK million	**6M '13**	**6M '12**	**Diff.**	**Diff. %**
Net interest income	12,667	13,880	-1,213	-9%
Net change in valuation on loans	134	2,532	-2,398	-95%
Net interest income less val. on loans	12,801	16,412	-3,611	-22%
Net commission income	5,298	5,338	-40	-1%
Net financial income	1,544	330	1,214	368%
Net gain/ -loss on foreign exchange	-1,248	-149	-1,099	738%
Other income	2,425	3,006	-581	-19%
Operating income	**20,820**	**24,937**	**-4,117**	**-17%**
Salaries and related expense	-6,679	-6,169	-510	8%
Other operating expense	-6,228	-5,475	-753	14%
Net earnings before taxes	**7,913**	**13,293**	**-5,380**	**-40%**
Income tax	-1,749	-2,913	1,164	-40%
Bank Levy	-188	-510	322	-63%
Net earnings from continuing operation	**5,976**	**9,870**	**-3,894**	**-39%**
Net gain/ -loss from discont. operation net of tax	-65	1,379	-1,444	-
Net earnings	**5,911**	**11,249**	**-5,338**	**-47%**

Operating income

Operating income during the first half of 2013 amounted to ISK 20,820 million, compared with ISK 4,117 million during the same period of 2012. This decrease is primarily a result of the lower interest-rate differential and a lower increase in the valuation of loans than in the same period of 2012.

Net interest income amounted to ISK 12,667 million during the period, compared with ISK 13,880 million during the same period of 2012. This represents a decrease between years of more than ISK one billion and is largely explained by lower inflation and higher interest expenses on deposits; the proportion of term deposits has increased and such deposits cost the Bank more in the form of higher interest. The interest-rate differential as a percentage of average interest-bearing assets was 3.1% during the period, compared with 3.4% during the same period of 2012.

Net valuation changes on loans and receivables amounted to ISK 134 million, compared with ISK 2,532 million in the same period of 2012. The valuation of part of the group's loan portfolio is still subject to some uncertainty. This is shown by the ISK 6,798 million increase in the value of the loan portfolio, which can be primarily attributed to the strong recovery of loans to larger companies following financial restructuring. This is counterbalanced by loan impairment of ISK 6,664 million, which is largely a result of loans being deemed illegally linked to a foreign currency.

Net commission income remained almost unchanged between years at ISK 5,298 million, compared with ISK 5,338 million in the same period of 2012. Commission income in Asset Management and Investment Banking has increased considerably, while income from card transactions and loans has decreased.

Net financial income amounted to ISK 1,544 million, compared with ISK 330 million in the same period of 2012. Income derives from both the Bank's equity and bond holdings and has been generated by positive conditions on the Icelandic securities market in the first half of 2013.

Net exchange rate loss amounted to ISK 1,248 million, compared with a loss of ISK 149 million in the same period of 2012. The Bank's net foreign exchange balance was ISK 24.3 billion at the end of the period which meant that volatility in the exchange rate had a significant impact on operating income. The foreign exchange balance is within the 15% limit imposed by the Central Bank of Iceland. It is the Bank's policy to have a strong liquidity in foreign currency. However, the exchange rate in the first half of the year meant this policy generated an exchange rate loss during the period.

Other operating income amounted to ISK 2,425 million, compared with ISK 3,006 million in the same period of 2012. The main types of income included in other operating income are lease income from commercial property owned by Landfestar and Landey and income from insurance premiums at OKKAR Life Insurance, all of which are subsidiaries of the Bank. It also includes valuation changes and profits on investment properties owned by the Bank's real estate companies, and this largely accounts for the decrease between years – valuation changes and profits on the sale of investment properties were higher in the first half of 2012.

Operating expenses

Operating expenses increased by ISK 1,263 million, or 10.8%, between years to ISK 12,907 million during the period. Operating expenses include a fine of ISK 500 million imposed on Valitor by the Competition Authority. Valitor has appealed the decision to the Competition Authority Appeals Committee. Excluding the fine, operating expenses increased by ISK 763 million or 6.5%. The cost-to-income ratio was 62.4% during the period, compared with 52.0% during the same period of 2012. The cost-to-income ratio in the second quarter of 2013 is lower than in the first, 54.4% compared with 72.6% in the first quarter. The cost-to-assets ratio was 2.8% during the period, compared with 2.6% in the first half of 2012. The cost-to-income ratio is heavily influenced by the decrease in operating income relating to lower interest income and valuation changes during the period and the aforementioned fine imposed on Valitor.

