Interim Consolidated Financial Statements

1 January - 30 September 2013

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 Interim Consolidated Financial Statements of Arion Bank for the period ended 30 September 2013 include the Interim Consolidated Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Arion Bank is a group of undertakings which provide comprehensive financial services to companies, institutions and private customers. These services include corporate and retail banking, investment banking and asset management. Within the Group are subsidiaries in investment property management, credit card and insurance services.

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

Operations during the period

Net earnings amounted to ISK 10,130 million for the 9 months period ended 30 September 2013. The Group's equity amounted to ISK 140,887 million at the end of the period, including share capital of ISK 2,000 million. The capital adequacy ratio of the Group, calculated according to the Act on Financial Undertakings, was 23.6%. By law this ratio is required to be no lower than 8.0%, but the Icelandic Financial Supervisory Authority ("FME") makes more stringent requirements. The Bank comfortably meets these requirements. The Bank's liquidity position was strong with the liquidity ratio and cash ratio being 35% and 29% respectively at the end of the period, compared with the regulatory minimum of 20% and 5% respectively.

Operating results in the nine months show stability in regular operations, however net earnings are affected by the volatility of the Icelandic Krona and one-time expenses. The Icelandic Krona strengthened during the period which contributes ISK 1.6 billion to the difference in net earnings compared to same period last year and a ISK 500 million fine set on Valitor by the Icelandic Competition Authority negatively affects Administration expenses. Other differences from last year are mainly lower net valuation changes of the loan book and gain from discontinued operations in the first nine months of 2012, which does not repeat in 2013. Higher net valuation changes in 2012 were the result of good progress in the restructuring of loans to companies and sale of overtaken entities, while postive changes in valuation of loans in the first nine months of 2013 are evened out by increased impairment for uncertainties related to FX loans and other losses.

The Balance Sheet has grown by 4% from year end 2012. Total loans to customers have incresed by 3% from year end 2012. During the period considerable changes have been in the valuation of loans. However the amount of losses on loans and impairment due to recalculation of loans are off-set by revaluation of loans where expected payments exceed previous estimates. Certainty regarding the valuation of the loan book continues to improve, even if minor volatility may remain in the near term, mainly due to continued legal uncertainty. Increased investments in associates are due to the takeover of a 38.2% share in Skipti in June 2013.

The Bank completed its third non-indexed covered bonds offering in January by issuing ISK 1.8 billion worth of bonds. In February the Bank was the first Icelandic bank since 2007 to complete international bond offering, issuing NOK 500 million, equalling ISK 11 billion, of senior unsecured bonds that have now been listed on the Oslo Stock Exchange. In July the bank finished an offering of a new indexed Covered Bonds issuance for ISK 3 billion worth and in October additional bonds worth ISK 1.5 billion were sold.

The international bond offering in February represented the first phase in raising international funding since the Bank was founded. As a follow up, steps have been taken to apply for a credit rating from an international rating agency. In July the Icelandic rating agency Reitun issued an updated rating for both Arion Bank as a debtor and covered bonds issued by the Bank. For the Bank the rating improved from B with stable outlook to B+ with positive outlook. For covered bonds the rating is unchanged at A, which is at par with the rating of the Icelandic State.

Arion Bank´s objective is to balance risk and returns in it‘s operations. The Bank has therefore sought to improve the funding structure of the Bank by increasing the weight of term deposits and long term borrowings, both domestically and abroad. The aim is to decrease the re-financing risk and to strengthen the liquidity ratios that need to be met by the Bank. This has resulted in a decrease in net interest income.

Assets under management increased considerably during the year 2012 and have continued to grow in 2013 with an increase of 9.8% in the first nine months of 2013. The Bank has in recent periods successfully attracted new customers and the market has contributed by positive progress.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Outlook

The Icelandic economy is expected to grow by 3% in 2014. Arion Bank is well positioned to grow and its strong balance sheet will enable it to be an active participant in the further strengthening of the Icelandic economy. As debt recovery cases decrease, traditional banking activities are becoming more characteristic of the Bank’s operations. This provides opportunities for further streamlining, yet at the same time creates greater potential for generating earnings. The Bank aims to be a relationship bank and a fundamental aspect of this is to know the needs of the customers and how to respond to them.

Endorsement of the Board of Directors and the Chief Executive Officer

The Interim Consolidated Financial Statements for the period ended 30 September 2013 have been prepared in accordance with International Financial Reporting Standards (IAS 34 Interim Financial Reporting) as endorsed by the European Union.

It is our opinion that the Interim Consolidated Financial Statements give a true and fair view of the financial performance of the Group for the period ended 30 September 2013, its financial position as at 30 September 2013 and its cash flows for the period ended 30 September 2013.

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

The Board of Directors and the CEO have today discussed the Interim Consolidated Financial Statements of Arion Bank for the period ended 30 September 2013 and confirm them by means of their signatures.

Reykjavík, 28 November 2013

Board of Directors

Monica Caneman
Chairman

Agnar Kofoed-Hansen	Gudrún Johnsen	Måns Höglund
Björg Arnardóttir	Jón G. Briem	Thóra Hallgrímsdóttir

Chief Executive Officer

Höskuldur H. Ólafsson

INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE PERIOD FROM 1 JANUARY TO 30 SEPTEMBER 2013

	Notes	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.7.-30.9.	2012 1.7.-30.9.
Interest income		43,363	43,463	13,314	11,310
Interest expense		(25,050)	(23,329)	(7,668)	(5,056)
Net interest income	10	18,313	20,134	5,646	6,254
Reversal of impairment (acquired and incurred) on loans and receivables	11	7,632	8,073	834	905
Impairment of loans and receivables	12	(7,751)	(7,594)	(1,087)	(2,958)
Net interest income less net impairment change on loans and receivables		18,194	20,613	5,393	4,201
Fee and commission income		11,881	12,089	4,141	4,121
Fee and commission expense		(3,597)	(4,036)	(1,155)	(1,406)
Net fee and commission income	13	8,284	8,053	2,986	2,715
Net financial income (expense)	14-17	1,989	491	445	161
Net foreign exchange gain (loss)	18	(1,035)	559	213	708
Share of profit (loss) of associates	36	430	13	442	6
Other operating income	19	3,605	4,630	1,168	1,631
Operating income		31,467	34,359	10,647	9,422
Salaries and related expense	21	(9,439)	(8,813)	(2,760)	(2,644)
Administration expense		(6,686)	(6,055)	(1,817)	(1,908)
Depositors' and investors' guarantee fund	47	(565)	(683)	(186)	(238)
Depreciation and amortisation		(849)	(714)	(299)	(251)
Other operating expense	22	(644)	(609)	(214)	(189)
Earnings before tax		13,284	17,485	5,371	4,192
Income tax expense	23	(2,851)	(3,375)	(1,102)	(462)
Bank Levy	24	(300)	(771)	(112)	(261)
Net earnings from continuing operations		10,133	13,339	4,157	3,469
Net gain (loss) from discontinued operations, net of tax	25	(3)	1,198	62	(181)
Net earnings		10,130	14,537	4,219	3,288
Attributable to:					
Shareholders of Arion Bank		10,230	14,176	4,093	3,124
Non-controlling interest		(100)	361	126	164
Net earnings		10,130	14,537	4,219	3,288
Other comprehensive income:					
Exchange difference on translating foreign subsidiaries	45	(2)	-	(1)	-
Total comprehensive income for the period		10,128	14,537	4,218	3,288
Earnings per share					
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	26	5.12	7.09	2.05	1.56

The notes on pages 10 to 51 are an integral part of these Interim Consolidated Financial Statements.

Arion Bank Interim Consolidated Financial Statements 30 September 2013 5 Amounts are in ISK millions

INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 2013

Assets	Notes	30.9.2013	31.12.2012	30.9.2012
Cash and balances with Central Bank	27	20,116	29,746	16,026
Loans and receivables to credit institutions	28-29	113,202	101,011	88,007
Loans and receivables to customers	30-31	576,204	566,610	572,484
Bonds and debt instruments	32-33	131,511	117,730	119,697
Shares and equity instruments with variable income	32	17,748	16,844	15,860
Derivatives	32,43	1,080	788	969
Securities used for hedging	32	4,048	2,438	1,398
Investment property	35	29,382	28,919	28,171
Investments in associates	36	14,856	7,050	3,024
Property and equipment		7,165	6,311	6,147
Intangible assets		5,348	4,941	5,102
Tax assets	37	702	463	475
Non-current assets and disposal groups held for sale	38	9,931	11,923	13,711
Other assets	39	5,651	5,901	5,174
Total Assets		936,944	900,675	876,245
Liabilities				
Due to credit institutions and Central Bank	32	28,548	32,990	16,459
Deposits	32	471,768	448,683	454,405
Financial liabilities at fair value	32	9,834	13,465	11,122
Tax liabilities	37	4,815	3,237	3,220
Non-current liabilities and disposal groups held for sale	38	591	1,769	2,683
Other liabilities	40	41,627	40,348	35,010
Borrowings	32,41	206,065	195,085	192,412
Subordinated liabilities	32.42	32,809	34,220	32,502
Total Liabilities		796,057	769,797	747,813
Equity				
Share capital	44	2,000	2,000	2,000
Share premium	44	73,861	73,861	73,861
Other reserves	45	1,637	1,639	1,637
Retained earnings		59,802	49,572	47,126
Total Shareholders' Equity		137,300	127,072	124,624
Non-controlling interest		3,587	3,806	3,808
Total Equity		140,887	130,878	128,432
Total Liabilities and Equity		936,944	900,675	876,245

The notes on pages 10 to 51 are an integral part of these Interim Consolidated Financial Statements.

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INTERIM CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE PERIOD FROM 1 JANUARY TO 30 SEPTEMBER 2013

	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 2013						
Equity 1 January 2013	75,861	1,639	49,572	127,072	3,806	130,878
Total comprehensive income for the period		(2)	10,230	10,228	(100)	10,128
Decrease due to dividend paid to non-controlling interest					(119)	(119)
Equity 30 September 2013	75,861	1,637	59,802	137,300	3,587	140,887
Changes in equity from 1 January to 30 September 2012						
Equity 1 January 2012	75,861	1,637	32,950	110,448	4,110	114,558
Total comprehensive income for the period			14,176	14,176	362	14,538
Acquisition of non-controlling interest					(664)	(664)
Equity 30 September 2012	75,861	1,637	47,126	124,624	3,808	128,432

The notes on pages 9 to 51 are an integral part of these Interim Consolidated Financial Statements.

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CONDENSED INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 30 SEPTEMBER 2013

	Notes	2013 1.1.-30.9.	2012 1.1.-30.9.
Cash flows from (used in) operating activities:			
Earnings before tax		13.283	17.485
Adjustments to reconcile earnings before income tax to net cash from (used in) operating activities:			
Non-cash items included in net earnings before income tax and other adjustments	52	493	(1.955)
Changes in operating assets and liabilities	53	(21.063)	(13.242)
Income tax and Bank Levy paid		(1.512)	(3.326)
Net cash from (used in) operating activities		(8.799)	(1.038)
Net cash from (used in) investing activities		(2.149)	(1.584)
Net cash from (used in) financing activities		(119)	-
Net increase (decrease) in cash and cash equivalents		(11.067)	(2.622)
Cash and cash equivalents at beginning of the period		105.173	82.815
Effect of exchange rate changes on cash and cash equivalents		(4.923)	2.322
Cash and cash equivalents at the end of the period		89.183	82.515
Cash and cash equivalents comprises:			
Cash in hand and demand deposits		20.116	16.026
Due from credit institutions		78.054	74.051
Mandatory reserve with Central Bank		(8.987)	(7.562)
Cash and cash equivalents at the end of the period		89.183	82.515
Non-cash investing and financing transactions:			
Assets acquired through foreclosure on collateral from customers with view to resale		9.127	1.226
Settlement of loans and receivables through foreclosure on collateral from customers with view to resale		(9.127)	(1.226)

The notes on pages 9 to 51 are an integral part of these Interim Consolidated Financial Statements.

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NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS CONTENTS

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

ACCOUNTING POLICIES

General information

1. Reporting entity

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Interim Consolidated Financial Statements for the period ended 30 September 2013 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

The Interim Consolidated Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 28 November 2013.

