



Interim Consolidated Financial Statements

1 January - 31 March 2014

Unaudited

Arion Bank
Borgartún 19
105 Reykjavík
Iceland

Reg. no. 581008 - 0150

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ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The Interim Consolidated Financial Statements of Arion Bank for the period ended 31 March 2014 include the Interim Consolidated Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Operations during the period

Net earnings amounted to ISK 2,864 million for the period ended 31 March 2014. The Group's equity amounted to ISK 147,813 million at period end. The capital adequacy ratio of the Group, calculated according to the Financial Undertakings Act, was 22.5% and comfortably meets the requirements set by law and the Financial Supervisory Authority ("FME"). The liquidity position was strong at period end and well above the regulatory minimum.

The Group performance during the period was characterized by general stability in its operations. The strengthening of the Icelandic króna and lower inflation had, however, the effect of reducing interest income and the value of the loan portfolio. Fee income on the other hand increased substantially from the same period last year, with asset management and credit card operations being the main drivers of the increase. Expenses are lower than in the first quarter last year as the current quarter is free from unexpected one-off expenses. Net impairment of loans is positive, reflecting a successful closure of loan restructuring during the period. The bank levy is significantly higher compared with the same period previous year.

The Financial position of the Group at end of March is very similar to the position at year end with slightly lower total balance. Change in Cash with Central Bank is reflected in increased Financial instruments and new lending. Greater changes are shown from the same period last year in the shift from Financial assets to Loans to customers. The shift is due to the settlement of the Drómi bond with the transfer of loans from two failed banks, SPRON savings bank and Frjálsi Investment Bank to Arion Bank. This resulted in an increase in the proportion of loans to individuals in the total loan book, which is in line with the Bank's strategy.

Included in Other assets is the shareholding in HB Grandi which has been held by the Bank for several years. The sale of this shareholding has been in preparation and in April a large part of the Bank's shareholding was sold in an offering related to the listing of HB Grandi on NASDAQ OMX Iceland.

The Group had 1,140 full-time equivalent positions at the end of the period, compared with 1,145 at the end of 2013. 908 of these positions were at the parent company Arion Bank hf., compared with 911 at the end of 2013.

Outlook

Arion Bank is a leading financial institution on the Icelandic market and enjoys a strong position in all its business segments. In recent years the Bank has reduced the risk in its loan portfolio by increasing the share of retail mortgage loans. The loan portfolio now comprises loans to individuals and companies in equal measure. The Bank has also greatly improved the quality of its funding. The Bank is financially robust in international comparisons and has a very good liquidity position.

The core of the Bank's business is traditional banking activities. The Bank continues to see great opportunity in strengthening the business relationship with the new customers from SPRON and Frjálsi Investment Bank. The focus in the near future will be to further improve operations and to take advantage of the foundations already in place to take the business forward. In the coming months a new main branch will be opened in Borgartún 18, where banking will be taken into the future with the introduction of user friendly technology to greater extent than before. This in line with the Bank's aims to continue reducing operating expenses, mainly through automation and further optimization in both back office functions as well as the branch network. The Bank's solid position will enable it to support its customers in their operations and investment activities domestically as well as in their current operation and expansion internationally.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

Group business and ownership

Arion Bank is a group of financial undertakings which provide comprehensive financial services to companies, institutions and private customers. These services include corporate banking, retail banking, investment banking and asset management. The Group includes subsidiaries in the real estate sector, card services and insurance.

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.

Endorsement of the Board of Directors and the Chief Executive Officer

The Interim Consolidated Financial Statements for the period ended 31 March 2014 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 and cash flows of the Group for the period ended 31 March 2014 and its financial position as at 31 March 2014.

Further, in our opinion the 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 31 March 2014 and confirm them by means of their signatures.

Reykjavík, 21 May 2014

Board of Directors



Monica Caneman
Chairman



Benedikt Olgeirsson



Guðrún Johnsen



Måns Höglund



Björgvin Skúli Sigurdsson



Kírstín Th. Flygenring



Thóra Hallgrímsdóttir

Chief Executive Officer



Höskuldur H. Ólafsson

INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE PERIOD FROM 1 JANUARY TO 31 MARCH 2014

	Notes	2014 1.1.-31.3.	2013 1.1.-31.3.
Interest income		12,891	16,472
Interest expense		(7,408)	(10,184)
Net interest income	6	5,483	6,288
Fee and commission income		4,264	3,660
Fee and commission expense		(1,116)	(1,211)
Net fee and commission income	7	3,148	2,449
Net financial income	8	(572)	(827)
Other operating income	9	918	1,176
Operating income		8,977	9,086
Salaries and related expense	10	(3,450)	(3,322)
Other operating expense	11	(2,747)	(3,277)
Net impairment	12	1,967	(322)
Earnings before tax		4,747	2,165
Income tax expense	13	(1,315)	(586)
Bank levy	14	(660)	(91)
Net earnings from continuing operations		2,772	1,488
Net gain from discontinued operations, net of tax	15	92	(79)
Net earnings		2,864	1,409
Attributable to			
Shareholders of Arion Bank		2,808	1,697
Non-controlling interest		56	(288)
Net earnings		2,864	1,409
Other comprehensive income			
Exchange difference on translating foreign subsidiaries	31	2	(1)
Total comprehensive income for the period		2,866	1,408
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	16	1.36	0.89

The notes on pages 10 to 54 are an integral part of these Interim Consolidated Financial Statements.

INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 2014

Assets	Notes	31.3.2014	31.12.2013	31.3.2013
Cash and balances with Central Bank	17	18,744	37,999	28,099
Loans to credit institutions	18	95,158	102,307	103,444
Loans to customers	19	642,341	635,774	565,526
Financial instruments	20-22	99,710	86,541	145,533
Investment property	22	28,503	28,523	28,112
Investments in associates	24	17,785	17,929	7,061
Intangible assets		5,371	5,383	5,108
Tax assets	25	409	818	507
Other assets	26	25,124	23,576	24,075
Total Assets		<u>933,145</u>	<u>938,850</u>	<u>907,465</u>
Liabilities				
Due to credit institutions and Central Bank	21	25,915	28,000	21,617
Deposits	21	470,665	471,866	462,255
Financial liabilities at fair value	21	9,145	8,960	11,298
Tax liabilities	25	5,263	4,924	3,483
Other liabilities	27	39,821	43,667	40,080
Borrowings	21.28	203,226	204,568	204,394
Subordinated liabilities	21.29	31,297	31,918	32,052
Total Liabilities		<u>785,332</u>	<u>793,903</u>	<u>775,179</u>
Equity				
Share capital and share premium	31	75,861	75,861	75,861
Other reserves	31	1,639	1,637	1,638
Retained earnings		65,400	62,591	51,269
Total Shareholders' Equity		<u>142,900</u>	<u>140,089</u>	<u>128,768</u>
Non-controlling interest		4,913	4,858	3,518
Total Equity		<u>147,813</u>	<u>144,947</u>	<u>132,286</u>
Total Liabilities and Equity		<u>933,145</u>	<u>938,850</u>	<u>907,465</u>

The notes on pages 10 to 54 are an integral part of these Interim Consolidated Financial Statements.