Salaries and related expenses amounted to ISK 6,679 million, compared with ISK 6,169 million in the same period of 2012. There were on average 1,177 full-time equivalent positions at Arion Bank during the period, compared with 1,159 in the same period of 2012. The average salary has increased by 4.6% which is less than the 5.4% increase in the salary index between periods.

Other operating expenses amounted to ISK 6,228 million, compared with ISK 5,475 million in the same period of 2012. This increase of ISK 753 million is largely related to the fine imposed on Valitor by the Competition Authority. In other respects other operating expenses were as expected.

Taxes

Income tax amounted to ISK 1,749 million, compared with ISK 2,913 million in the same period of 2012. The effective income tax rate is virtually the same as in the same period last year, 22.1% in 2013 and 21.9% in 2012.

Special tax on financial companies amounted to ISK 188 million, compared with ISK 510 million in the same period of 2012. The decrease is due to a lower tax rate in 2013 than in the previous two years.

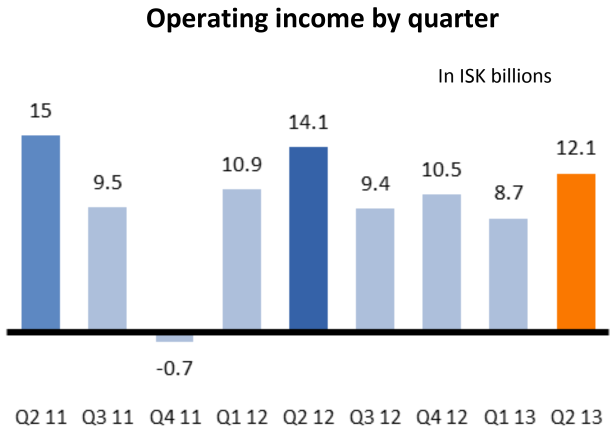
Discontinued operations

Net expenses from discontinued operations amounted to ISK 65 million, compared with net income of ISK 1,379 million in the same period of 2012. During the first half of 2012 the Bank generated capital gains from the sale of a major shareholding in Hagar and the sale of the Bank's share in N1. The sale of assets during the first half this year had an insignificant effect and there was a loss on other discontinued operations and foreclosure assets owned by the Bank.

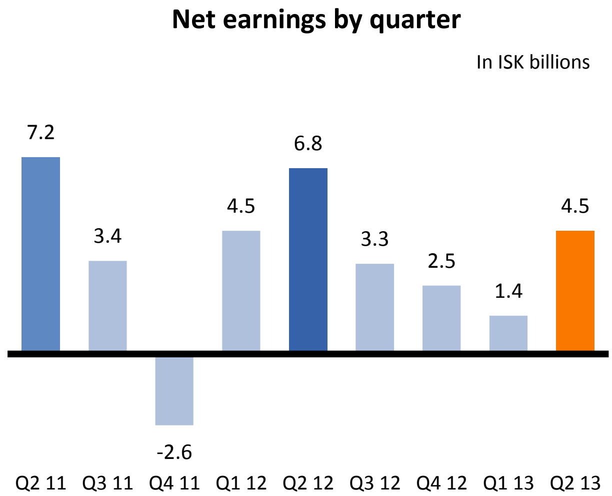
Second quarter of 2013

The financial results for the second quarter of 2013 were most satisfactory. Return on equity was 13.5%, compared with 22.7% in the same period of 2012. Financial results fluctuate between quarters but the differences are not as pronounced now as they were at their peak in 2010 and 2011.

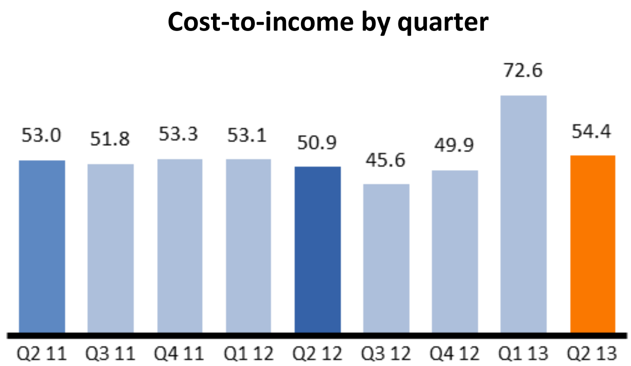
Operating income during the second quarter of 2013 amounted to ISK 12,056 million, compared with ISK 14,082 million during the same period in 2012. As shown in the diagram, operating income fluctuates considerably and valuation changes on loans and exchange rate differences are the key factors behind quarterly differences. Operating income was unusually high in the second quarter of 2012 as a result of significant valuation changes and a high interest-rate differential due to inflation.