2. Basis of preparation

a) *Statement of compliance*

The Interim Consolidated Financial Statements are 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 Consolidated Financial Statements do not include all the information and disclosures required in the annual financial statements, and should be read in conjunction with Arion Bank´s annual Financial Statements for the year 2012. The statements are available at Arion Bank's website www.arionbanki.is.

b) *Basis of measurement*

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

- Financial assets and financial liabilities held for trading are measured at fair value; and
- Investment properties are measured at fair value.

Non-current assets and disposal groups classified as held for sale are stated at the lower of their carrying amount and fair value less costs to sell. 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 IFRS.

c) *Functional and presentation currency*

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

d) *Use of estimates and judgements*

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

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

Judgements made by management that have an effect on the Interim Consolidated Financial Statements and estimates with a risk of material adjustment within the next financial year are discussed in Note 4 in these Interim Consolidated Financial Statements and in the annual Consolidated Financial Statements for 2012.

Significant accounting policies

The accounting policies adopted in the preparation of these Interim Consolidated Financial Statements are consistent with those followed in the preparation of the Group's annual Consolidated Financial Statements for the year ended 31 December 2012.

The Group has implemented International Financial Reporting Standards endorsed by the EU with effective dates in 2013. The adoption of these new and revised standards had no impact on the financial position and financial results of the Group.

3. Going concern assumption

The Interim Consolidated Financial Statements are prepared on a going concern basis. The Group's management has made an assessment of the ability to continue as a going concern and is satisfied that the Group has the resources to continue. In making this assessment, management has taken into consideration the risk exposures facing the Group which are further described in the Risk Management Disclosures in the Group's Financial Statements for the year 2012.

4. Significant accounting estimates and judgements in applying accounting policies

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

ii) Foreign loan portfolio

In 2011 the Group recognised the estimated impact of the Supreme Court judgement of 15 February 2012 on the foreign loan portfolio. In 2012 the Group has estimated the impacts of the Supreme Court judgements of 15 June, 18 October and 1 November 2012, dealing with foreign loans or currency linked loans.

As set out in Note 51 of these Interim Consolidated Financial Statements, the Group recognised impairment of the foreign loan portfolio at the end of the respective periods for the estimated loss arising from the above judgments. The Group remains exposed to uncertainty regarding the foreign loan portfolio arising from firstly, the Group‘s interpretation of the above judgments, and secondly, the outcome of future legal decisions and new or amended government legislation.

iii) Fair value of financial instruments

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. Where valuation techniques (for example, models) are used to determine fair values, they are validated and periodically reviewed by qualified personnel independent of the area that created them. 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 have impact on the reported fair value of financial instruments.

iv) Assets classified as held for sale

The Group classifies assets as held for sale if the assets are available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets and the sale is considered highly probable. When classifying assets as held for sale the Group has determined that the requirements of IFRS 5 have been met.

4. cont.

As set out in Note 21 in the annual Consolidated Financial Statements for the year 2012, 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, could have impact on the fair value of these disposal groups.

v) Fair value of Investment Property

As the property market in Iceland is relatively inactive and assets are often quite dissimilar it is difficult to obtain reliable estimates of fair values of investment properties. This being the case there is uncertainty about the actual fair value of the properties.

vi) Intangible assets

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

The Group

5. Shares in subsidiaries in which Arion Bank held a direct interest at the end of the period were as follows:

			Equity interest in %	
Company:	Country	Currency	30.09.2013	31.12.2012
AFL - sparisjódur, Adalgata 34, Siglufjördur	Iceland	ISK	99.3	99.3
ALT ehf., Borgartún 19, Reykjavík	Iceland	ISK	100.0	100.0
Arion Bank Mortgages Institutional Investor Fund, Borgartún 19, Reykjavík	Iceland	ISK	100.0	100.0
EAB 1 ehf., Borgartún 19, Reykjavík	Iceland	ISK	100.0	100.0
Eignabjarg ehf., Álfheimar 74, Reykjavík	Iceland	ISK	100.0	100.0
Eignarhaldsfélagid Landey ehf., Hátún 2b, Reykjavík	Iceland	ISK	100.0	100.0
Einkaklúbburinn ehf., Borgartún 19, Reykjavík	Iceland	ISK	100.0	100.0
Gen hf., Borgartún 19, Reykjavík	Iceland	ISK	100.0	100.0
GIR Fund Management Ltd., Walker House Mary Street, George Town	Cayman Isl.	ISK	-	100.0
Kaupthing Management Company S.A., 35a, avenue J.F. Kennedy	Luxemb.	EUR	-	100.0
Landfestar ehf., Álfheimar 74, Reykjavík	Iceland	ISK	100.0	100.0
NS1 ehf., Borgarbraut 14, Borgarnes	Iceland	ISK	100.0	100.0
Okkar líftryggingar hf., Sóltún 26, Reykjavík	Iceland	ISK	100.0	100.0
Stefnir hf., Borgartún 19, Reykjavík	Iceland	ISK	100.0	100.0
Tekjuvernd ehf., Hlídarsmári 17, Kópavogur	Iceland	ISK	100.0	100.0
Valitor Holding hf., Laugavegur 77, Reykjavík	Iceland	ISK	60.8	60.8

6. Changes within the Group

In March 2013 Fram Foods ehf. sold its subsidiary Fram Foods Ísland hf. Fram Foods ehf. is a wholly owned subsidiary of Eignabjarg ehf. Fram Foods Ísland hf. was classified as non-current assets and disposal groups held for sale at year-end 2012. The effects from the sale of this entity has minor effects on the Interim Consolidated Statement of Comprehensive Income.

In June 2013 GIR Fund Management Ltd. was dissolved and assets of the company transferred to Arion Bank hf. This transaction has minor effects on the Interim Consolidated Statement of Comprehensive Income.

In September 2013 Kaupthing Management Company S.A. was dissolved and assets of the company transferred to Arion Bank hf. This transaction has no effects on the Interim Consolidated Statement of Comprehensive Income.

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OPERATING SEGMENT REPORTING

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

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

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

Operating segments

The Group comprises six main operating segments:

Corporate Banking provides services to the Bank’s larger corporate clients. Its role is to provide comprehensive financial services and tailored services to meet the needs of each company. Corporate Banking offers diverse solutions relating to loans and other services required by companies. The division is also responsible for the financial restructuring of companies when necessary.

Retail Banking, Arion Bank Mortgages Institutional Investor Fund and AFL - spairsjódur provide a comprehensive range of services, including advice on deposits and loans, savings, payment cards, pension savings, insurance, securities, funds and more. To maximize operational efficiency the branch network is divided into seven clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Customers of Retail Banking's 27 branches all around Iceland are over 100,000.

The Asset Management division comprises Institutional Asset Management, Private Banking and Investment Services. Asset Management is the fund distributor for Stefnir, an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds. Asset Management offers investment options suited to every investor’s needs, including pension savings, other regular savings, investments or asset management. Asset Management also offers funds from other leading global fund management companies.

Investment Banking is divided into Corporate Advisory, Capital Markets and Research. Corporate Advisory advises clients on securities offerings and the admission of securities for trading on regulated securities markets and also provides M&A advisory services. Capital Markets handles securities brokerage and foreign exchange trading for the Bank’s clients. Research publishes regular analyses of listed securities, the major business sectors, markets and the Icelandic economy and also produces economic forecasts. Investment Banking’s clients are private individuals, companies and institutions.

Treasury is responsible for the Bank’s liquidity management as well as currency and interest rate management. The other main functions of Treasury are the internal pricing of interest rates and currency and liaison with other financial institutions.

Other divisions and Subsidiaries include market making in domestic securities and currencies. The subsidiaries are Eignabjarg ehf., Eignarhaldsfélagid Landey ehf., Landfestar ehf., Okkar líftryggingar hf., Valitor holding hf. and other smaller entities of the Group.

Headquarters: Overhead, Funding, Risk Management, Accounting, Legal, Operations and Corporate Development.

8. Summary of the Group's business segments:

1.1.-30.9.2013	Corporate Banking	Retail Banking	Asset Manage-ment and Stefnir	Investment Banking	Treasury	Other divisions and Sub-sidiaries	Head-quarters and Elimination	Total
Net interest income	6,648	8,942	393	80	3,213	(1,129)	166	18,313
Other income	1,294	(1,023)	2,313	3,950	(306)	6,324	602	13,154
Operating income	7,942	7,919	2,706	4,030	2,907	5,195	768	31,467
Operating expense	(462)	(4,073)	(920)	(439)	(174)	(3,865)	(8,250)	(18,183)
Earnings before tax	7,480	3,846	1,786	3,591	2,733	1,330	(7,482)	13,284
Net seg. rev. from ext. customers	13,878	14,119	992	3,854	(8,421)	7,282	(237)	31,467
Net seg. rev. from other segments	(5,936)	(6,200)	1,714	176	11,328	(2,087)	1,005	-
Operating income	7,942	7,919	2,706	4,030	2,907	5,195	768	31,467
Depreciation and amortisation	-	131	-	-	-	161	557	849
Total assets	243,267	338,882	4,357	32,876	234,838	82,724	-	936,944
Total liabilities	204,344	307,221	2,050	27,616	200,600	54,226	-	796,057
Allocated equity	38,923	31,661	2,307	5,260	34,238	28,498	-	140,887

1.1.-30.9.2012								
Net interest income	8,131	7,507	1,609	41	3,993	(1,107)	(40)	20,134
Other income	1,954	(695)	1,714	4,168	(248)	6,709	623	14,225
Operating income	10,085	6,812	3,323	4,209	3,745	5,602	583	34,359
Operating expense	(435)	(3,982)	(782)	(423)	(130)	(3,458)	(7,664)	(16,874)
Earnings before tax	9,650	2,830	2,541	3,786	3,615	2,144	(7,081)	17,485
Net seg. rev. from ext. customers	16,848	13,649	253	4,142	(8,173)	7,126	514	34,359
Net seg. rev. from other segments	(6,763)	(6,837)	3,070	67	11,918	(1,524)	69	-
Operating income	10,085	6,812	3,323	4,209	3,745	5,602	583	34,359
Depreciation and amortisation	-	127	-	-	-	153	434	714
Total assets	264,011	312,157	4,072	19,263	192,168	84,574	-	876,245
Total liabilities	221,770	286,079	988	16,181	149,925	72,870	-	747,813
Allocated equity	42,241	26,078	3,084	3,082	42,243	11,704	-	128,432

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

Discontinued operations are excluded from the profit and loss segment information.

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NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

QUARTERLY STATEMENTS

9. Operations by quarters

2013	Q3	Q2	Q1	Total
Net interest income	5,646	6,379	6,288	18,313
Increase in book value of loans and receivables	834	4,425	2,373	7,632
Impairment of loans and receivables	(1,087)	(3,969)	(2,695)	(7,751)
Net fee and commission income	2,986	2,849	2,449	8,284
Net financial income (expense)	445	974	570	1,989
Net foreign exchange gain (loss)	213	149	(1,397)	(1,035)
Other income	1,610	1,249	1,176	4,035
Operating income	10,647	12,056	8,764	31,467
Salaries and related expense	(2,760)	(3,357)	(3,322)	(9,439)
Other expense	(2,516)	(2,951)	(3,277)	(8,744)
Earnings before tax	5,371	5,748	2,165	13,284
Income tax expense	(1,102)	(1,163)	(586)	(2,851)
Bank Levy	(112)	(97)	(91)	(300)
Net earnings from continuing operations	4,157	4,488	1,488	10,133
Net gain (loss) from discontinued operations, net of tax	62	14	(79)	(3)
Net earnings	4,219	4,502	1,409	10,130

2012				
Net interest income	6,254	7,666	6,214	20,134
Increase in book value of loans and receivables	905	7,049	119	8,073
Impairment of loans and receivables	(2,958)	(4,441)	(195)	(7,594)
Net fee and commission income	2,715	3,002	2,336	8,053
Net financial income (expense)	161	(16)	346	491
Net foreign exchange gain (loss)	708	(1,232)	1,083	559
Other income	1,637	2,054	952	4,643
Operating income	9,422	14,082	10,855	34,359
Salaries and related expense	(2,644)	(3,124)	(3,045)	(8,813)
Other expense	(2,586)	(2,718)	(2,757)	(8,061)
Earnings before tax	4,192	8,240	5,053	17,485
Income tax expense	(462)	(1,852)	(1,061)	(3,375)
Bank Levy	(261)	(242)	(268)	(771)
Net earnings from continuing operations	3,469	6,146	3,724	13,339
Net gain (loss) from discontinued operations, net of tax	(181)	652	727	1,198
Net earnings	3,288	6,798	4,451	14,537