INTERIM CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE PERIOD FROM 1 JANUARY TO 31 MARCH 2014

	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 31 March 2014						
Equity 1 January 2014	75,861	1,637	62,591	140,089	4,858	144,947
Total comprehensive income for the period		2	2,808	2,811	56	2,867
Equity 31 March 2014	<u>75,861</u>	<u>1,639</u>	<u>65,400</u>	<u>142,900</u>	<u>4,913</u>	<u>147,813</u>
Changes in equity from 1 January to 31 March 2013						
Equity 1 January 2013	75,861	1,639	49,572	127,072	3,806	130,878
Total comprehensive income for the period		(1)	1,697	1,696	(288)	1,408
Equity 31 March 2013	<u>75,861</u>	<u>1,638</u>	<u>51,269</u>	<u>128,768</u>	<u>3,518</u>	<u>132,286</u>

The notes on pages 10 to 54 are an integral part of these Interim Consolidated Financial Statements.

INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 31 MARCH 2014

	2014 1.1.-31.3.	2013 1.1.-31.3.
Operating activities		
Net earnings	2,864	1,409
Non-cash items included in net earnings and other adjustments	(4,012)	(4,250)
Changes in operating assets and liabilities	(32,623)	(11,086)
Interest received	8,083	9,998
Interest paid*	(2,669)	(3,237)
Dividend received	599	4
Income tax and bank levy paid	(566)	(396)
Net cash used in operating activities	<u>(28,324)</u>	<u>(7,558)</u>
Investing activities		
Investment in associated companies	-	(12)
Purchase of property and equipment and intangible assets	(327)	(473)
Proceeds from sale of property and equipment	3	3
Net cash used in investing activities	<u>(324)</u>	<u>(482)</u>
Net decrease in cash and cash equivalents	(28,648)	(8,040)
Cash and cash equivalents at beginning of the period	99,683	105,173
Effect of exchange rate changes on cash and cash equivalents	(961)	(5,330)
Cash and cash equivalents at the end of the period	<u>70,074</u>	<u>91,803</u>
Non-cash investing and financing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	295	303
Settlement of loans through foreclosure on collateral from customers with view to resale	(295)	(303)

* Interest paid includes interest credited to deposit accounts at the end of the period.

The notes on pages 10 to 54 are an integral part of these Interim Consolidated Financial Statements.

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF CASH FLOW FOR THE PERIOD FROM 1 JANUARY TO 31 MARCH 2014

	2014 1.1.-31.3.	2013 1.1.-31.3.
Non-cash items included in net earnings and other adjustments		
Net interest income	(5,480)	(6,288)
Net impairment	(1,967)	322
Income tax expense	1,315	586
Bank levy	660	91
Net foreign exchange loss	476	1,397
Net loss (gain) on financial instruments	695	(565)
Depreciation and amortisation	319	262
Share of profit of associates and fair value change	64	-
Net gain on disposal of property and equipment	(1)	(1)
Net gain on disposal of investment property	(1)	(133)
Net (gain) loss from discontinued operations, net of tax	(92)	79
Non-cash items included in net earnings and other adjustments	(4,012)	(4,250)
Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	(112)	187
Loans to credit institutions	(3,073)	(14,682)
Loans to customers	(3,847)	(1,666)
Financial instruments	(13,605)	(6,909)
Investment property	21	939
Other assets	(1,646)	(825)
Due to credit institutions and Central Bank	(2,441)	(11,373)
Deposits	(2,427)	12,808
Borrowings	(1,547)	11,833
Subordinated liabilities	-	26
Other liabilities	(3,946)	(1,424)
Changes in operating assets and liabilities	(32,623)	(11,086)
Cash and cash equivalents comprises		
Cash in hand and demand deposits	18,744	49,133
Due from credit institutions	60,429	51,220
Mandatory reserve with Central Bank	(9,099)	(8,550)
Cash and cash equivalents at the end of the period	70,074	91,803

The notes on pages 10 to 54 are an integral part of these Interim Consolidated Financial Statements.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

General information

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Interim Consolidated Financial Statements for the period ended 31 March 2014 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

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 2013. The statements are available at Arion Bank's website www.arionbanki.is.

The Interim Consolidated Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 21 May 2014.

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.

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. At the end of the period the exchange rate of the ISK against the USD was 112.71 and 155.30 for the EUR (31.12.2013: USD 115.09 and EUR 158.49).

2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Financial Statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

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

The key sources of estimation uncertainty are within:

- impairment losses and reversal of impairment losses on loans;
- the foreign currency loan portfolio caused by legal dispute and court judgements ;
- investment property; and
- assets classified as held for sale.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

3. The Group

Shares in main subsidiaries in which Arion Bank held a direct interest at the end of the period

	Country	Currency	Equity interest		
			30.3.2014	31.12.2013	30.3.2013
AFL - sparisjóður, Aðalgata 34, Siglufjörður	Iceland	ISK	99.3%	99.3%	99.3%
Arion Bank Mortgages Institutional					
Investor Fund, Borgartún 19, Reykjavík	Iceland	ISK	100.0%	100.0%	100.0%
BG 12 silhf., Borgartún 19 Reykjavík	Iceland	ISK	62.0%	62.0%	-
EAB 1 ehf., Borgartún 19, Reykjavík	Iceland	ISK	100.0%	100.0%	100.0%
Eignabjarg ehf., Álfsheimar 74, Reykjavík	Iceland	ISK	100.0%	100.0%	100.0%
Eignarhaldsfélagið Landey ehf., Hátún 2b, Reykjavík	Iceland	ISK	100.0%	100.0%	100.0%
Landfestar ehf., Álfsheimar 74, Reykjavík	Iceland	ISK	100.0%	100.0%	100.0%
Okkar líftryggingar hf., Sóltún 26, Reykjavík	Iceland	ISK	100.0%	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík	Iceland	ISK	100.0%	100.0%	100.0%
Valitor Holding hf., Laugavegur 77, Reykjavík	Iceland	ISK	60.8%	60.8%	60.8%

In addition the bank hold subsidiaries classified as Non-current assets and disposal groups held for sale, see Note 26.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

OPERATING SEGMENT REPORTING

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

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.

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.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund and AFL Sparisjóður, provide a comprehensive range of services. That includes among other advice on deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into six 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 manages financial assets on behalf of its clients according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefmir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Stefmir hf. is an independently operating financial company owned by Arion Bank. Stefmir manages a broad range of mutual funds, investment funds and institutional investor funds.

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., Eignarhaldsfélagið Landey ehf., Landfestar ehf., Okkar líftryggingar hf., Valitor holding hf. and other smaller entities of the Group.