Net earnings for the second quarter of 2013 amounted to ISK 4,502 million, compared with ISK 6,798 million in the same period of 2012. As is the case with operating income, valuation changes on loans and exchange rate differences are the key factors behind quarterly differences in earnings.



The cost-to-income ratio in the second quarter of 2013 was 54.4%, compared with 50.9% during the same period of 2012. The cost-to-income ratio varies sharply between quarters both as a result of one-off costs and fluctuations in operating income. The high cost-to-income ratio in the first quarter of 2013 is attributable to lower operating income and higher costs than in the same period of 2012.



Balance sheet – highlights

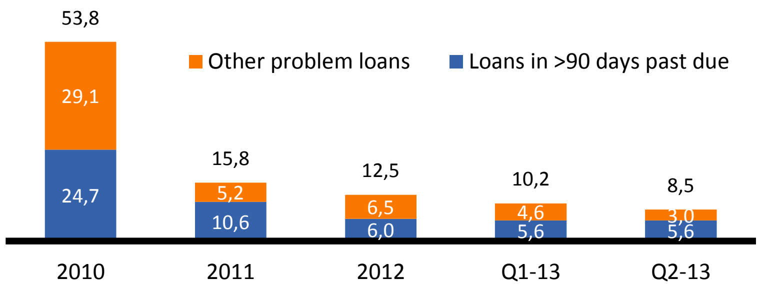
Assets					
In ISK million	**30.06.2013**	**31.12.2012**	**Diff.%**	**30.06.2012**	**Diff.%**
Cash and balances with CB	25,717	29,746	-14%	16,280	58%
Loans to credit institutions	109,732	101,011	9%	71,769	53%
Loans to customers	567,257	566,610	0%	578,886	-2%
Financial assets	153,771	137,800	12%	147,140	5%
Investment properties	28,911	28,919	0%	28,379	2%
Non-current assets & disp.groups HFS	10,086	11,923	-15%	16,303	-38%
Other assets	33,556	24,666	36%	21,293	58%
Total assets	**929,030**	**900,675**	**3%**	**880,050**	**6%**

Arion Bank had *total assets* of ISK 929,030 million at the end of the period, compared with ISK 900,675 million at the end of 2012. Changes during the period are insignificant and can largely be attributed to increased liquidity. The Bank's financial strength remains virtually unchanged from the end of 2012. The liquidity ratio is 38.0% and the cash ratio is 31.8%, compared with 32.9% and 30.8% respectively at the end of 2012. The statutory minimums for these ratios are 20% and 5%.

Loans to customers

Loans to customers amounted to ISK 567,257 million at the end of June 2013, compared with ISK 566,610 million at the end of 2012. A substantial amount of new loans were issued in the first half of 2013 and a substantial amount was paid off, meaning that the loan portfolio remained virtually unchanged. The ratio of problem loans has decreased sharply in recent quarters and this trend is expected to continue. At the end of 2010, 53.8% of total loans to customers were classed as problem loans but by the end of June 2013 this figure had dropped to 8.5%. Problem loans are defined as loans which have been in default for more than 90 days and loans which have been written down even if they have not defaulted.

Problem loans



Securities

Securities holdings amounted to ISK 153,771 million at the end of the period, compared with ISK 137,800 million at the end of 2012.

Securities					
In ISK million	**30.06.2013**	**31.12.2012**	**Diff.%**	**30.06.2012**	**Diff.%**
Bonds	132,744	117,730	13%	128,853	3%
Shares and instruments w. variable income	16,735	16,844	-1%	15,408	9%
Derivatives	832	788	6%	1,363	-39%
Securities used for hedging	3,460	2,438	42%	1,516	128%
Securities total	**153,771**	**137,800**	**12%**	**147,140**	**5%**

Arion Bank uses cash to invest in liquid bonds, which explains the fluctuations in bondholdings between years. Changes in other securities are insignificant.

Non-current assets and disposal groups held for sale

Non-current assets and disposal groups held for sale amounted to ISK 10,086 million at the end of June 2013, compared with ISK 11,923 million at the end of 2012. The decrease is largely due to the sale of Fram Foods Ísland hf. The main assets in this category are real estate and shareholdings in companies which have been acquired by the Bank in connection with the settlement of customers' loans.