Arion Bank Interim Consolidated Financial Statements 30 September 2013 15 Amounts are in ISK millions

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

Net interest income

10. Interest income and interest expense is specified as follows:

	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.7.-30.9.	2012 1.7.-30.9.
Cash and balances with Central Bank	621	461	157	160
Loans and receivables	35,663	36,121	10,946	8,643
Securities	6,579	6,530	2,095	2,366
Other	500	351	116	141
Interest income	43,363	43,463	13,314	11,310
Deposits	(14,417)	(12,943)	(4,511)	(3,323)
Borrowings	(9,555)	(9,095)	(2,783)	(1,344)
Subordinated liabilities	(996)	(1,169)	(334)	(357)
Other	(82)	(122)	(40)	(32)
Interest expense	(25,050)	(23,329)	(7,668)	(5,056)
Net interest income	18,313	20,134	5,646	6,254
Net interest income from assets and liabilities at fair value	6,578	6,530	2,094	2,366
Interest income from assets not at fair value	36,785	36,934	11,220	8,945
Interest expense from liabilities not at fair value	(25,050)	(23,330)	(7,668)	(5,057)
Net interest income	18,313	20,134	5,646	6,254

Reversal of impairment (acquired and incurred) on loans and receivables

11. Reversal of impairment (acquired and incurred) on loans and receivables:

Reversal of impairment on loans and receivables to corporates	7,087	7,626	606	651
Reversal of impairment on loans and receivables to individuals	545	447	228	254
Reversal of Impairment (acquired and incurred) on loans and receivables	7,632	8,073	834	905

Impairment of loans and receivables

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

Impairment (reversal) of loans and receivables to credit institutions	-	3	23	5
Impairment of loans and receivables to customers	7,751	7,591	1,064	2,953
Impairment of loans and receivables	7,751	7,594	1,087	2,958

Arion Bank Interim Consolidated Financial Statements 30 September 2013 16 Amounts are in ISK millions

Net fee and commission income

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

	2013	2012	2013	2012
Fee and commission income	1.1.-30.9.	1.1.-30.9.	1.7.-30.9.	1.7.-30.9.
Asset management	2,532	1,881	812	667
Cards	5,580	6,816	2,024	2,339
Collection and payment services	848	640	296	146
Investment banking	904	554	273	87
Interbank clearing	529	532	177	183
Lending and guarantees	685	914	297	462
Other fee and commission income	803	752	262	237
Fee and commission income	11,881	12,089	4,141	4,121
Fee and commission expense				
Asset management	(143)	(136)	(47)	(35)
Cards	(2,523)	(2,965)	(803)	(1,055)
Collection and payment services	(13)	(13)	(4)	(4)
Investment banking	(30)	(33)	(8)	(6)
Interbank clearing	(527)	(545)	(175)	(185)
Other fee and commission expense	(361)	(344)	(118)	(121)
Fee and commission expense	(3,597)	(4,036)	(1,155)	(1,406)
Net fee and commission income	8,284	8,053	2,986	2,715

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 (expense)

14. Net financial income (expense) is specified as follows:

	2013	2012	2013	2012
	1.1.-30.9.	1.1.-30.9.	1.7.-30.9.	1.7.-30.9.
Dividend income	46	24	-	3
Net gain (loss) on financial assets and financial liabilities classified as held for trading	484	(610)	287	(303)
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	1,459	1,077	158	461
Net financial income (expense)	1,989	491	445	161

15. Dividend income is specified as follows:

Dividend income on trading assets	9	15	-	-
Dividend income on financial assets designated at fair value through profit or loss	37	9	-	3
Dividend income	46	24	-	3

16. Net gain (loss) on financial assets and financial liabilities held for trading is specified as follows:

Net gain (loss) on equity instruments and related derivatives	477	(51)	148	(137)
Net gain (loss) on interest rate instruments and related derivatives	58	(445)	74	9
Net gain (loss) on other derivatives	(51)	(114)	65	(175)
Net gain (loss) on financial assets and financial liabilities held for trading	484	(610)	287	(303)

Arion Bank Interim Consolidated Financial Statements 30 September 2013 17 Amounts are in ISK millions

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

	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.7.-30.9.	2012 1.7.-30.9.
Net gain (loss) on interest rate instruments designated at fair value	542	317	5	(56)
Net gain (loss) on equity instruments designated at fair value	917	760	153	517
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	1,459	1,077	158	461

Net foreign exchange gain (loss)

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

	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.7.-30.9.	2012 1.7.-30.9.
From loans and receivables	(6,133)	1,851	569	1,527
From cash and cash equivalents	(4,923)	2,322	176	1,443
From deposits and borrowings	8,315	(2,646)	(78)	(1,287)
From subordinated liabilities	1,408	(402)	(321)	(337)
On bonds, equity instruments and derivatives	605	(557)	(148)	(670)
On other assets and liabilities	(307)	(9)	15	32
Net foreign exchange gain (loss)	(1,035)	559	213	708

Other operating income

19. Other operating income is specified as follows:

	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.7.-30.9.	2012 1.7.-30.9.
Rental income from investment properties	1,673	1,558	560	554
Fair value changes on investment property	475	1,007	168	288
Net realised gain on investment property	140	500	32	403
Earned premiums, net of reinsurance	796	649	263	228
Net gain on disposals of assets other than held for sale	5	389	-	4
Other income	516	527	145	154
Other operating income	3,605	4,630	1,168	1,631

Personnel and salaries

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

	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.7.-30.9.	2012 1.7.-30.9.
Average number of full time equivalent positions during the period	1,164	1,160	1,139	1,160
Full time equivalent positions at the end of the period	1,139	1,177	1,139	1,177

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

	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.7.-30.9.	2012 1.7.-30.9.
Average number of full time equivalent positions during the period	927	921	902	924
Full time equivalent positions at the end of the period	906	936	906	936

Arion Bank Interim Consolidated Financial Statements 30 September 2013 18 Amounts are in ISK millions

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Salaries and related expense are specified as follows:

	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.7.-30.9.	2012 1.7.-30.9.
Salaries	7,189	6,688	2,094	1,978
Defined contribution pension plans	937	916	273	271
Salary related expense	1,313	1,209	393	395
Salaries and related expense	9,439	8,813	2,760	2,644

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

Salaries	5,662	5,185	1,619	1,542
Defined contribution pension plans	738	710	211	211
Salary related expense	1,025	968	290	316
Salaries and related expense	7,425	6,863	2,120	2,069

Other operating expense

22. Other operating expense is specified as follows:

Direct operating expense derived from rental-earning investment properties	382	364	126	117
Claims incurred, net of reinsurance	236	245	65	72
Other expense	26	-	23	-
Other operating expense	644	609	214	189

Tax expense

23. Income tax recognised in the Interim Consolidated Statement of Comprehensive Income is specified as follows:

Current tax expense				
Current period	3,356	3,689	1,247	693
Deferred tax expense				
Changes in temporary differences	(505)	(314)	(145)	(231)
Total income tax expense	2,851	3,375	1,102	462

The Icelandic corporation tax rate is 20%. Effective tax rate of the Group is 21.5% and reconciles as follows:

	1.1.-30.9.2013		1.1.-30.9.2012	
Earnings before tax		13,284		17,485
Income tax using the Icelandic corporation tax rate	20.0%	2,657	20.0%	3,497
Additional 6% tax on financial institutions	5.5%	733	4.1%	718
Non-deductible expense	0.9%	115	0.1%	17
Tax exempt revenues	(3.3%)	(439)	(0.6%)	(110)
Tax incentives not recognised in the Statement of Comprehensive Income	(1.3%)	(172)	(3.5%)	(616)
Non-deductible taxes	0.0%	-	0.7%	131
Other changes	(0.3%)	(43)	(1.5%)	(262)
Effective tax rate	21.5%	2,851	19.3%	3,375

Financial institutions pay 6% additional tax on taxable profit exceeding ISK 1,0 billion.

Arion Bank Interim Consolidated Financial Statements 30 September 2013 19 Amounts are in ISK millions

24. Bank Levy

Bank levy is calculated according to law. The levy is 0.041% on total debt excluding tax liabilities at end of the period. Non-financial subsidiaries are exempt from this tax. Additional temporary levy of 0.0875% is assessed for the years 2012 and 2013 to meet the funding of a special interest relief provided to individual tax payers.

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

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

	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.7.-30.9.	2012 1.7.-30.9.
Net gain (loss) from legal entities	11	903	-	3
Net gain (loss) from associated companies	-	868	-	-
Net gain (loss) from real estate	(14)	(549)	62	(463)
Net gain (loss) from other assets	-	(24)	-	279
Net gain (loss) from discontinued operations, net of tax	(3)	1,198	62	(181)

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

Earnings per share

26. Earnings per share are specified as follows:

	Discontinued operations			
	Excluded		Included	
	2013 1.1.-30.9.	2012 1.1.-30.9.	2013 1.1.-30.9.	2012 1.1.-30.9.
Net earnings attributable to the shareholders of Arion Bank	10,233	12,978	10,230	14,176
Weighted average share capital:				
Weighted average number of outstanding shares for the period, million	2,000	2,000	2,000	2,000
Basic earnings per share	5.12	6.49	5.12	7.09
Number of outstanding shares at the end of the period, million	2,000	2,000	2,000	2,000

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

Arion Bank Interim Consolidated Financial Statements 30 September 2013 20 Amounts are in ISK millions

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Cash and balances with Central Bank

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

	30.09.2013	31.12.2012	30.09.2012
Cash on hand	3,251	3,495	3,574
Cash with Central Bank	7,878	17,514	4,890
Mandatory reserve deposit with Central Bank	8,987	8,737	7,562
Cash and balances with Central Bank	20,116	29,746	16,026

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

Loans and receivables to credit institutions

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

Bank accounts	78,054	84,164	74,051
Money market loans	29,394	13,763	10,830
Other loans	6,060	3,888	3,903
Provision on loans and receivables	(306)	(804)	(777)
Loans and receivables to credit institutions	113,202	101,011	88,007

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	804	774	774
Provision for losses (reversal) during the period	-	70	3
Write-offs during the period	(498)	(40)	-
Provision for losses on loans and receivables to credit institutions	306	804	777

Loans and receivables to customers

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

30.09.2013	Individuals	Corporates	Total
Overdrafts	18,263	19,010	37,273
Credit cards	9,890	874	10,764
Mortgage loans	205,295	6,719	212,014
Subordinated loans	-	550	550
Other loans and receivables	37,584	320,137	357,721
Provision on loans and receivables	(14,406)	(27,712)	(42,118)
Loans and receivables to customers	256,626	319,578	576,204

31.12.2012			
Overdrafts	17,236	18,470	35,706
Credit cards	10,302	769	11,071
Mortgage loans	190,897	4,376	195,273
Subordinated loans	-	573	573
Other loans and receivables	43,560	340,208	383,768
Provision on loans and receivables	(19,222)	(40,559)	(59,781)
Loans and receivables to customers	242,773	323,837	566,610

Arion Bank Interim Consolidated Financial Statements 30 September 2013 21 Amounts are in ISK millions

30. cont.

30.09.2012	Individuals	Corporates	Total
Overdrafts	17,441	17,030	34,471
Credit cards	9,852	850	10,702
Mortgage loans	-	549	549
Subordinated loans	194,238	4,830	199,068
Other loans and receivables	39,153	348,347	387,500
Provision on loans and receivables	(22,460)	(37,346)	(59,806)
Loans and receivables to customers	238,224	334,260	572,484

The total book value of pledged loans at the end of the period was ISK 172 billion (31.12.2012: ISK 167 billion and 30.9.2012: ISK 169 billion). Pledged loans comprised mortgage loans to individuals, loans to municipals and loans to state related entities that were pledged against amounts borrowed.

Further analysis of loans and receivables is provided in Risk Management Disclosures.