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

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

4. The Group's business segments

1.1.-31.3.2014	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	1,340	3,293	144	50	996	(372)	32	5,483
Other income	163	577	917	612	(549)	1,578	196	3,494
Operating income	1,503	3,870	1,061	662	447	1,206	228	8,977
Operating expense	(132)	(1,423)	(362)	(184)	(63)	(1,230)	(2,803)	(6,197)
Net impairment	2,340	(1,048)	-	7	686	(25)	7	1,967
Earnings before tax	3,711	1,399	699	485	1,070	(49)	(2,568)	4,747
Net seg. rev. from ext. customers	3,730	6,109	558	776	(3,945)	1,535	214	8,977
Net seg. rev. from other segments	(2,227)	(2,239)	503	(114)	4,392	(329)	14	-
Operating income	1,503	3,870	1,061	662	447	1,206	228	8,977
Depreciation and amortisation	-	70	-	-	-	76	173	319
Total assets	249,411	399,586	4,918	35,868	158,497	76,801	8,064	933,145
Total liabilities	209,505	356,638	1,769	35,177	133,643	41,485	7,115	785,332
Allocated equity	39,906	42,948	3,149	691	24,854	35,316	949	147,813
1.1.-31.3.2013								
Net interest income	2,162	2,499	161	25	1,893	(472)	20	6,288
Other income	133	562	756	541	(835)	1,423	218	2,798
Operating income	2,295	3,061	917	566	1,058	951	238	9,086
Operating expense	(180)	(1,413)	(324)	(153)	(62)	(1,682)	(2,785)	(6,599)
Net impairment	(1,117)	(1,086)	-	1,896	3	(18)	-	(322)
Earnings before tax	998	562	593	2,309	999	(749)	(2,547)	2,165
Net seg. rev. from ext. customers	4,569	6,611	87	518	(4,288)	1,581	8	9,086
Net seg. rev. from other segments	(2,274)	(3,550)	830	48	5,346	(630)	230	-
Operating income	2,295	3,061	917	566	1,058	951	238	9,086
Depreciation and amortisation	-	45	-	-	-	47	170	262
Total assets	244,374	325,785	4,953	26,002	225,675	72,942	7,734	907,465
Total liabilities	205,274	298,314	2,019	21,842	195,361	45,585	6,784	775,179
Allocated equity	39,100	27,471	2,934	4,160	30,314	27,357	950	132,286

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.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	2014 1.1.-31.3.	2013 1.1.-31.3.
6. Net interest income		
Cash and balances with Central Bank	179	319
Loans	11,616	13,720
Securities	971	2,278
Other	125	155
Interest income	<u>12,891</u>	<u>16,472</u>
Deposits	(4,448)	(5,560)
Borrowings	(2,629)	(4,265)
Subordinated liabilities	(324)	(335)
Other	(7)	(24)
Interest expense	<u>(7,408)</u>	<u>(10,184)</u>
Net interest income	<u>5,483</u>	<u>6,288</u>
Net interest income from assets and liabilities at fair value	971	2,278
Interest income from assets not at fair value	11,920	14,194
Interest expense from liabilities not at fair value	(7,408)	(10,184)
Net interest income	<u>5,483</u>	<u>6,288</u>

7. Net fee and commission income

Fee and commission income

Asset management	1,009	873
Cards	2,006	1,685
Collection and payment services	277	250
Investment banking	392	214
Interbank clearing	122	173
Lending and guarantees	228	186
Other fee and commission income	230	279
Fee and commission income	<u>4,264</u>	<u>3,660</u>

Fee and commission expense

Asset management	(83)	(47)
Cards	(808)	(863)
Collection and payment services	(25)	(4)
Investment banking	(14)	(12)
Interbank clearing	(122)	(173)
Other fee and commission expense	(64)	(112)
Fee and commission expense	<u>(1,116)</u>	<u>(1,211)</u>
Net fee and commission income	<u>3,148</u>	<u>2,449</u>

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.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

8. Net financial income	2014 1.1.-31.3.	2013 1.1.-31.3.
Dividend income	599	4
Net gain (loss) on financial assets and financial liabilities classified as held for trading	(361)	122
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	(334)	444
Net foreign exchange gain (loss)	(476)	(1,397)
Net financial income	(572)	(827)

Net gain (loss) on financial assets and financial liabilities held for trading

Net gain (loss) on equity instruments and related derivatives	(116)	216
Net gain (loss) on interest rate instruments and related derivatives	(121)	2
Net gain (loss) on other derivatives	(124)	(96)
Net gain (loss) on financial assets and financial liabilities held for trading	(361)	122

Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss

Net gain (loss) on equity instruments designated at fair value	(253)	107
Net gain (loss) on interest rate instruments designated at fair value	(81)	337
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	(334)	444

9. Other operating income

Share of profit (loss) of associates	(64)	-
Rental income from investment property	588	559
Realised gain on investment property	1	133
Earned premiums, net of reinsurance	227	255
Net gain on disposals of assets other than held for sale	8	5
Other income	158	224
Other operating income	918	1,176

10. Personnel and salaries

The Group's total number of employees

Average number of full time equivalent positions during the period	1,144	1,187
Full time equivalent positions at the end of the period	1,140	1,187

The Bank's total number of employees

Average number of full time equivalent positions during the period	913	950
Full time equivalent positions at the end of the period	908	950

Salaries and related expense

Salaries	2,658	2,538
Defined contribution pension plans	375	342
Salary related expense	417	442
Salaries and related expense	3,450	3,322

Salaries and related expense for the Bank

Salaries	2,093	2,009
Defined contribution pension plans	295	271
Salary related expense	340	361
Salaries and related expense	2,728	2,641

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

10. Personnel and salaries, continued

During the period the Group made a provision of ISK 79 million (Q1 2013: nil) for performance plan payments, including salary related expense. During the period the Bank made a provision of ISK 64 million (Q1 2013: nil). Forty per cent of the payment is deferred for three years in accordance with FME rules on remuneration policy for financial undertakings. At the end of the period the Group had made a provision amounting to ISK 456 million (31.12.2013: ISK 494 million and 31.3.2013: nil). The Bank had made a provision of ISK 393 million at the end of the period (31.12.2013: ISK 452 million and 31.3.2013: nil).

11. Other operating expense

	2014	2013
	1.1.-31.3.	1.1.-31.3.
Administration expense	2,013	2,605
Depositors' and investors' guarantee fund	203	187
Depreciation of property and equipment	221	211
Amortisation of intangible assets	98	51
Direct operating expense derived from rental-earning investment properties	137	141
Claims incurred, net of reinsurance	73	82
Other expense	2	-
Other operating expense	2,747	3,277

12. Net impairment

Increase in book value of loans to corporates	588	2,234
Increase in book value of loans to individuals	203	139
Increase in book value of other assets	683	-
Reversal of impairment (impairment) of loans to corporates	1,394	(1,986)
Reversal of impairment of loans to credit institutions	-	31
Impairment of loans to individuals	(1,024)	(615)
Collective reversal (impairment)	123	(125)
Net impairment	1,967	(322)

13. Income tax expense

Current tax expense	1,107	894
Deferred tax expense	208	(308)
Income tax expense	1,315	586

<i>Reconciliation of effective tax rate</i>	1.1.-31.3.2014		1.1.-31.3.2013	
Earnings before tax		4,747		2,165
Income tax using the Icelandic corporation tax rate	20.0%	949	20.0%	433
Additional 6% tax on financial institutions	6.0%	283	10.4%	225
Non-deductible expenses	1.9%	89	4.8%	103
Tax exempt revenue	(0.0%)	(1)	(5.2%)	(112)
Recognition of previously unrecognised tax losses	(0.0%)	(1)	(7.1%)	(154)
Other changes	(0.1%)	(4)	4.2%	91
Effective tax rate	27.7%	1,315	27.1%	586

Financial institutions pay 6% additional tax on taxable profit exceeding ISK 1.0 billion.