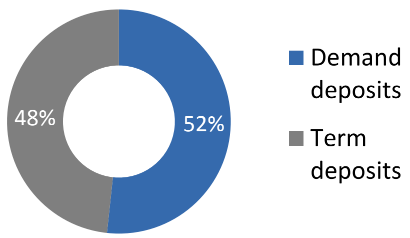
Liabilities and equity

Liabilities and equity

In ISK million	30.06.2013	31.12.2012	Diff.%	30.06.2012	Diff.%
Due to credit institutions & CB	25,727	32,990	-22%	20,837	23%
Deposits from customers	466,834	448,683	4%	445,249	5%
Non current liab. & disp.groups HFS	614	1,769	-65%	4,174	-85%
Financial liabilities at fair value	10,005	13,465	-26%	10,439	-4%
Other liabilities	53,459	43,585	23%	49,080	9%
Borrowings	203,100	195,085	4%	192,953	5%
Subordinated loans	32,503	34,220	-5%	32,175	1%
Equity	136,788	130,878	5%	125,143	9%
Total liabilities and equity	**929,030**	**900,675**	**3%**	**880,050**	**6%**

Total liabilities amounted to ISK 792,242 million at the end of June, compared with ISK 769,797 million at the end of 2012. The increase is primarily attributable to bond issues in Iceland and abroad during the period, while deposits have also increased.

Deposits



Total deposits amounted to ISK 492,561 million at the end of the period, compared with ISK 481,673 million at the end of 2012. Despite the growth in deposits during the period, deposits in the banking sector have decreased overall during the last few periods. Nevertheless the Bank has maintained its share on the domestic market. Capital is expected to continue to be moved from deposits to other investment options as opportunities become available. The Bank has made systematic efforts in recent years to increase its term deposits in order to make its funding more secure.

Borrowings

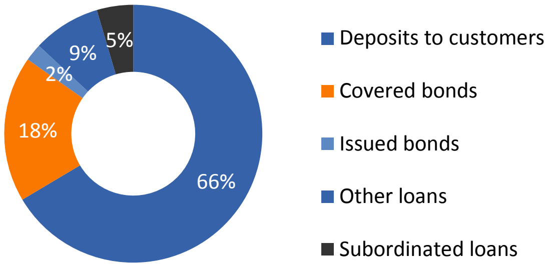
Borrowings amounted to ISK 203,100 million at the end of June 2013, compared with ISK 195,085 million at the end of 2012. This increase is explained by the Bank's issue of ISK 1.8 billion in covered bonds, which are listed on NASDAQ OMX Iceland, and NOK 500 million (approx. ISK 11 billion) in bonds which were sold to international investors and are listed on the Oslo Stock Exchange. The Bank will continue to work on diversifying its funding base, both in Iceland and internationally.

Subordinated liabilities

Subordinated liabilities amounted to ISK 32,503 million at the end of the period, compared with ISK 34,220 million at the end of 2012. The change is solely related to changes in the exchange rate of foreign currencies linked to the loans.

Funding

The diagram to the right shows the Bank's funding structure at the end of June 2013. When the Bank was established at the end of October 2008 it was almost entirely funded with deposits, most of which were demand deposits. The Bank has systematically managed to change this structure and has, therefore, crucially distributed risk.



Shareholders' equity

Shareholders' equity amounted to ISK 136,788 million at the end of June 2013, compared with ISK 130,878 million at the end of 2012. The change relates entirely to the H1 2013 financial results. The capital ratio calculated in accordance with the rules of the FME was 24.3% at the end of the period, compared with the statutory minimum of 8%.

Key performance indicators	6M 2013	2012	6M 2012
Return on equity (ROE)	8.9%	13.8%	18.8%
Return on total assets (ROA)	1.3%	1.9%	2.5%
Net interest margin (int. bearing assets)	3.1%	3.4%	3.4%
Net interest margin (total assets)	2.8%	3.1%	2.8%
Cost-to-income ratio	62.4%	49.8%	52.0%
Cost-to-total assets ratio	2.8%	2.8%	2.6%
Effective tax rate	22.1%	18.0%	21.9%
CAD-ratio	24.3%	24.3%	22.3%
Tier 1 ratio	19.5%	19.1%	17.5%
Problem loans	8.5%	12.5%	15.5%
RWA/Total assets	72.2%	73.0%	78.7%
Loans to deposit ratio	121.5%	126.3%	130.0%
Secured liquidity ratio	38.0%	32.9%	31.6%
Cash ratio	31.8%	30.8%	14.5%
The Group's average number of employees	1,177	1,166	1,159
The Group's employees at the end of period	1,153	1,190	1,173
The parent's average number of employees	939	927	912
The parent's empl. at the end of the period	918	949	920

Financial calendar 2013

The Bank's interim financial statements are scheduled for publication in the weeks stated below.

Third quarter 2013	Week 48
Annual financial statement for 2013	Week 9 2014
Annual General Meeting	March 2014

This calendar may be subject to change.