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

1.1.-30.9.2013

	Specific	FX rulings	Collective	Total
Balance at the beginning of the period	41,499	14,942	3,341	59,782
Provision for losses during the period	3,601	4,168	(18)	7,751
Write-offs during the period	(11,780)	(11,099)	(20)	(22,899)
Transferred to liabilities	-	(2,979)	-	(2,979)
Payment of loans previously written off	464	-	-	464
Balance at the end of the period	33,783	5,032	3,303	42,118

1.1.-31.12.2012

Balance at the beginning of the year	32,953	13,823	9,513	56,289
Provision for losses during the year	11,818	5,744	(118)	17,444
Write-offs during the year	(3,830)	-	(6,054)	(9,884)
Transferred to liabilities	-	(4,625)	-	(4,625)
Payment of loans previously written off	557	-	-	557
Balance at the end of the year	41,498	14,942	3,341	59,781

1.1.-30.9.2012

Balance at the beginning of the period	32,953	13,823	9,513	56,289
Provision for losses during the period	10,212	732	(3,353)	7,591
Write-offs during the period	(1,514)	-	(2,803)	(4,317)
Payment of loans previously written off	243	-	-	243
Balance at the end of the period	41,894	14,555	3,357	59,806

Arion Bank Interim Consolidated Financial Statements 30 September 2013 22 Amounts are in ISK millions

Financial assets and financial liabilities

32. Financial assets and financial liabilities are specified as follows:

30.9.2013	Amortised cost	Trading	Designated at fair value	Total
Loans and receivables				
Cash and balances with Central Bank	20,116	-	-	20,116
Loans and receivables to credit institutions	113,202	-	-	113,202
Loans and receivables to customers	576,204	-	-	576,204
Loans and receivables	709,522	-	-	709,522
Bonds and debt instruments				
Listed	-	4,264	41,303	45,567
Unlisted	-	50	85,894	85,944
Bonds and debt instruments	-	4,314	127,197	131,511
Shares and equity instruments with variable income				
Listed	-	1,665	2,711	4,376
Unlisted	-	1,297	8,458	9,755
Bond funds with variable income	-	2,043	1,574	3,617
Shares and equity instruments	-	5,005	12,743	17,748
Derivatives				
OTC derivatives	-	1,080	-	1,080
Derivatives	-	1,080	-	1,080
Securities used for hedging				
Bonds and debt instruments	-	755	-	755
Shares and equity instruments	-	3,293	-	3,293
Securities used for hedging	-	4,048	-	4,048
Other financial assets	4,037	-	-	4,037
Financial assets	713,559	14,447	139,940	867,946
Liabilities at amortised cost				
Due to credit institutions and Central Bank	28,548	-	-	28,548
Deposits	471,768	-	-	471,768
Borrowings	206,065	-	-	206,065
Subordinated liabilities	32,809	-	-	32,809
Liabilities at amortised cost	739,190	-	-	739,190
Financial liabilities at fair value				
Short position in bonds	-	8,860	-	8,860
Derivatives	-	974	-	974
Financial liabilities at fair value	-	9,834	-	9,834
Other financial liabilities	35,954	-	-	35,954
Financial liabilities	775,144	9,834	-	784,978

Arion Bank Interim Consolidated Financial Statements 30 September 2013 23 Amounts are in ISK millions

32. cont.

31.12.2012	Amortised cost	Trading	Designated at fair value	Total
Loans and receivables				
Cash and balances with Central Bank	29,746	-	-	29,746
Loans and receivables to credit institutions	101,011	-	-	101,011
Loans and receivables to customers	566,610	-	-	566,610
Loans and receivables	697,367	-	-	697,367
Bonds and debt instruments				
Listed	-	2,132	42,441	44,573
Unlisted	-	3,515	69,642	73,157
Bonds and debt instruments	-	5,647	112,083	117,730
Shares and equity instruments with variable income				
Listed	-	374	2,446	2,820
Unlisted	-	1,037	8,682	9,719
Bond funds with variable income	-	2,623	1,682	4,305
Shares and equity instruments	-	4,034	12,810	16,844
Derivatives				
OTC derivatives	-	788	-	788
Derivatives	-	788	-	788
Securities used for hedging				
Bonds and debt instruments	-	1,460	-	1,460
Shares and equity instruments	-	978	-	978
Securities used for hedging	-	2,438	-	2,438
Other financial assets	5,030	-	-	5,030
Financial assets	702,397	12,907	124,893	840,197
Liabilities at amortised cost				
Due to credit institutions and Central Bank	32,990	-	-	32,990
Deposits	448,683	-	-	448,683
Borrowings	195,085	-	-	195,085
Subordinated liabilities	34,220	-	-	34,220
Liabilities at amortised cost	710,978	-	-	710,978
Financial liabilities at fair value				
Short position in bonds	-	12,490	-	12,490
Derivatives	-	975	-	975
Financial liabilities at fair value	-	13,465	-	13,465
Other financial liabilities	35,141	-	-	35,141
Financial liabilities	746,119	13,465	-	759,584

Arion Bank Interim Consolidated Financial Statements 30 September 2013 24 Amounts are in ISK millions

32. cont.

30.09.2012	Amortised cost	Trading	Designated at fair value	Total
Loans and receivables				
Cash and balances with Central Bank	16,026	-	-	16,026
Loans and receivables to credit institutions	88,007	-	-	88,007
Loans and receivables to customers	572,484	-	-	572,484
Loans and receivables	676,517	-	-	676,517
Bonds and debt instruments				
Listed	-	3,354	42,402	45,756
Unlisted	-	62	73,879	73,941
Bonds and debt instruments	-	3,416	116,281	119,697
Shares and equity instruments with variable income				
Listed	-	1,338	1,364	2,702
Unlisted	-	687	8,328	9,015
Bond funds with variable income	-	2,395	1,748	4,143
Shares and equity instruments	-	4,420	11,440	15,860
Derivatives				
OTC derivatives	-	969	-	969
Derivatives	-	969	-	969
Securities used for hedging				
Bonds and debt instruments	-	777	-	777
Shares and equity instruments	-	621	-	621
Securities used for hedging	-	1,398	-	1,398
Other financial assets	4,067	-	-	4,067
Financial assets	680,584	10,203	127,721	818,508
Liabilities at amortised cost				
Due to credit institutions and Central Bank	16,459	-	-	16,459
Deposits	454,405	-	-	454,405
Borrowings	192,412	-	-	192,412
Subordinated liabilities	32,502	-	-	32,502
Liabilities at amortised cost	695,778	-	-	695,778
Financial liabilities at fair value				
Short position in bonds	-	11,019	-	11,019
Derivatives	-	103	-	103
Financial liabilities at fair value	-	11,122	-	11,122
Other financial liabilities	29,705	-	-	29,705
Financial liabilities	725,483	11,122	-	736,605

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

Arion Bank Interim Consolidated Financial Statements 30 September 2013 25 Amounts are in ISK millions

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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

	30.09.2013	31.12.2012	30.09.2012
Financial and insurance services	70,479	70,142	69,900
Governments	55,678	40,679	45,152
Corporates	1,040	1,262	1,229
Bonds and debt instruments designated at fair value	127,197	112,083	116,281

The total amount of pledged bonds at the end of the period was ISK 20.8 billion (31.12.2012: ISK 35.7 billion and 30.9.2012: ISK 21.3 billion). Pledged bonds comprised Icelandic Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

34. 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.

Further information regarding fair value measurement are set out in Note 71 in the annual Consolidated Financial Statements for the year 2012.

For financial instruments that are recognised at fair value on a recurring basis, the Group determines wether transfers have occurred between Levels in the hierarchy by re-assessing categorisation (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting period.

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

30.09.2013	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through P/L				
Bonds and debt instruments	2,993	123,067	1,137	127,197
Shares and equity instruments with variable income	1,954	10,428	361	12,743
	4,947	133,495	1,498	139,940
Financial assets held for trading				
Bonds and debt instruments	3,374	918	22	4,314
Shares and equity instruments with variable income	1,665	3,340	-	5,005
Derivatives	-	1,080	-	1,080
Securities used for hedging	2,418	1,630	-	4,048
	7,457	6,968	22	14,447
	12,404	140,463	1,520	154,387
Financial liabilities held for trading				
Short position in bonds	8,860	-	-	8,860
Derivatives	-	974	-	974
	8,860	974	-	9,834

Arion Bank Interim Consolidated Financial Statements 30 September 2013 26 Amounts are in ISK millions

34. cont.

31.12.2012	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through P/L				
Bonds and debt instruments	2,277	108,408	1,398	112,083
Shares and equity instruments with variable income	1,425	10,870	515	12,810
	3,702	119,278	1,914	124,893
Financial assets held for trading				
Bonds and debt instruments	2,120	3,506	21	5,647
Shares and equity instruments with variable income	374	3,660	-	4,034
Derivatives	-	788	-	788
Securities used for hedging	1,732	706	-	2,438
	4,226	8,660	21	12,907
	7,928	127,938	1,935	137,800
Financial liabilities held for trading				
Short position in bonds	12,490	-	-	12,490
Derivatives	-	975	-	975
	12,490	975	-	13,465

30.09.2012	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through P/L				
Bonds and debt instruments	2,256	112,657	1,368	116,281
Shares and equity instruments with variable income	188	10,743	509	11,440
	2,444	123,400	1,877	127,721
Financial assets held for trading				
Bonds and debt instruments	3,342	52	22	3,416
Shares and equity instruments with variable income	1,337	3,083	-	4,420
Derivatives	-	969	-	969
Securities used for hedging	1,398	-	-	1,398
	6,077	4,104	22	10,203
	8,521	127,504	1,899	137,924
Financial liabilities held for trading				
Short position in bonds	11,019	-	-	11,019
Derivatives	-	103	-	103
	11,019	103	-	11,122

The classification of assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2013 is consistent with the classification used in 2012.

Arion Bank Interim Consolidated Financial Statements 30 September 2013 27 Amounts are in ISK millions

34. cont.

There have been no transfers between Level 1 and Level 2 in 2013 and 2012.

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 the movements of Level 3 financial assets and financial liabilities:

	30.09.2013	31.12.2012	30.09.2012
Balance at the beginning of the period	1,935	2,021	2,021
Gain (loss) recognised in Statement of Comprehensive Income	84	191	153
Acquisition	-	105	105
Disposal	(407)	(391)	(389)
Transfers into Level 3	-	9	9
Transfers out of Level 3	(92)	-	-
Balance at the end of the period	1,520	1,935	1,899

The following table shows the line items in the Interim Consolidated Statement of Comprehensive Income where gain (loss) related to fair value measurements in Level 3 is recognised:

	2013 1.1.-30.9.	2012 1.1.-31.12.	2012 1.1.-30.9.
Net interest income	66	151	125
Net financial income (expense)	31	3	(1)
Net foreign exchange gain (loss)	(13)	37	29
Gain (loss) recognised in the Interim Consolidated Statement of Comprehensive Income	84	191	153

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

30.09.2013

Financial assets not carried at fair value	Carrying value	Fair value	Unrealised gain (loss)
Cash and balances with Central bank	20,116	20,116	-
Loans and receivables to credit institutions	113,202	113,202	-
Loans and receivables to customers	576,204	566,298	(9,906)
Other financial assets	4,037	4,037	-
Financial assets not carried at fair value	713,559	703,653	(9,906)

Arion Bank Interim Consolidated Financial Statements 30 September 2013 28 Amounts are in ISK millions

34. cont.

Financial liabilities not carried at fair value	Carrying value	Fair value	Unrealised gain (loss)
Due to credit institutions and Central bank	28.548	28.548	-
Deposits	471.768	472.046	(278)
Borrowings	206.065	203.778	2.287
Subordinated loans	32.809	32.809	-
Other financial liabilities	35.954	35.954	-
Financial liabilities not carried at fair value	775.144	773.135	2.009

Net unrealised gain (loss) not recognised in the Interim Consolidated Statement of Comprehensive Income (7.897)

31.12.2012

Financial assets not carried at fair value	Carrying value	Fair value	Unrealised gain (loss)
Cash and balances with Central bank	29.746	29.746	-
Loans and receivables to credit institutions	101.011	101.011	-
Loans and receivables to customers	566.610	555.468	(11.142)
Other financial assets	5.030	5.030	-
Financial assets not carried at fair value	702.397	691.255	(11.142)

Financial liabilities not carried at fair value			
Due to credit institutions and Central bank	32.990	32.990	-
Deposits	448.683	449.047	(364)
Borrowings	195.085	192.222	2.863
Subordinated loans	34.220	34.220	-
Other financial liabilities	35.141	35.141	-
Financial liabilities not carried at fair value	746.119	743.620	2.499

Net unrealised gain (loss) not recognised in the Interim Consolidated Statement of Comprehensive Income (8.643)

Comparative information for 30 September 2012 is not available.