14. Bank levy

Bank levy is calculated according to law. The levy is 0.376% on total debt excluding tax liabilities, in excess of ISK 50 billions. Non-financial subsidiaries are exempt from this tax. The tax is assessed on financial institutions to meet the funding of a special index and interest relief provided to individual tax payers.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

15. Net gain from discontinued operations, net of tax

	2014 1.1.-31.3.	2013 1.1.-31.3.
Net gain (loss) from legal entities	-	12
Net gain (loss) from real estate	89	(91)
Net gain (loss) from other assets	3	-
Net gain from discontinued operations, net of tax	92	(79)

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.

16. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2014 1.1.-31.3.	2013 1.1.-31.3.	2014 1.1.-31.3.	2013 1.1.-31.3.
Net earnings attributable to the shareholders of Arion Bank	2,716	1,776	2,808	1,697
Weighted average number of outstanding shares for the year, million	2,000	2,000	2,000	2,000
Basic earnings per share	1.36	0.89	1.40	0.85

There were no instruments at the end of the period that could potentially dilute basic earnings per share (2013: none).

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION

17. Cash and balances with Central Bank

	31.3.2014	31.12.2013	31.3.2013
Cash on hand	3,735	4,099	3,187
Cash with Central Bank	5,761	24,912	16,362
Mandatory reserve deposit with Central Bank	9,248	8,987	8,550
Cash and balances with Central Bank	18,744	37,999	28,099

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

18. Loans to credit institutions

<i>Loans to credit institutions</i>	31.3.2014	31.12.2013	31.3.2013
Bank accounts	60,429	70,671	72,254
Money market loans	31,142	26,197	24,817
Other loans	3,587	5,439	7,146
Provision on loans	-	-	(773)
Loans to credit institutions	95,158	102,307	103,444

Changes in the provision for losses on loans to credit institutions

Balance at the beginning of the period	-	804	804
Provision for losses (reversal)	-	-	(31)
Write-offs	-	(804)	-
Provision for losses on loans to credit institutions at the end of the period	-	-	773

19. Loans to customers

31.3.2014	Individuals	Corporates	Total
Overdrafts	19,003	23,218	42,221
Credit cards	9,669	761	10,430
Mortgage loans	259,252	8,539	267,791
Subordinated loans	-	521	521
Other loans	38,251	312,633	350,884
Provision on loans	(14,234)	(15,272)	(29,506)
Loans to customers	311,941	330,400	642,341
31.12.2013			
Overdrafts	18,205	19,669	37,874
Credit cards	11,296	878	12,174
Mortgage loans	258,065	8,103	266,168
Subordinated loans	-	531	531
Other loans	36,133	312,120	348,253
Provision on loans	(13,208)	(16,018)	(29,226)
Loans to customers	310,491	325,283	635,774

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

19. Loans to customers, continued

31.3.2013	Individuals	Corporates	Total
Overdrafts	17,729	19,172	36,901
Credit cards	8,724	720	9,444
Mortgage loans	195,895	5,488	201,383
Subordinated loans	-	541	541
Other loans	40,145	330,440	370,585
Provision on loans	(15,248)	(38,080)	(53,328)
Loans to customers	247,245	318,281	565,526

The total book value of pledged loans that were pledged against amounts borrowed was ISK 169 billion at the end of the period (31.12.2013: ISK 173 billion and 31.3.2013: ISK 172 billion). Pledged loans comprised mortgage loans to individuals, loans to municipals and loans to state related entities.

Further analysis of loans is provided in Risk Management Disclosures.

Changes in the provision for losses on loans to customers

1.1.-31.3.2014	Specific	FX rulings	Collective	Total
Balance at the beginning of the period	24,224	902	4,100	29,226
Provision for losses during the period	(782)	412	(123)	(493)
Write-offs during the period	1,404	(660)	(37)	707
Payment of loans previously written off	67	-	-	67
Balance at the end of the period	24,913	654	3,939	29,506

1.1.-31.12.2013

Balance at the beginning of the year	41,498	14,942	3,341	59,781
Provision for losses during the year	6,041	1,952	947	8,940
Write-offs during the year	(24,228)	(12,008)	(188)	(36,424)
Transferred to liabilities	-	(3,984)	-	(3,984)
Payment of loans previously written off	914	-	-	914
Balance at the end of the year	24,224	902	4,100	29,226

1.1.-31.3.2013

Balance at the beginning of the period	41,499	14,942	3,341	59,782
Provision for losses during the period	2,310	292	124	2,726
Write-offs during the period	(2,170)	(6,251)	(8)	(8,429)
Transferred to liabilities	-	(815)	-	(815)
Payment of loans previously written off	64	-	-	64
Balance at the end of the period	41,703	8,168	3,457	53,328

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

20. Financial instruments

	31.3.2014	31.12.2013	31.3.2013
Bonds and debt instruments	71,858	62,171	125,526
Shares and equity instruments with variable income	19,277	17,449	16,975
Derivatives	1,040	1,070	1,179
Securities used for hedging	7,535	5,851	1,853
Financial instruments	99,710	86,541	145,533

21. Financial assets and financial liabilities

31.3.2014	Amortised cost	Trading	Designated at fair value	Total
<i>Loans</i>				
Cash and balances with Central Bank	18,744	-	-	18,744
Loans to credit institutions	95,158	-	-	95,158
Loans to customers	642,341	-	-	642,341
Loans	756,243	-	-	756,243
<i>Bonds and debt instruments</i>				
Listed	-	4,090	53,896	57,986
Unlisted	-	45	13,827	13,872
Bonds and debt instruments	-	4,135	67,723	71,858
<i>Shares and equity instruments with variable income</i>				
Listed	-	2,586	2,383	4,969
Unlisted	-	1,476	10,797	12,273
Bond funds with variable income	-	797	1,238	2,035
Shares and equity instruments with variable income	-	4,859	14,418	19,277
<i>Derivatives</i>				
OTC derivatives	-	1,040	-	1,040
Derivatives	-	1,040	-	1,040
<i>Securities used for hedging</i>				
Bonds and debt instruments	-	1,330	-	1,330
Shares and equity instruments with variable income	-	6,205	-	6,205
Securities used for hedging	-	7,535	-	7,535
Other financial assets	6,802	-	-	6,802
Financial assets	763,045	17,569	82,141	862,755
<i>Liabilities at amortised cost</i>				
Due to credit institutions and Central Bank	25,915	-	-	25,915
Deposits	470,665	-	-	470,665
Borrowings	203,226	-	-	203,226
Subordinated liabilities	31,297	-	-	31,297
Liabilities at amortised cost	731,103	-	-	731,103
<i>Financial liabilities at fair value</i>				
Short position in bonds	-	8,600	-	8,600
Derivatives	-	545	-	545
Financial liabilities at fair value	-	9,145	-	9,145
Other financial liabilities	32,819	-	-	32,819
Financial liabilities	763,922	9,145	-	773,067

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Financial assets and financial liabilities

31.12.2013	Amortised cost	Trading	Designated at fair value	Total
<i>Loans</i>				
Cash and balances with Central Bank	37,999	-	-	37,999
Loans to credit institutions	102,307	-	-	102,307
Loans to customers	635,774	-	-	635,774
Loans	776,080	-	-	776,080
<i>Bonds and debt instruments</i>				
Listed	-	4,708	55,625	60,333
Unlisted	-	49	1,789	1,838
Bonds and debt instruments	-	4,757	57,414	62,171
<i>Shares and equity instruments with variable income</i>				
Listed	-	1,420	2,858	4,278
Unlisted	-	1,387	9,553	10,940
Bond funds with variable income	-	906	1,325	2,231
Shares and equity instruments with variable income	-	3,713	13,736	17,449
<i>Derivatives</i>				
OTC derivatives	-	1,070	-	1,070
Derivatives	-	1,070	-	1,070
<i>Securities used for hedging</i>				
Bonds and debt instruments	-	490	-	490
Shares and equity instruments with variable income	-	5,361	-	5,361
Securities used for hedging	-	5,851	-	5,851
Other financial assets	5,746	-	-	5,746
Financial assets	781,826	15,391	71,150	868,367
<i>Liabilities at amortised cost</i>				
Due to credit institutions and Central Bank	28,000	-	-	28,000
Deposits	471,866	-	-	471,866
Borrowings	204,568	-	-	204,568
Subordinated liabilities	31,918	-	-	31,918
Liabilities at amortised cost	736,352	-	-	736,352
<i>Financial liabilities at fair value</i>				
Short position in bonds	-	8,199	-	8,199
Derivatives	-	761	-	761
Financial liabilities at fair value	-	8,960	-	8,960
Other financial liabilities	36,747	-	-	36,747
Financial liabilities	773,099	8,960	-	782,059

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Financial assets and financial liabilities, continued

31.3.2013	Amortised cost	Trading	Designated at fair value	Total
<i>Loans</i>				
Cash and balances with Central Bank	28,099	-	-	28,099
Loans to credit institutions	103,444	-	-	103,444
Loans to customers	565,526	-	-	565,526
Loans	697,069	-	-	697,069
<i>Bonds and debt instruments</i>				
Listed	-	4,090	42,973	47,063
Unlisted	-	2,881	75,582	78,463
Bonds and debt instruments	-	6,971	118,555	125,526
<i>Shares and equity instruments with variable income</i>				
Listed	-	722	2,354	3,076
Unlisted	-	1,412	8,401	9,813
Bond funds with variable income	-	2,495	1,591	4,086
Shares and equity instruments with variable income	-	4,629	12,346	16,975
<i>Derivatives</i>				
OTC derivatives	-	1,179	-	1,179
Derivatives	-	1,179	-	1,179
<i>Securities used for hedging</i>				
Bonds and debt instruments	-	869	-	869
Shares and equity instruments with variable income	-	984	-	984
Securities used for hedging	-	1,853	-	1,853
Other financial assets	5,708	-	-	5,708
Financial assets	702,777	14,632	130,901	848,310
<i>Liabilities at amortised cost</i>				
Due to credit institutions and Central Bank	21,617	-	-	21,617
Deposits	462,255	-	-	462,255
Borrowings	204,394	-	-	204,394
Subordinated liabilities	32,052	-	-	32,052
Liabilities at amortised cost	720,318	-	-	720,318
<i>Financial liabilities at fair value</i>				
Short position in bonds	-	11,111	-	11,111
Derivatives	-	187	-	187
Financial liabilities at fair value	-	11,298	-	11,298
Other financial liabilities	32,787	-	-	32,787
Financial liabilities	753,105	11,298	-	764,403

Included in unlisted Bonds and debt instruments designated at fair value at 31 March 2013 is the Drómi bond, which the Group received when acquiring deposits from SPRON hf. in March 2009 and was closed by contract at year end 2013.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Financial assets and financial liabilities, continued

<i>Bonds and debt instruments designated at fair value specified by issuer</i>	31.3.2014	31.12.2013	31.3.2013
Financial and insurance activities	1,367	1,363	69,883
Public administration, human health and social activities	65,342	55,007	47,607
Corporates	1,014	1,044	1,065
Bonds and debt instruments designated at fair value	67,723	57,414	118,555

The total amount of pledged bonds at the end of the period was ISK 19.0 billion (31.12.2013: ISK 18.4 billion and 31.3.2013: 21.3 billion ISK). 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.

Settlement of Drómi Bond

At the end of 2013 the Bank reached an agreement with Eignasafn Seðlabanka Íslands ehf. (ESÍ) on the settlement of a bond issued by Drómi hf. in 2009, when deposits from SPRON were transferred to Arion Bank. The bond was secured with all Drómi's assets and also with a hold harmless statement from the Ministry of Finance and Economic Affairs. The bond was due in June 2014 with a possible extension to 2015. The agreement stated that the Bank would acquire loans to individuals held by Drómi hf., Frjálsi hf. (subsidiary of Drómi hf.) and Hilda hf. (entity held by ESÍ). The Hilda loans transferred were previously owned by SPRON but pledged against liabilities with the Central Bank.

The bond, with a book value of approximately ISK 70 billion, will be fully settled through this agreement and the settlement of the potential value of business relationships attributable to the deposits transferred from SPRON in 2009. In respect of these transactions and the former customers of SPRON and Frjálsi fjárfestingarbankinn that became the customers of Arion Bank when their loans are transferred, business relationships worth ISK 1 billion were capitalized. The financial effect of this settlement was as follows:

	2013
Loans to customers	49,977
Financial instruments, bonds	(69,020)
Intangible assets	1,000
Other assets	1,675
Total effect on assets	(16,368)
Deposits	(15,374)
Tax liabilities	(234)
Other liabilities	178
Total effect on liabilities	(15,430)
Interest income on Drómi Bond	444
Net impairment on loans	(1,616)
Tax expense	234
Total effect on Net earnings	(938)

The remaining balance of 1.7 billion was settled in April 2014.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

22. Fair value hierarchy

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

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

Level 2: valuation techniques for which all significant inputs are market observable, either directly or indirectly; and

Level 3: valuation techniques which include significant inputs that are not based on observable market data.

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

Assets and liabilities recorded at fair value by level of the fair value hierarchy

31.3.2014	Level 1	Level 2	Level 3	Total
<i>Assets at fair value</i>				
Bonds and debt instruments	19,558	51,053	1,247	71,858
Shares and equity instruments with variable income	4,510	14,400	367	19,277
Derivatives	-	1,040	-	1,040
Securities used for hedging	6,023	1,512	-	7,535
Investment property	-	-	28,503	28,503
Assets at fair value	30,092	68,005	30,117	128,213
<i>Liabilities at fair value</i>				
Short position in bonds	8,600	-	-	8,600
Derivatives	-	545	-	545
Liabilities at fair value	8,600	545	-	9,145
31.12.2013				
<i>Assets at fair value</i>				
Bonds and debt instruments	21,411	39,531	1,229	62,171
Shares and equity instruments with variable income	3,570	13,441	438	17,449
Derivatives	-	1,070	-	1,070
Securities used for hedging	4,495	1,356	-	5,851
Investment property	-	-	28,523	28,523
Assets at fair value	29,476	55,397	30,190	115,063
<i>Liabilities at fair value</i>				
Short position in bonds	8,199	-	-	8,199
Derivatives	-	761	-	761
Liabilities at fair value	8,199	761	-	8,960

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

22. Fair value hierarchy, continued

31.3.2013	Level 1	Level 2	Level 3	Total
<i>Assets at fair value</i>				
Bonds and debt instruments	6,954	117,418	1,154	125,526
Shares and equity instruments with variable income	2,405	14,215	355	16,975
Derivatives	-	1,179	-	1,179
Securities used for hedging	934	918	-	1,853
Investment property	-	-	28,112	28,112
Assets at fair value	10,293	133,730	29,621	173,644
<i>Liabilities at fair value</i>				
Short position in bonds	11,111	-	-	11,111
Derivatives	-	187	-	187
Liabilities at fair value	11,111	187	-	11,298

There have been no transfers between Level 1 and Level 2 during the period (2013: none).