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

Investment property

35. Investment property is specified as follows:	30.09.2013	31.12.2012	30.09.2012
Balance at the beginning of the period	28.918	27.100	27.100
Additions during the period	1.360	3.729	2.424
Disposals during the period	(1.517)	(3.494)	(2.360)
Transferred from property and equipment	146	-	-
Fair value adjustments	475	1.584	1.007
Investment property	29.382	28.919	28.171

Arion Bank Interim Consolidated Financial Statements 30 September 2013 29 Amounts are in ISK millions

Investments in associates

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

	30.09.2013	31.12.2012	30.09.2012
Audkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20,0%	20,0%	20,0%
Bakkavör Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	30,1%	30,1%	31,3%
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	43,5%	43,5%	43,5%
GO fjárfesting ehf., Undirheimar, 845 Flúdir, Iceland	30,0%	30,0%	30,0%
Klakki ehf., Ármúli 3, 108 Reykjavík, Iceland	31,8%	36,3%	36,3%
Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland	21,7%	23,3%	23,3%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42,7%	42,7%	42,7%
Sementsverksmidjan ehf., Mánabraut 20, 300 Akranes, Iceland	23,6%	23,6%	23,6%
Skipti hf., Ármúla 25, 108 Reykjavík, Iceland	38,2%	-	-
SMI ehf., Smáratorg 3, 200 Kópavogur, Iceland	39,1%	39,1%	39,1%

Investments in associates are specified as follows:

Carrying amount at the beginning of the period	7.050	2.987	2.987
Additions during the period	7.386	1.658	24
Share of profit (loss) of associates and reversal of impairment	430	2.405	13
Dividends received	(10)	-	-
Investment in associates	14.856	7.050	3.024

On 30 April 2013 creditors of Skipti hf. reached an agreement on financial restructuring of Skipti hf. Arion bank hf., the largest creditor, converted claims to shares and holds 38.2% of shares in Skipti hf. The shareholders of Skipti hf. aim to list the company at NASDAQ OMX Iceland.

The shareholding in Klakki ehf. decreased to 31.8% in August 2013 due to approval of dispute claims that Klakki ehf. approved as settled claims.

The carrying value of investments in associates is significantly below the net asset values disclosed in financial reports of associates. Note 73 in the annual Consolidated Financial Statements for 2012 discloses summarised financial information in respect of this gap as at 31 December 2012.

Tax assets and tax liabilities

37. Tax assets and tax liabilities are specified as follows:

	30.09.2013		31.12.2012		30.09.2012	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Current tax	-	3.726	17	1.899	13	2.027
Deferred tax	702	1.089	446	1.338	462	1.193
Tax assets and tax liabilities	702	4.815	463	3.237	475	3.220

Non-current assets and disposal groups held for sale

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

	30.09.2013	31.12.2012	30.09.2012
Legal entities	302	1.733	3.459
Associates	5.820	6.384	6.384
Real estates	3.610	3.275	3.250
Other assets	199	531	618
Non-current assets and disposal groups held for sale	9.931	11.923	13.711

The legal entities are subsidiaries that were acquired exclusively with view to resale and are classified as disposal groups held for sale in accordance with IFRS 5.

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

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

Arion Bank Interim Consolidated Financial Statements 30 September 2013 30 Amounts are in ISK millions

38. cont.

Liabilities associated with the legal entities held for sale are as follows:	30.09.2013	31.12.2012	30.09.2012
Legal entities, total liabilities	591	1.769	2.683

Other assets

39. Other assets are specified as follows:

Accounts receivable	2.296	4.084	2.748
Prepaid expenses	1.402	687	868
Accrued income	623	456	566
Unsettled securities trading	724	125	290
Sundry assets	606	549	702
Other assets	5.651	5.901	5.174

Other liabilities

40. Other liabilities are specified as follows:

Accounts payable	18.448	19.318	19.416
Provision for settled FX loans	6.817	4.625	-
Depositors' and investors' guarantee fund	2.869	2.919	2.910
Insurance claim	2.248	2.138	2.198
Withholding tax	387	1.926	462
Unsettled securities trading	213	842	520
Sundry liabilities	10.645	8.580	9.504
Other liabilities	41.627	40.348	35.010

Borrowings

41. Borrowings are specified as follows:

Covered bonds	131.741	124.992	123.894
Bonds issued	18.312	8.909	6.434
Other loans	56.012	61.184	62.084
Borrowings	206.065	195.085	192.412

The Group did not repurchase any own debts during the period (2012: nil).

Arion Bank has issued three series of covered bonds from its EUR 1.0 billion covered bond programme for the total of ISK 9,840 million. Series 1 is a ISK 2.500 million inflation linked bond, bearing 3.60% interest rate and matures in 2034. Series 2 is a ISK 4.340 million non-inflation linked bond, bearing 6.50% interest rate and matures in 2015. Series 3 is a ISK 3.000 million inflation linked bond, bearing 2.50% interest rate and matures in 2019.

In February 2013 Arion Bank completed its first international bond offering, issuing NOK 500 million of senior unsecured bonds, equalling ISK 11.2 billion. The series was admitted for trading on Oslo Börs on 2 July 2013. The bonds issued bear floating interest rate of 5.0% on NIBOR and mature in 2016.

At the end of 2011 Arion Bank took over the issuance of covered bonds which had originally been issued by Kaupthing hf. in 2006 to 2008. The bonds in question are covered bonds amounting to ISK 121.7 billion, net outstanding, with security in mortgages and bank deposits in an institutional investment fund, Arion Bank Mortgages Institutional Investor Fund. It is a four-series issue, with two 25-year series and two 40-year series maturing in 2031, 2033, 2045 and 2048. The bonds are inflation-indexed with fixed 3.75% to 4.00% interest. Currently repayment of principal is approximately ISK 1.6 billion a year and total payment including repayment of principal, indexation and interest is ISK 7.6 billion a year. Those bonds are not listed.

Book value of listed bonds was ISK 22.859 million at the end of the period. Market value of those bonds was ISK 23.505 million.

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Subordinated liabilities

42. Subordinated liabilities are specified as follows:

	30.09.2013	31.12.2012	30.09.2012
Tier II capital	32.809	34.220	32.502
Subordinated liabilities	32.809	34.220	32.502

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

Derivatives

43. Derivatives at fair value are specified as follows:

	Fair value	
30.09.2013	Assets	Liabilities
Forward exchange rate agreements, unlisted	48	24
Interest rate and exchange rate agreements, unlisted	217	74
Bond swap agreements, unlisted	9	839
Share swap agreements, unlisted	346	33
Options - purchased agreements, unlisted	460	4
Derivatives	1.080	974
31.12.2012		
Forward exchange rate agreements, unlisted	250	92
Interest rate and exchange rate agreements, unlisted	71	792
Bond swap agreements, unlisted	17	42
Share swap agreements, unlisted	16	49
Options - purchased agreements, unlisted	434	-
Derivatives	788	975
30.09.2012		
Forward exchange rate agreements, unlisted	103	21
Interest rate and exchange rate agreements, unlisted	441	27
Bond swap agreements, unlisted	39	16
Share swap agreements, unlisted	6	37
Options - purchased agreements, unlisted	380	2
Derivatives	969	103

Equity

44. Share capital and share premium

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 approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	30.09.2013	Number (million)	31.12.2012	Number (million)	30.09.2012
Issued share capital	2.000	75.861	2.000	75.861	2.000	75.861
	2.000	75.861	2.000	75.861	2.000	75.861

Share premium represents excess of payment above nominal value that Shareholders have paid for shares issued by Arion banki hf.

45. Other reserves are specified as follows:

	30.09.2013	31.12.2012	30.09.2012
Statutory reserve	1.637	1.637	1.637
Foreign currency translation reserve	-	2	-
Other reserves	1.637	1.639	1.637

OFF BALANCE SHEET INFORMATION

Obligations

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

	30.09.2013	31.12.2012	30.09.2012
Guarantees	9.966	9.185	10.628
Unused overdrafts	36.713	34.545	34.899
Loan commitments	69.725	36.001	35.262

47. Depositors' and Investors' Guarantee fund

The Group expensed ISK 565 million during the period to meet payments requirements to the Depositors' and Investors' Guarantee fund according to act no 98/1999 as amended in 2012.

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. Due to uncertainty of the shape of future legislation the liability brought forward from previous years is not changed from the balance of ISK 2,669 million. The Group has granted the Fund a guarantee for obligations amounting to ISK 3,210 million.

Pledged assets

48. The Group has pledged assets against liabilities as follows:

	30.09.2013	31.12.2012	30.09.2012
Assets which have been pledged as collateral against borrowings	262.389	244.653	244.069
Assets which have been pledged as collateral against loans from banks and short positions	20.801	35.701	21.302
Pledged assets against liabilities	283.190	280.354	265.371

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 262 billion at the end of the period (31.12.2012: ISK 245 billion and 30.9.2012: ISK 244 billion). Those assets were mainly pool of mortgage loans to individuals, loans to municipals and loans to state related entities. The book value of those borrowings was ISK 187 billion at the end of the period (31.12.2012: ISK 183 billion and 30.9.2012: ISK 183 billion).

Assets are primarily pledged against borrowings associated with the acquisition of the pledged assets. Two major events are most significant. Assets were acquired from the Central Bank in conjunction with the recapitalization of Arion Bank on 8 January 2010 and a portfolio of mortgages was acquired from Kaupthing hf. and is pledged against a structured covered bond that Arion Bank took over as issuer of from Kaupthing hf. at the end of 2011.

The Group has pledged bonds against short term lending from the Central Bank and against short positions, related to swap agreements, to hedge market risk of those assets.

Assets under management and under custody

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

	30.09.2013	31.12.2012	30.09.2012
Assets under management	900.214	819.684	770.692
Assets under custody	1.414.477	1.378.454	1.538.934

Arion Bank Interim Consolidated Financial Statements 30 September 2013 33 Amounts are in ISK millions

Legal Matters

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

i) Contingent liabilities

Investigation by the Icelandic Competition Authority

The Icelandic Competition Authority (ICA) has opened a formal investigation into alleged abuse of a dominant position and collusion between all card issuers in Iceland, including the Group, following a complaint by Kortathjónustan hf., a credit card payment acquirer, made in 2009. The ICA has also opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks, including the Bank. The investigation was initiated by separate complaints from BYR hf. and MP banki hf. made in 2010. The ICA received a similar complaint from Tryggingamidstödin hf. in 2010. The complaints from BYR hf. and MP banki hf. concern the terms of the banks' mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition. The complaint from Tryggingamidstödin hf. concerns the banks' alleged tying of banking services and insurances. The Group has made objections to all of the complaints. The extent of the investigations and outcome of the cases is still uncertain as well as any effect on the Group. However, if the Group will be deemed to have violated the competition law, it could result in a fine or restrictions set on the Bank by the ICA.

Legal proceedings regarding FX loans

The Bank has received a letter from a company stating that the company suffered significant damage, both directly and indirectly, on account of the Bank's actions to satisfy a debt, which resulted in the forced sale of the company's pledged assets. This action was taken as a result of the defaulting of currency-linked loans. In the letter it is requested that the Bank state its position to its liability for damages in the aforementioned circumstances. The Bank has examined the claim and considers that if the Bank is deemed liable for the damage, it will not be material for the Bank.

Legal proceedings regarding the Bank's variable interest rate

Two borrowers have issued summons against the Group where they claim that a clause in their mortgage loan (in foreign currency), where it is stated that the bond shall bear a variable interest rate, which the Bank was authorised to change, is illegal and unbinding. The borrowers make e.g. the claim that it will be recognised by the court that said clause on interest rates is illegal. The Bank will defend against the borrowers' summons. If the courts side with the borrowers in the case, it could have a negative effect on the Bank's loan portfolio with variable interest rates in foreign currency (i.e. foreign currency-linked loans in ISK) and also in ISK.

ii) Other legal disputes

Legal proceedings regarding Stefnir hf.

In October 2011 the winding-up committee of Landsbanki Íslands brought legal action against the company demanding the annulment and repayment of payments made by Landsbanki Íslands of money market deposits which matured in early October 2008 to two funds managed by Stefnir. The amount involved is ISK 450 million plus interest. As a result of this judgment by Reykjavík District Court, Stefnir, on behalf of the two funds, has been ordered to repay the amounts. The company made provision in respect of this case in 2012. The case has been appealed to the Supreme Court of Iceland.

50. cont.

Legal proceedings regarding FX loans

With a summons, presented to the Bank on 14 November 2012, Hagar hf., a listed company, claimed from the Bank ISK 1,152 million plus interest from 19 October 2009 until the date of payment, minus a payment of ISK 515 million made on 19 December 2011. The summons followed Hagar‘s announcement on the Icelandic Stock Exchange from 21 March 2012, whereby Hagar announced that it had decided to take legal action against the Bank regarding Hagar’s foreign currency linked loans, which it had reimbursed in full to the Bank in October 2009. Hagar’s foreign currency linked loans were recalculated by the Bank in accordance with the Bank's notification of 15 June 2011. The outcome of the recalculation showed that the Bank owed Hagar ISK 515 million, which the Bank subsequently paid to Hagar. After the Supreme Court of Iceland had passed its judgment of 15 February 2012 (in case no. 600/2011), Hagar expressed its view to the Bank that, in light of the above judgment, Hagar believed it had a further claim against the Bank regarding said foreign currency linked loans. The Bank has rejected Hagar’s claim and will defend the case in court. With a judgement of the District Court pronounced on 28 May 2013 the Bank was acquitted of Hagar’s claim. Hagar has appealed the judgement to the Supreme Court.

Legal proceedings regarding CPI loans

Recently, there has been discussion in the media where it has been claimed that the indexation of the principal of mortgage loans to consumers to the Consumer Price Index (CPI) is possibly illegal and therefore the appreciation of the principal of each loan, due to the rise of the CPI, should be annulled. Reportedly, there are two court cases in motion regarding this issue, but the Bank is not a party to those cases. Recently, the Supreme Court requested an Advisory Opinion from the EFTA Court on the interpretation of certain provisions of an EC directive, in a case where the disagreement is whether the CPI-indexation of a loan is in accordance with certain provisions of Icelandic law on contracts. If successful in a court case, one possible outcome is that a debtor would receive a part or all of the CPI-indexation of his loan annulled. The Group considers the possibility of this happening remote, and has therefore made no provision due to this.

Legal proceedings regarding Valitor hf.

In a letter dated 18 June 2013 to the Bank’s subsidiary Valitor hf., Datacell ehf. and Sunshine Press Productions demand damages from the company in relation to damage which they claim to have sustained following the termination by Valitor of a sale dealership agreement with Datacell, since in a judgment on 24 April 2013 in case no. 612/2012 the Supreme Court considered that Valitor had exceeded its authority to terminate the agreement. Valitor has already categorically turned down the demand for damages and it can be expected that Datacell and Sunshine Press Productions will bring an action for damages against Valitor whereby the court will appoint assessors and the final amount demanded in the action will take into account this assessment.

The uncertainty regarding the book value of foreign currency loans

51. As summarized in Note 96 to the 2012 annual financial statements, the book value of foreign currency loans has been subject to uncertainty arising from various court cases and changes in law since the Group’s formation in 2008. This uncertainty continues in 2013 and the group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans.

After consideration of such judgments, the Group has provisioned a total amount of ISK 23.8 billion of which ISK 12.0 billion have been written-off in the first nine months of 2013.

Although there is more clarity in the matters of foreign currency loans, due to the judgments pronounced by the Supreme Court of Iceland in 2013, there still remains uncertainty regarding those loans, e.g. what interest rate foreign currency-linked loans should bear from the date they are recalculated and until their final maturity. Nevertheless, the Group considers its portfolio of foreign currency-linked loans fully provisioned for the most likely outcome.

NOTES TO THE CONDENSED INTERIM CONSOLIDATED STATEMENT OF CASH FLOW

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

	2013 1.1.-30.9.	2012 1.1.-30.9.
Increase in book value of loans and receivables	(7.632)	(8.073)
Impairment of loans and receivables	7.751	7.954
Depreciation and amortisation	849	714
Share of loss (profit) of associates and fair value change	(430)	(13)
Investment property, fair value change	(475)	(1.007)
Net foreign exchange loss (gain)	1.036	(559)
Net loss (gain) on financial assets and liabilities at fair value through profit or loss	(484)	(467)
Net loss (gain) on disposal of property and equipment	18	(4)
Net loss (gain) on disposal of investment property	(140)	(500)
	493	(1.955)

53. Changes in operating assets and liabilities are specified as follows:

Mandatory reserve with Central Bank	(250)	998
Loans and receivables to credit institutions	(18.581)	(7.028)
Loans and receivables to customers	(24.693)	(11.539)
Bonds and debt instruments	(13.038)	19.948
Shares and equity instruments	(2.884)	117
Derivatives and financial liabilities at fair value	(3.208)	5.777
Investment property	158	6.447
Non-current assets and liabilities and disposals group held for sale	2.577	12.170
Other assets	(57)	115
Due to credit institutions and Central Bank	(4.442)	299
Deposits	26.050	(37.839)
Borrowings	16.330	1.080
Other liabilities	975	(3.787)
	(21.063)	(13.242)

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RISK MANAGEMENT DISCLOSURES

Introduction

54. As a financial institution, the Group faces various risks arising from its day to day operations. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels.

Further information regarding risk management is available in the annual Consolidated Financial Statements for 2012 and in the Pillar 3 Risk Disclosures for 2012, published on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not audited.

Credit risk

55. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. The main sources of credit risk are the Group's loan portfolio, commitments and guarantees and derivatives trading.

56. Maximum exposure to credit risk

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

Maximum exposure to credit risk related to on-balance sheet items:

	30.09.2013	31.12.2012	30.09.2012
Cash and balances with Central Bank	20,116	29,746	16,026
Loans and receivables to credit institutions	113,202	101,011	88,007
Loans and receivables to customers	576,204	566,610	572,484
Bonds and debt instruments	131,511	117,730	119,697
Derivatives	1,080	788	969
Bonds and debt instruments, hedging	755	1,460	777
Other assets with credit risk	4,037	5,030	4,067
Total on-balance sheet maximum exposure to credit risk	846,905	822,375	802,027

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

	30.09.2013	31.12.2012	30.09.2012
Financial guarantees	9,966	9,185	10,628
Unused overdrafts	36,713	34,545	34,899
Loan commitments	69,725	36,001	35,262
Total off-balance sheet maximum exposure to credit risk	116,404	79,731	80,789
Maximum exposure to credit risk	963,309	902,106	882,816

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57. Loans and receivables to customers specified by sectors:

	30.09.2013	31.12.2012	30.09.2012
Individuals	44.5%	42.8%	41.6%
Real estate activities and construction	13.5%	12.1%	13.7%
Fishing industry	10.4%	12.0%	10.6%
Information and communication technology	4.3%	5.1%	4.8%
Wholesale and retail trade	8.2%	9.8%	9.7%
Financial and insurance activities	5.9%	4.4%	6.9%
Industry, energy and manufacturing	4.0%	4.0%	3.9%
Transportation	3.4%	3.8%	3.6%
Services	3.5%	3.3%	2.8%
Public sector	1.5%	1.8%	1.5%
Agriculture and forestry	0.8%	0.9%	0.9%
	100.0%	100.0%	100.0%

58. Collateral and other credit enhancements

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- Retail loans to individuals: Mortgages in residential properties.
- Corporate loans: Charges over real estate properties, fishing vessels and other fixed and current assets, inventory and trade receivables, cash and securities.
- Derivative exposures: 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.

Collateral held by the Bank against different types of financial assets is specified as follows:

30.09.2013	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	-	-	-	-	-
Loans and receivables to credit institutions	-	-	-	-	-
Loans and receivables to customers:					
Individuals	486	216,636	53	1,356	218,531
Real estate activities and construction	1,513	52,492	5	632	54,642
Fishing industry	1,860	2,490	51,696	2,058	58,104
Information and communication technology	24	818	-	22,032	22,874
Wholesale and retail trade	1,640	9,872	5	23,790	35,308
Financial and insurance activities	17,352	1,709	-	3,840	22,902
Industry, energy and manufacturing	168	7,907	1	11,505	19,580
Transportation	65	514	46	4,048	4,673
Services	279	3,307	71	2,718	6,375
Public sector	33	3,580	-	123	3,736
Agriculture and forestry	5	2,278	-	177	2,460
Bond, debt instruments and derivatives	1,661	-	-	68,987	70,648
Collateral held against different types of financial assets	25,086	301,603	51,878	141,266	519,833

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58. cont.

31.12.2012	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	-	-	-	-	-
Loans and receivables to credit institutions	-	-	-	-	-
Loans and receivables to customers:					
Individuals	556	212,357	40	219	213,172
Real estate activities and construction	675	49,416	6	702	50,799
Fishing industry	1,877	2,325	58,274	6,222	68,698
Information and communication technology	78	547	-	18,312	18,937
Wholesale and retail trade	1,909	12,705	-	8,550	23,164
Financial and insurance activities	9,924	532	-	8,876	19,332
Industry, energy and manufacturing	140	6,659	1	1,189	7,989
Transportation	71	503	19	904	1,497
Services	252	2,785	57	1,973	5,067
Public sector	29	3,261	-	91	3,381
Agriculture and forestry	10	1,569	-	12	1,591
Bond, debt instruments and derivatives	1,219	-	-	68,628	69,847
Collateral held against different types of financial assets	16,740	292,659	58,397	115,678	483,474

The information is for loans and collateral at the Bank only.

Comparative information for 30 September 2012 is not available.

59. Credit quality by class of financial assets is specified as follows:

30.09.2013	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired*	Total
Cash and balances with Central Bank	20,116	-	-	20,116
Loans and receivables to credit institutions	113,202	-	-	113,202
Loans and receivables to customers:				
Loans to corporates	278,435	22,445	18,698	319,578
Loans to individuals	223,228	24,230	9,168	256,626
Bonds and debt instruments	131,511	-	-	131,511
Derivatives	1,080	-	-	1,080
Bonds and debt instruments used for hedging	755	-	-	755
Other assets with credit risk	4,037	-	-	4,037
Credit quality of loans and receivables	772,364	46,675	27,866	846,905

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59. cont.

31.12.2012	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired*	Total
Cash and balances with Central Bank	29,746	-	-	29,746
Loans and receivables to credit institutions	101,011	-	-	101,011
Loans and receivables to customers:				
Loans to corporates	275,837	17,851	30,149	323,837
Loans to individuals	200,080	22,845	19,848	242,773
Bonds and debt instruments	117,730	-	-	117,730
Derivatives	788	-	-	788
Bonds and debt instruments used for hedging	1,460	-	-	1,460
Other assets with credit risk	5,030	-	-	5,030
Credit quality of loans and receivables	731,682	40,696	49,997	822,375

30.09.2012				
Cash and balances with Central Bank	16,026	-	-	16,026
Loans and receivables to credit institutions	88,007	-	-	88,007
Loans and receivables to customers:				
Loans to corporates	272,681	21,366	41,429	335,476
Loans to individuals	191,462	20,356	25,190	237,008
Bonds and debt instruments	119,697	-	-	119,697
Derivatives	969	-	-	969
Bonds and debt instruments used for hedging	777	-	-	777
Other assets with credit risk	4,067	-	-	4,067
Credit quality of loans and receivables	693,686	41,722	66,619	802,027

* The figures for individually impaired reflects both impairment due to legal uncertainty related to foreign currency loans as well as impairment due to a deterioration in the borrower's credit quality.

60. Past due but not impaired loans by class of loans and receivables:

30.09.2013	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans and receivables to corporates	9,135	2,867	741	9,703	22,445
Loans and receivables to individuals	9,495	4,650	428	9,657	24,230
Past due but not impaired loans and receivables	18,630	7,517	1,168	19,360	46,675
31.12.2012					
Loans and receivables to corporates	6,285	951	322	10,293	17,851
Loans and receivables to individuals	8,719	3,558	287	10,281	22,845
Past due but not impaired loans and receivables	15,004	4,509	609	20,574	40,696
30.09.2012					
Loans and receivables to corporates	10,604	1,715	199	8,848	21,366
Loans and receivables to individuals	9,404	2,329	200	8,423	20,356
Past due but not impaired loans and receivables	20,008	4,044	399	17,271	41,722

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60. cont.