The level of the fair value hierarchy of assets is determined at the end of each reporting period.

<i>Movements in Level 3 assets measured at fair value</i>	Investment property		Financial assets		Total	
	31.3.2014	31.12.2013	31.3.2014	31.12.2013	31.3.2014	31.12.2013
Balance at the beginning of the period	28,523	28,919	1,667	1,935	30,190	30,854
Fair value adjustments	-	1,219	(53)	231	(53)	1,450
Additions	181	1,804	-	-	181	1,804
Disposal	(201)	(3,419)	-	(407)	(201)	(3,826)
Transfers out of Level 3	-	-	-	(92)	-	(92)
Balance at the end of the period	28,503	28,523	1,614	1,667	30,117	30,190

Within line items in the Consolidated Statement of Comprehensive Income where gain (loss) related to fair value measurements in Level 3 is recognised

	2014	2013
	1.1.-31.3.	1.1.-31.3.
Net interest income	19	27
Net financial income	(72)	27
Other operating income	-	(19)
Gain (loss) recognised in the Consolidated Statement of Comprehensive Income	(53)	35

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

22. Fair value hierarchy, continued

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.

31.3.2014	Carrying value	Fair value	Unrealised gain (loss)
<i>Financial assets not carried at fair value</i>			
Cash and balances with Central bank	18,744	18,744	-
Loans to credit institutions	95,158	95,158	-
Loans to customers	642,341	633,009	(9,332)
Other financial assets	6,802	6,802	-
Financial assets not carried at fair value	763,045	753,713	(9,332)
<i>Financial liabilities not carried at fair value</i>			
Due to credit institutions and Central bank	25,915	25,915	-
Deposits	470,665	470,831	(166)
Borrowings	203,226	197,280	5,946
Subordinated loans	31,297	31,297	-
Other financial liabilities	32,819	32,819	-
Financial liabilities not carried at fair value	763,922	758,142	5,780
31.12.2013			
<i>Financial assets not carried at fair value</i>			
Cash and balances with Central bank	37,999	37,999	-
Loans to credit institutions	102,307	102,307	-
Loans to customers	635,774	626,825	(8,949)
Other financial assets	5,746	5,746	-
Financial assets not carried at fair value	781,826	772,877	(8,949)
<i>Financial liabilities not carried at fair value</i>			
Due to credit institutions and Central bank	28,000	28,000	-
Deposits	471,866	472,063	(197)
Borrowings	204,568	196,981	7,587
Subordinated loans	31,918	31,918	-
Other financial liabilities	36,747	36,747	-
Financial liabilities not carried at fair value	773,099	765,709	7,390

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

22. Fair value hierarchy, continued

31.3.2013	Carrying value	Fair value	Unrealised gain (loss)
<i>Financial assets not carried at fair value</i>			
Cash and balances with Central bank	28,099	28,099	-
Loans to credit institutions	103,444	103,444	-
Loans to customers	565,526	553,935	(11,591)
Other financial assets	5,708	5,708	-
Financial assets not carried at fair value	702,777	691,186	(11,591)
<i>Financial liabilities not carried at fair value</i>			
Due to credit institutions and Central bank	21,617	21,617	-
Deposits	462,255	462,775	(520)
Borrowings	204,394	201,505	2,889
Subordinated loans	32,052	32,052	-
Other financial liabilities	32,787	32,787	-
Financial liabilities not carried at fair value	753,105	750,736	2,369

Financial assets and financial liabilities predominantly bear interest at floating rates. For assets and liabilities not at floating rates fair value is determined by Level 2 methods for which the valuation input is market observable interest rates.

Derivatives	Fair value	
	Assets	Liabilities
31.3.2014		
Forward exchange rate agreements, unlisted	35	26
Interest rate and exchange rate agreements, unlisted	282	90
Bond swap agreements, unlisted	25	34
Share swap agreements, unlisted	257	370
Options - purchased agreements, unlisted	441	25
Derivatives	1,040	545
31.12.2013		
Forward exchange rate agreements, unlisted	68	20
Interest rate and exchange rate agreements, unlisted	518	42
Bond swap agreements, unlisted	4	54
Share swap agreements, unlisted	33	632
Options - purchased agreements, unlisted	447	13
Derivatives	1,070	761
31.3.2013		
Forward exchange rate agreements, unlisted	247	70
Interest rate and exchange rate agreements, unlisted	427	-
Bond swap agreements, unlisted	49	65
Share swap agreements, unlisted	23	44
Options - purchased agreements, unlisted	433	8
Derivatives	1,179	187

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

23. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

Reverse repurchase agreements have been made for assets amounting to ISK 10,972 millions (31.12.2013: 10,381 millions) to meet short positions on derivative contracts amounting to ISK 8,600 millions (31.12.2013: ISK 8,199 millions). Other nettings are similar to year end nettings, including the netting of Deposits against Other assets.

Accounting policies for offsetting are provided in Note 53 in the Annual Financial Statements for 2013.

24. Investments in associates

<i>The Group's interest in its principal associates</i>	31.3.2014	31.12.2013	31.3.2013
Auðkenni hf., Borgartún 31, 105 Reykjavík, Iceland	20.0%	20.0%	20.0%
Bakkavör Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	45.8%	45.8%	30.1%
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	39.3%	39.3%	43.5%
GO fjárfesting ehf., Undirheimar, 845 Flúðir, Iceland	30.0%	30.0%	30.0%
Klakki ehf., Ármúli 3, 108 Reykjavík, Iceland	31.8%	31.8%	36.3%
Reiknistofa bankanna hf., Kalkofnsvegur 1, 150 Reykjavík, Iceland	21.7%	21.7%	23.3%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42.7%	42.7%	42.7%
Sementsverksmiðjan ehf., Mánabraut 20, 300 Akranes, Iceland	-	23.6%	23.6%
Skipti hf., Ármúla 25, 108 Reykjavík, Iceland	38.3%	38.3%	-
SMI ehf., Smáratorg 3, 200 Kópavogur, Iceland	-	-	39.1%
<i>Investments in associates</i>			
Carrying amount at the beginning of the period	17,929	7,050	7,050
Additions during the period	-	8,903	11
Dividend	-	(10)	-
Exchange difference	(80)	-	-
Share of profit (loss) of associates and reversal of impairment	(64)	1,986	-
Investment in associates	17,785	17,929	7,061

On 27 March the shareholders of Sementsverksmiðjan ehf. agreed on a write down of all of issued shares of Sementsverksmiðjan ehf. After the write down the Bank's shareholding is nil.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

25. Tax assets and tax liabilities

	31.3.2014		31.12.2013		31.3.2013	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Current tax	-	4,239	-	3,698	12	2,404
Deferred tax	409	1,024	818	1,226	495	1,079
Tax assets and tax liabilities	409	5,263	818	4,924	507	3,483

26. Other assets

	31.3.2014	31.12.2013	31.3.2013
Non-current assets and disposal groups held for sale	10,217	10,046	10,877
Property and equipment	6,961	6,943	6,353
Accounts receivable	5,135	4,610	4,028
Prepaid expenses	950	690	925
Accrued income	877	619	499
Unsettled securities trading	387	255	833
Sundry assets	597	413	560
Other assets	25,124	23,576	24,075

Non-current assets and disposal groups held for sale

Legal entities	296	300	432
Associates	5,457	5,457	6,384
Real estates	4,431	4,150	4,029
Other assets	33	139	32
Non-current assets and disposal groups held for sale	10,217	10,046	10,877

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. (31% share).

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

	31.3.2014	31.12.2013	31.3.2013
Liabilities associated with the legal entities held for sale	560	567	758

27. Other liabilities

Accounts payable	17,665	19,264	17,930
Provision for settled FX loans	4,126	4,524	5,440
Unsettled securities trading	783	144	738
Depositors' and investors' guarantee fund	2,875	2,886	2,890
Insurance claim	2,279	2,266	2,235
Withholding tax	355	1,552	406
Non-current liabilities and disposal groups held for sale	560	567	758
Bank levy	3,540	2,835	427
Sundry liabilities	7,638	9,629	9,256
Other liabilities	39,821	43,667	40,080

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

28. Borrowings

	Issued	Maturity	Maturity		31.3.2014	31.12.2013	31.3.2013
			type	Terms of interest			
Covered bond in ISK	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,588	4,453	-
Covered bond in ISK	2012	2015	At maturity	Fixed, 6.50%	4,437	4,378	4,062
Covered bond in ISK	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	2,544	2,603	2,356
Covered bond in ISK	2008	2045	Amortizing	Fixed, CPI linked, 4.00%	21,340	21,361	4,566
Covered bond in ISK	2008	2031	Amortizing	Fixed, CPI linked, 4.00%	4,898	4,934	19,416
Covered bond in ISK	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	77,933	77,894	70,794
Covered bond in ISK	2005	2033	Amortizing	Fixed, CPI linked, 3.75%	17,772	17,873	27,423
Covered bonds					133,512	133,497	128,617
Senior unsecured bond in NOK	2013	2016	At maturity	Floating, NIBOR + 5.00%	9,312	9,356	10,403
Senior unsecured bond in ISK	2010	2018	Amortizing	Floating, REIBOR + 1.00%	2,716	2,662	3,257
Senior unsecured bond in EUR	2009	2018	Amortizing	Floating, EURIBOR +1.00%	2,173	2,202	2,659
Secured bond, Landfestar in ISK	2010	2044	Amortizing	Fixed, CPI linked, 4.70%	2,995	2,932	2,953
Bonds issued					17,197	17,152	19,272
Central Bank, secured, various curr. ..	2010	2022	At maturity	Floating, LIBOR + 3.00%	52,175	52,998	55,981
Other					343	922	523
Other loans					52,518	53,920	56,504
Borrowings					203,226	203,226	204,394

Book value of listed bonds was ISK 23,899 million (31.12.2013: ISK 23,770 million and 31.3.2013: ISK 9,938 million) at the end of the period. Market value of those bonds was ISK 24,252 million (31.12.2013: ISK 24,472 million and 31.3.2013: ISK 10,621 million).

The Group did not repurchase any own debts during the period (2013: nil).

29. Subordinated liabilities

	Issued	Maturity	Maturity		31.3.2014	31.12.2013	31.3.2013
			type	Terms of interest			
Tier II capital in various currencies	2010	2020	At maturity	Floating, LIBOR + 4.00%*	31,297	31,918	32,052
Subordinated liabilities					31,297	31,918	32,052

* In 2015 and thereafter 3 month EURIBOR/LIBOR +500 basis points.

30. Pledged assets

	31.3.2014	31.12.2013	31.3.2013
<i>Pledged assets against liabilities</i>			
Assets, pledged as collateral against borrowings	260,825	258,762	253,594
Assets, pledged as collateral against loans from credit institutions and short positions	19,004	18,440	21,294
Pledged assets against liabilities	279,829	277,202	274,888

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 261 billion at the end of the period (31.12.2013: ISK 259 billion and 31.3.2013: ISK 255 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 189 billion at the end of the period (31.12.2013: ISK 190 billion and 31.3.2013: ISK 185 billion).

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

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

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

31. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million) 31.3.2014		Number (million) 31.12.2013		Number (million) 31.3.2013	
Issued share capital	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.

<i>Other reserves</i>	31.3.2014	31.12.2013	31.3.2013
Statutory reserve	1,637	1,637	1,637
Foreign currency translation reserve	2	-	1
Other reserves	1,639	1,637	1,638

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

OFF BALANCE SHEET INFORMATION

32. Obligations

<i>Guarantees, unused overdraft and loan commitments the Group has granted its customers</i>	31.3.2014	31.12.2013	31.3.2013
Guarantees	9,262	9,922	9,557
Unused overdrafts	37,677	37,371	35,108
Loan commitments	56,381	48,585	37,944

Depositors' and Investors' Guarantee fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. 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.

33. Assets under management and under custody

	31.3.2014	31.12.2013	31.3.2013
Assets under management	907,628	895,457	873,356
Assets under custody	1,429,206	1,490,888	1,403,746

34. Legal matters

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

i) Contingent liabilities

Investigation and legal proceedings regarding alleged breaches of competition law

The Icelandic Competition Authority (ICA) has opened a formal investigation into practices of all card issuers in Iceland, including the Bank, and by two card payment acquirers, including Valitor. The investigation was initiated by a complaint by Kortþjónustan hf., a card payment acquirer, in 2009. The case concerns alleged concerted practices through associations of undertakings connected to decisions on multilateral interchange fees and alleged anti-competitive practices towards competitors in the field of acquiring.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

34. Legal matters, continued

The ICA has also opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including the Bank. The investigation was initiated by separate complaints from BYR hf. and MP banki hf. made in 2010. The complaints from BYR hf. and MP banki hf. concern the terms of the Banks' mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition.

The extent of the investigations and outcome of the cases before the ICA is still uncertain as well as any effect on the Group. However, if the Bank or Valitor will be deemed to have violated the Competition Act, it could result in a fine or restrictions by the ICA.

In April 2013 the ICA imposed a ISK 500 million fine on Valitor for abusing its dominant position on the payment card market and violating conditions set in an earlier decision of the Authority. Valitor appealed the decision to the Competition Appeals Committee. In October 2013 the Committee confirmed the decision of the Competition Authority. Valitor has referred the decision to the courts of law for annulment.

In 2012 Kortþjónustan hf. filed a suit against Valitor claiming damages for the alleged loss suffered by Kortþjónustan hf. due to alleged breaches of competition law based on a settlement made by Valitor with the ICA, published in ICA decision No 4/2008. The case is still being contested before the District Court of Reykjavík. In July 2013 Kortþjónustan hf. filed another suit, now against the Bank and Valitor, as well as Landsbanki, Íslandsbanki and Borgun, claiming damages for the alleged loss suffered by Kortþjónustan hf. in relation to the alleged breaches of competition law based on the complaint to the ICA in 2009, stated above. The case is being contested before the District Court of Reykjavík.