The majority of the past due but not impared loans have been acquired at discount. These loans are not considered to be impaired unless the specific allowance exceeds the discount received.

61. Collateral repossessed

During the period, the Group took possession of real estates with the carrying value of ISK 1.764 million and other assets with the value of ISK 2 million, all which the Group is in the process of selling, see Note 38.

62. Impaired loans and receivables to customers specified by sector:

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
30.09.2013	Impair-ment amount	Loan carrying amount	Impair-ment amount	Loan carrying amount	Total im-pairment amount	Total loan carrying amount
Individuals	12,119	19,617	967	2,637	13,086	22,254
Real estate activities and construction	4,532	8,098	854	1,745	5,386	9,843
Fishing industry	1,578	2,481	989	3,230	2,567	5,711
Information and communication technology	190	227	47	56	237	283
Wholesale and retail trade	5,564	8,623	499	1,549	6,063	10,172
Financial and insurance activities	7,003	9,865	1,008	1,394	8,011	11,259
Industry, energy and manufacturing	739	1,424	77	224	816	1,648
Transportation	24	25	334	2,244	358	2,269
Services	1,196	1,510	137	331	1,333	1,841
Public sector	27	36	101	132	128	168
Agriculture and forestry	812	1,110	18	123	830	1,233
	33,784	53,016	5,031	13,665	38,815	66,681
31.12.2012						
Individuals	13,143	19,397	5,032	18,626	18,175	38,023
Real estate activities and construction	4,684	10,091	1,586	4,139	6,270	14,230
Fishing industry	2,361	4,343	2,648	6,913	5,009	11,256
Information and communication technology	7,561	11,192	187	307	7,748	11,499
Wholesale and retail trade	5,295	8,399	2,639	5,638	7,934	14,037
Financial and insurance activities	6,405	8,363	1,142	1,492	7,547	9,855
Industry, energy and manufacturing	604	1,152	483	999	1,087	2,151
Transportation	35	40	36	120	71	160
Services	744	1,168	505	1,328	1,249	2,496
Public sector	30	38	262	406	292	444
Agriculture and forestry	636	895	422	1,391	1,058	2,286
	41,498	65,078	14,942	41,359	56,440	106,437

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62. cont.

30.09.2012	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
	Impair-ment amount	Loan carrying amount	Impair-ment amount	Loan carrying amount	Total im-pairment amount	Total loan carrying amount
Individuals	13,469	21,906	6,525	23,278	19,994	45,184
Real estate activities and construction	4,302	10,701	1,597	4,005	5,899	14,706
Fishing industry	875	8,045	2,889	3,318	3,764	11,363
Information and communication technology	7,520	7,958	171	453	7,691	8,411
Wholesale and retail trade	3,680	7,134	2,774	10,481	6,454	17,615
Financial and insurance activities	6,567	8,394	57	111	6,624	8,505
Industry, energy and manufacturing	1,065	4,545	407	2,919	1,472	7,464
Transportation	24	34	54	96	78	130
Services	784	2,483	553	1,001	1,337	3,484
Public sector	420	776	79	470	499	1,246
Agriculture and forestry	1,097	2,415	483	1,488	1,580	3,903
	39,803	74,391	15,589	47,620	55,392	122,011

This note refines the presentation of impairments by separating those that are due to the uncertainty related to foreign currency loans from impairments that are due to deteriorating borrower credit quality. At 30 September 2013, a provision of ISK 11.848 million had been made for losses due to court rulings for illegal FX loans, in addition to the ISK 12.001 million previously written off for this reason. ISK 5.031 million of provisions are due to loans with a carrying value of ISK 13.665 million that are still on the Group's balance sheet. The balance of ISK 6.187 million is due to loans which have been paid up and is accounted for in the Statement of Financial Position as other liabilities. This balance will be paid out following the calculation of the loans.

63. Large exposure

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

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

The largest exposure to a group of connected clients at the end of the period was ISK 29 billion (31.12.2012: ISK 29 billion and 30.9.2012: ISK 30 billion) before taking account of eligible collateral, excluding claim on Drómi. The Group has four large exposures at the end of the period (31.12.2012: four exposures and 30.9.2012: four exposures) net of eligible collateral.

	30.09.2013		31.12.2012		30.09.2012	
no.	Gross	Net	Gross	Net	Gross	Net
1 Drómi	42%	0%	43%	0%	45%	0%
2	18%	18%	18%	18%	19%	19%
3	17%	17%	18%	17%	20%	20%
4	13%	13%	14%	14%	13%	13%
5	11%	11%	11%	11%	11%	11%
Sum of exposure gross > 10%	101%	59%	104%	60%	108%	63%

No large exposure exceeds the legal limit of 25% of the Group's capital base at the end of the period. 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. Consequently, the Group finds that the net exposure on Drómi is zero.

The sum of all large exposures is 101% of the Group's capital base before collateral mitigation or 59% net of eligible collateral, which is well below the 400% legal maximum.

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Market risk

64. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments.

65. Interest rate risk in the non-trading book

The following table shows the sensitivity of net present value of interest bearing assets and liabilities to changes in interest rates by currency and interest fixing period in million of ISK in the Group. Risk is quantified as the net change in value of interest bearing assets and liablities, when assuming a simultaneous parallel shift upwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income.

30.09.2013		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked	ISK	(37)	(827)	(7)	(357)	295
Non Indexed linked	ISK	(121)	(616)	(25)	(27)	(15)
	EUR	65	(2)	-	-	-
	Other	39	(3)	-	-	-
31.12.2012						
CPI Indexed linked	ISK	(35)	(603)	(282)	(1,980)	811
Non Indexed linked	ISK	(102)	(433)	57	-	(10)
	EUR	71	(3)	-	-	-
	Other	(35)	(6)	(50)	-	-

Comparative information for 30 September 2012 is not available.

66. Interest rate risk in the trading book

Interest rate risk in the trading book is quantified in the same way as that of the non-trading book.

30.09.2013		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
CPI Indexed linked	ISK	(15)	7	(80)	(21)	(215)
Non Indexed linked	ISK	(31)	8	(32)	5	-
	EUR	(0)	-	-	-	-
	Other	(2)	-	-	-	-
31.12.2012						
CPI Indexed linked	ISK	-	(19)	(80)	(5)	(270)
Non Indexed linked	ISK	(50)	(17)	(8)	(36)	-
	EUR	(5)	-	-	-	-
	Other	(2)	-	-	-	-

Comparative information for 30 September 2012 is not available.

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

30.09.2013	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Assets							
Cash and balances with Central Bank	20,116	10,926	-	9,190	-	-	-
Loans and receivables to credit institutions	113,202	77,868	35,092	-	242	-	-
Loans and receivables to customers	576,204	3,811	51,829	85,844	206,035	228,685	-
Bonds and debt instruments	131,511	5,445	8	69,243	15,346	41,469	-
Shares and equity instruments	17,748	-	-	-	-	-	17,748
Derivatives	1,080	460	402	117	101	-	-
Assets leg	27,022	460	11,718	3,619	11,225	-	-
Liabilities leg	(25,941)	-	(11,315)	(3,502)	(11,124)	-	-
Securities used for hedging	4,048	756	-	-	-	-	3,292
Investment property	29,382	-	-	-	-	-	29,382
Investments in associates	14,856	-	-	-	-	-	14,856
Property and equipment	7,165	-	-	-	-	-	7,165
Intangible assets	5,348	-	-	-	-	-	5,348
Tax assets	702	-	-	-	702	-	-
Non-current assets held for sale	9,931	-	-	-	-	-	9,931
Other assets	5,651	62	2,293	714	952	16	1,614
Assets 30.09.2013	936,944	99,328	89,624	165,108	223,378	270,170	89,336
Liabilities							
Due to credit institutions and Central Bank	28,548	15,323	7,025	6,124	49	27	-
Deposits	471,768	252,058	147,056	43,928	26,233	2,493	-
Financial liabilities at fair value	9,834	-	9,759	16	59	-	-
Assets leg	(13,830)	-	(12,056)	(167)	(1,607)	-	-
Liabilities leg	14,803	-	12,954	183	1,666	-	-
Short position bonds and derivatives	4,520	-	4,520	-	-	-	-
Short position bonds used for hedging	4,341	-	4,341	-	-	-	-
Tax liabilities	4,815	-	932	2,794	1,089	-	-
Non-current liabilities held for sale	591	-	-	-	-	-	591
Other liabilities	41,627	869	31,047	621	3,198	219	5,673
Borrowings	206,065	-	2,091	2,450	29,138	172,386	-
Subordinated liabilities	32,809	-	-	-	-	32,809	-
Liabilities 30.09.2013	796,057	268,250	197,910	55,933	59,766	207,934	6,264
Off-balance sheet items:							
Guarantees	9,966	1,831	1,847	3,628	1,411	1,249	-
Unused overdraft	36,713	816	6,215	18,246	11,341	95	-
Loan commitments	69,725	1,459	46,486	10,419	11,361	-	-
Off-balance sheet items	116,404	4,106	54,548	32,293	24,113	1,344	-
Net interest sensitivity gap	24,483	(173,028)	(162,834)	76,882	139,499	60,892	83,072

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67. cont.

31.12.2012 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	29,746	21,121	-	8,625	-	-	-
Loans and receivables to credit institutions	101,011	84,033	16,721	-	257	-	-
Loans and receivables to customers	566,610	3,000	47,511	92,258	208,232	215,609	-
Bonds and debt instruments	117,730	7,034	-	25	69,087	41,584	-
Shares and equity instruments	16,844	-	-	-	-	-	16,844
Derivatives	788	-	693	23	72	-	-
Assets leg	*18,737*	-	*16,739*	*444*	*1,554*	-	-
Liabilities leg	*(17,949)*	-	*(16,046)*	*(421)*	*(1,482)*	-	-
Securities used for hedging	2,438	1,460	-	-	-	-	978
Investment property	28,919	-	-	-	-	-	28,919
Investments in associates	7,050	-	-	-	-	-	7,050
Property and equipment	6,311	-	-	-	-	-	6,311
Intangible assets	4,941	-	-	-	-	-	4,941
Tax assets	463	-	-	17	446	-	-
Non-current assets held for sale	11,923	-	-	-	-	-	11,923
Other assets	5,901	64	2,500	2,047	401	18	871
Assets 31.12.2012	900,675	116,712	67,425	102,995	278,495	257,211	77,837
Liabilities							
Due to credit institutions and Central Bank	32,990	12,742	12,360	7,659	229	-	-
Deposits	448,683	268,016	118,584	34,890	24,947	2,246	-
Financial liabilities at fair value	13,465	-	12,575	98	480	312	-
Assets leg	*(25,677)*	-	*(6,037)*	*(4,533)*	*(9,646)*	*(5,461)*	-
Liabilities leg	*26,652*	-	*6,122*	*4,631*	*10,126*	*5,773*	-
Short position bonds and derivatives	*5,163*	-	*5,163*	-	-	-	-
Short position bonds used for hedging	*7,327*	-	*7,327*	-	-	-	-
Tax liabilities	3,237	-	474	1,425	1,338	-	-
Non-current liabilities held for sale	1,769	-	-	-	-	-	1,769
Other liabilities	40,348	492	25,952	5,180	3,207	308	5,209
Borrowings	195,085	601	1,865	2,858	31,686	158,075	-
Subordinated liabilities	34,220	-	-	-	-	34,220	-
Liabilities 31.12.2012	769,797	281,851	171,810	52,110	61,887	195,161	6,978
Off-balance sheet items:							
Guarantees	9,185	1,806	3,639	1,462	939	1,339	-
Unused overdraft	34,545	691	8,971	11,768	13,035	80	-
Loan commitments	36,001	1,051	19,201	5,816	9,932	1	-
Off-balance sheet items	79,731	3,548	31,811	19,046	23,906	1,420	-
Net interest sensitivity gap	51,147	(168,687)	(136,196)	31,839	192,702	60,630	70,859

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67. cont.

30.09.2012 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	16,026	8,617	-	7,409	-	-	-
Loans and receivables to credit institutions	88,007	73,981	13,779	-	247	-	-
Loans and receivables to customers	572,484	5,414	45,059	69,879	238,528	213,604	-
Bonds and debt instruments	119,697	4,763	4,470	33	68,919	41,512	-
Shares and equity instruments	15,860	-	-	-	-	-	15,860
Derivatives	969	-	527	(2)	444	-	-
Assets leg	*17,108*	-	*13,094*	*267*	*3,747*	-	-
Liabilities leg	*(16,139)*	-	*(12,567)*	*(269)*	*(3,303)*	-	-
Securities used for hedging	1,398	777	-	-	-	-	621
Investment property	28,171	-	-	-	-	-	28,171
Investments in associates	3,024	-	-	-	-	-	3,024
Property and equipment	6,147	-	-	-	-	-	6,147
Intangible assets	5,102	-	-	-	-	-	5,102
Tax assets	475	-	-	-	-	-	475
Non-current assets held for sale	13,711	-	-	-	-	-	13,711
Other assets	5,174	64	1,489	2,009	458	47	1,107
Assets 30.09.2012	876,245	93,616	65,324	79,328	308,596	255,163	74,218
Liabilities							
Due to credit institutions and Central Bank	16,459	11,025	3,072	2,362	-	-	-
Deposits	454,405	277,939	113,950	33,777	26,056	2,683	-
Financial liabilities at fair value	11,122	-	11,084	15	5	18	-
Assets leg	*(24,617)*	-	*(9,953)*	*(188)*	*(8,623)*	*(5,853)*	-
Liabilities leg	*24,720*	-	*10,018*	*203*	*8,628*	*5,871*	-
Short position bonds and derivatives	*4,999*	-	*4,999*	-	-	-	-
Short position bonds used for hedging	*6,020*	-	*6,020*	-	-	-	-
Tax liabilities	3,220	-	822	2,398	-	-	-
Non-current liabilities held for sale	2,683	-	-	-	-	-	2,683
Other liabilities	35,010	1,091	4,692	21,259	2,477	188	5,303
Borrowings	192,412	-	1,810	2,288	13,271	175,043	-
Subordinated liabilities	32,502	-	-	-	-	32,502	-
Liabilities 30.09.2012	747,813	290,055	135,430	62,099	41,809	210,434	7,986
Off-balance sheet items:							
Guarantees	10,628	2,172	917	4,833	1,372	1,334	-
Unused overdraft	34,899	514	5,831	14,277	14,257	20	-
Loan commitments	35,262	6,087	7,166	12,481	9,408	120	-
Off-balance sheet items	80,789	8,773	13,914	31,591	25,037	1,474	-
Net interest sensitivity gap	47,643	(205,212)	(84,020)	(14,362)	241,750	43,255	66,232

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68. 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 263.0 billion (31.12.2012: ISK 262.0 billion and 30.09.2012: ISK 270.6 billion) and the total amount of indexed liabilities amount to ISK 219.9 billion (31.12.2012: 216.8 billion and 30.09.2012 ISK 221.0 billion).

30.09.2013	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI indexed linked				
Loans and receivables to customers	5,922	58,308	189,857	254,087
Bonds and debt instruments	69	81	3,464	3,614
Off-balance sheet position	1,633	3,618	-	5,251
Assets, CPI indexed linked	7,624	62,007	193,321	262,952
Liabilities, CPI indexed linked				
Deposits	63,206	20,582	5,423	89,211
Borrowings	45	517	130,144	130,706
Liabilities, CPI indexed linked	63,251	21,099	135,567	219,917
Net on-balance sheet position	(57,260)	37,290	57,754	37,784
Net off-balance sheet position	1,633	3,618	-	5,251
CPI Balance 30.09.2013	(55,627)	40,908	57,754	43,035
CPI Balance 31.12.2012	(60,232)	18,321	87,051	45,140
CPI Balance 30.09.2012	(64,467)	31,412	82,626	49,571

69. 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. Net exposures per currency are monitored centrally in the Bank.

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

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash and balances with Central Bank	16,194	2,330	425	211	290	352	314	20,116
Loans to credit institutions	23,839	24,256	15,101	1,705	20,411	2,809	25,081	113,202
Loans and receivables to customers	449,100	51,694	24,616	16,269	6,336	8,905	19,284	576,204
Bonds and debt instruments	130,927	-	584	-	-	-	-	131,511
Shares and equity instruments	10,668	5,923	891	-	219	-	47	17,748
Derivatives	574	475	1	23	4	3	-	1,080
Securities used for hedging	4,048	-	-	-	-	-	-	4,048
Investment property	29,382	-	-	-	-	-	-	29,382
Investments in associates	14,856	-	-	-	-	-	-	14,856
Property and equipment	7,165	-	-	-	-	-	-	7,165
Intangible assets	5,348	-	-	-	-	-	-	5,348
Tax assets	702	-	-	-	-	-	-	702
Non-current assets held for sale	9,931	-	-	-	-	-	-	9,931
Other assets	4,255	774	551	-	12	1	58	5,651
Assets 30.09.2013	706,989	85,452	42,169	18,208	27,272	12,070	44,784	936,944

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69. cont.

Liabilities	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Due to credit inst. and Central Bank ..	24,477	1,648	511	575	12	1,325	-	28,548
Deposits	391,066	25,109	14,576	418	10,605	1,053	28,941	471,768
Financial liabilities at fair value	9,764	53	2	-	5	-	10	9,834
Tax liabilities	4,815	-	-	-	-	-	-	4,815
Non-current liabilities held for sale ...	591	-	-	-	-	-	-	591
Other liabilities	35,310	1,139	1,138	123	2,156	497	1,264	41,627
Borrowings	138,225	2,505	19,514	20,640	6,870	8,455	9,856	206,065
Subordinated liabilities	-	26,525	2,407	-	3,877	-	-	32,809
Equity	140,887	-	-	-	-	-	-	140,887
Liabilities 30.09.2013	745,135	56,979	38,148	21,756	23,525	11,330	40,071	936,944
Net on-balance sheet position	(38,146)	28,473	4,021	(3,548)	3,747	740	4,713	
Net off-balance sheet position	11,822	(17,742)	2,347	2,931	259	579	(196)	
Net position 30.09.2013	(26,324)	10,731	6,368	(617)	4,006	1,319	4,517	
31.12.2012								
Net on-balance sheet position	(32,510)	16,235	1,258	(6)	274	3,388	11,361	
Net off-balance sheet position	14,347	(8,624)	3,667	(1,239)	3,321	(3,672)	(7,800)	
Net position 31.12.2012	(18,163)	7,611	4,925	(1,245)	3,595	(284)	3,561	
30.09.2012								
Net on-balance sheet position	(44,438)	27,283	558	2,814	160	6,611	7,012	
Net off-balance sheet position	15,248	(18,418)	3,884	3,595	2,175	(4,166)	(2,318)	
Net position 30.09.2012	(29,190)	8,865	4,442	6,409	2,335	2,445	4,694	

Liquidity risk

70. An important source of funding for the Group is deposits from individuals, corporations and institutional investors. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits.

Secured liquidity

The Bank calculates its secured liquidity ratio from cash on hand and cash balances with the Central Bank, Treasury notes and Housing Financing 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.

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70. cont.

The FME has set a guideline for minimum secured liquidity ratio and a minimum cash ratio. These guidelines stipulates that the Bank should have adequate liquidity reserves to withstand an instantaneous deposit outflow of 20% (Secured liquidity ratio), and that cash and cash equivalents shall amount to at least 5% (Cash ratio) of on-demand deposits. The Bank's ratios during the period were as follows, compared to last year:

	30.09.2013		31.12.2012		30.09.2012	
	Liquidity ratio	Cash ratio	Liquidity ratio	Cash ratio	Liquidity ratio	Cash ratio
Period-end	35%	29%	33%	31%	31%	18%
Maximum	42%	38%	37%	31%	35%	23%
Minimum	32%	20%	28%	10%	30%	13%
Average	37%	29%	32%	17%	33%	18%

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.

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

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

% of deposit base:

	30.09.2013		31.12.2012		30.09.2012	
Stickiness rating						
Due to Central Bank		-		12,358		-
1 Capital controls	2%	7,800	2%	8,746	2%	9,904
2 Resolution process	18%	90,167	18%	82,338	15%	71,661
3 Investors	23%	115,406	21%	101,827	25%	117,245
4 Deposits - legal entities	15%	73,105	14%	63,445	13%	60,163
5 Deposits - retail individuals	11%	53,366	11%	53,239	12%	54,801
6 Deposits - legal entities with business relationship	15%	73,578	16%	73,098	16%	75,772
7 Deposits - retail individuals with business relationship	17%	86,894	18%	86,622	17%	81,318
Total	100%	500,316	100%	481,673	100%	470,864

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Capital management

71. The capital base at 30 September 2013 amounts to ISK 167,342 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 23.6%, exceeding the minimum legal requirement of 8%.

The Group uses the standardised approach to calculate the capital requirements for credit risk and market risk and basic indicator approach for operational risk.

The Bank carries out an on-going process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank's total risk exposure. The ICAAP is aimed at identifying and measuring the Group's risk across all risk types and ensure that the Group has sufficient capital in accordance to its risk profile. FME supervises the Group, receives the Group's internal estimation on the capital adequacy (ICAAP) and sets capital requirements for the Group as a whole.

The Group is subject to capital requirements which are specified by the FME following the Supervisory Review and Evaluation Process (SREP). The Group's capital base exceeds the FME's SREP requirements (2012: the same).

A reclassification of securities was made in 2012, from the trading book into the banking book in precise compliance with the Basel II standard. Now only securities in the Bank's proprietary trading book are classified in the trading book, while other securities are classified in the banking book.

The table shows the Group's RWA calculations:	30.09.2013	31.12.2012	30.09.2012
Capital Base			
Share capital	2.000	2.000	2.000
Share premium	73.861	73.861	73.861
Other reserves	1.637	1.639	1.637
Retained earnings	59.802	49.572	47.126
Non-controlling interests	3.587	3.806	3.808
Total Equity	140.887	130.878	128.432
Intangible assets	(5.348)	(4.941)	(5.102)
Tax assets	(702)	(463)	(475)
Other statutory deductions	(158)	-	-
Total Tier 1 capital	134.679	125.474	122.855
Subordinated liabilities	32.809	34.220	32.502
Other statutory deductions	(146)	-	-
Total Capital base	167.342	159.694	155.357
Risk weighted assets			
Credit risk	584.912	557.964	557.607
Market risk FX	27.421	20.063	29.980
Market Risk Other	6.293	7.407	29.455
Operational risk	72.329	72.329	58.976
Total Risk weighted assets	690.955	657.763	676.018
Tier 1 ratio	19,5%	19,1%	18,2%
Capital adequacy ratio	24,2%	24,3%	23,0%
Official Tier 1 ratio*	18,9%	19,1%	17,7%
Official Capital adequacy ratio*	23,6%	24,3%	22,5%

* Official capital ratio is based on reviewed retained earnings at 30 June 2013.

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NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

OTHER INFORMATION

Related parties

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

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13% stake in Arion Bank. ISFI and related entities are defined as related parties and balances and transactions with these entities are included in the tables below under Shareholders with significant influence over the Group.

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.

30.09.2013

Balances with related parties:	Assets	Liabilities	Net balance
Shareholders with significant influence over the Group	-	(3,951)	(3,951)
Shareholders with control over the Group	567	(63,309)	(62,742)
Board of Directors and key Management personnel	192	(91)	101
Associates and other related parties	48,830	(21,099)	27,731
	49,589	(88,450)	(38,861)

31.12.2012

Balances with related parties:	Assets	Liabilities	Net balance
Shareholders with significant influence over the Group	-	(1,960)	(1,960)
Shareholders with control over the Group	704	(61,095)	(60,391)
Board of Directors and key Management personnel	129	(128)	1
Associates and other related parties	53,737	(16,379)	37,358
	54,570	(79,562)	(24,992)

30.09.2012

Balances with related parties:	Assets	Liabilities	Net balance
Shareholders with significant influence over the Group	-	1,767	(1,767)
Shareholders with control over the Group	546	62,013	(61,467)
Board of Directors and key Management personnel	120	107	13
Associates and other related parties	57,773	15,488	42,285
	58,439	79,375	(20,936)

Events after Balance Sheet date

73. In October 2013 Arion Bank completed ISK 1.5 billion covered bond offering in new serie, Arion CBI 19. The aim is to list the bonds at NASDAQ OMX Iceland. The bonds are inflation indexed with 2.50% fixed interest and mature in 2019.

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