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 defended against the borrowers' summons and with a judgment on 20 December 2013 the Group was acquitted. The case has been appealed to the Supreme Court of Iceland. If the Supreme Court sides with the borrowers, 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 matters

Legal proceedings regarding CPI loans

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. In 2013, the Supreme Court requested an Advisory Opinion from the EFTA Court in two separate cases regarding the interpretation of certain provisions of an EC directive, in cases where the disagreement is whether the CPI-indexation of a consumer loan is in accordance with certain provisions of Icelandic law on contracts and consumer loans. 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 unlikely, and has therefore made no provision due to this.

iii) Legal matters concluded

Legal proceedings regarding Stefmir hf.

In October 2011 the winding-up committee of Landsbanki Íslands brought legal action against Stefmir hf. 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 Stefmir. The amount involved was ISK 450 million plus interest. As a result of this judgment by Reykjavik District Court, Stefmir, on behalf of the two funds, was ordered to repay the amounts. The company made provision in respect of this case in 2012. The case was appealed to the Supreme Court of Iceland where Stefmir was acquitted on 16 January 2014 and the provision has been revised in the accounts for 2013.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

35. The uncertainty regarding the book value of foreign currency loans

As summarized in Note 37 to the Annual Financial Statements 2013, 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 2014 and the Group constantly monitors judgments in court cases it is party to as well as other relevant court cases to refine its provisions on foreign currency loans.

After consideration of such judgments, the Group has provisioned a total amount of ISK 22.5 billion of which ISK 17.7 billion have been written-off since 2011.

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.

36. Events after Balance Sheet date

In April 2014 the Bank sold 18.8% share in HB Grandi hf. in connection with the listing of the company on NASDAQ OMX Iceland. Prior to the sale the Bank held 31% share in HB Grandi. A substantial profit from the sale will be recognised in the Statement of Comprehensive Income in the second quarter of 2014. The Bank's aim is to further reduce its remaining shareholding in HB Grandi hf.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

RELATED PARTY

37. Related party

The Group has a related party relationship with Kaupskil ehf., being the ultimate controlling party with 87% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., being the parent company of Kaupskil ehf.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13% stake in Arion Bank and thus has influence over the Group. ISFI and related entities are defined as related parties.

The Board of Directors of Arion Bank, key Management personnel of the Bank and the Group's associates are defined as related parties, as well as close family members of individuals referred to above and legal entities controlled by them.

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.

Balances with related parties

	Assets	Liabilities	Net balance
31.3.2014			
Shareholders with control over the Group	1,238	(62,771)	(61,533)
Shareholders with influence over the Group	242	(22)	220
Board of Directors and key Management personnel	182	(82)	100
Associates and other related parties	36,050	(19,637)	16,413
Balances with related parties	37,712	(82,512)	(44,800)
31.12.2013			
Shareholders with control over the Group	554	(63,949)	(63,395)
Shareholders with influence over the Group	19	(2,003)	(1,984)
Board of Directors and key Management personnel	228	(68)	160
Associates and other related parties	36,546	(19,015)	17,531
Balances with related parties	37,347	(85,035)	(47,688)
31.3.2013			
Shareholders with control over the Group	758	(57,984)	(57,226)
Shareholders with influence over the Group	-	(1,976)	(1,976)
Board of Directors and key Management personnel	128	(76)	52
Associates and other related parties	55,599	(17,867)	37,732
Balances with related parties	56,485	(77,903)	(21,418)

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

RISK MANAGEMENT DISCLOSURES

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

Further information regarding risk management is available in the Annual Consolidated Financial Statements for 2013 and in the Pillar 3 Risk Disclosures for 2013, published on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not audited.

38. Credit risk

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

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off balance sheet items such as commitments and guarantees.

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

	31.3.2014	31.12.2013	31.3.2013
Cash and balances with Central Bank	18,744	37,999	28,099
Loans to credit institutions	95,158	102,307	103,444
Loans to customers	642,341	635,774	565,526
Financial instruments	74,228	63,731	127,574
Other assets with credit risk	6,802	5,746	5,708
Total on-balance sheet maximum exposure to credit risk	837,273	845,557	830,351

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

Financial guarantees	9,262	9,922	9,557
Unused overdrafts	37,677	37,371	35,105
Loan commitments	56,381	48,585	37,944
Total off-balance sheet maximum exposure to credit risk	103,320	95,878	82,606
Maximum exposure to credit risk	940,593	941,435	912,957

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

38. Credit risk, continued

<i>Loans to customers specified by sectors</i>	31.3.2014	31.12.2013	31.3.2013
Individuals	48.6%	48.8%	42.8%
Real estate activities and construction	13.6%	13.1%	12.1%
Fishing industry	9.7%	9.6%	12.0%
Information and communication technology	3.6%	3.8%	5.1%
Wholesale and retail trade	8.1%	8.7%	9.8%
Financial and insurance activities	4.9%	4.3%	4.4%
Industry, energy and manufacturing	3.7%	3.5%	4.0%
Transportation	2.9%	3.0%	3.8%
Services	3.1%	3.1%	3.3%
Public administration, human health and social activities	1.1%	1.4%	1.8%
Agriculture and forestry	0.7%	0.7%	0.9%
	100.0%	100.0%	100.0%

Collateral and other credit enhancements

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

- Retail loans to individuals: Mortgages 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, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

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

	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
31.3.2014					
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	672	275,395	52	421	276,540
Real estate activities and construction	1,182	43,112	12	1,144	45,450
Fishing industry	112	2,593	50,218	1,354	54,277
Information and communication technology	26	1,863	-	19,952	21,841
Wholesale and retail trade	9,630	12,965	8	20,573	43,176
Financial and insurance activities	10,663	720	-	8,933	20,316
Industry, energy and manufacturing	304	8,954	49	10,854	20,161
Transportation	68	585	53	2,299	3,005
Services	294	3,494	102	9,573	13,463
Public administration, human health and social activities	39	3,295	-	148	3,482
Agriculture and forestry	5	2,240	-	145	2,390
Financial instruments	4,451	-	-	-	4,451
Collateral held against different types of financial assets	27,446	355,216	50,494	75,396	508,552

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

38. Credit risk, continued

	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
31.12.2013					
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	659	269,700	49	362	270,770
Real estate activities and construction	3,887	55,427	12	1,053	60,379
Fishing industry	89	3,039	52,878	2,361	58,367
Information and communication technology	26	1,842	-	20,452	22,320
Wholesale and retail trade	6,664	10,095	5	28,447	45,211
Financial and insurance activities	12,416	441	-	9,116	21,973
Industry, energy and manufacturing	180	8,645	46	10,719	19,590
Transportation	69	563	51	2,310	2,993
Services	285	3,314	98	2,994	6,691
Public administration, human health and social activities	22	3,190	-	170	3,382
Agriculture and forestry	5	2,331	-	136	2,472
Financial instruments	2,867	-	-	-	2,867
Collateral held against different types of financial assets	27,169	358,587	53,139	78,120	517,015
31.3.2013					
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	513	195,591	39	360	196,503
Real estate activities and construction	589	45,339	6	557	46,491
Fishing industry	1,518	2,052	51,677	5,425	60,672
Information and communication technology	79	341	-	18,291	18,711
Wholesale and retail trade	2,290	11,767	7	20,189	34,253
Financial and insurance activities	8,934	605	-	10	9,549
Industry, energy and manufacturing	158	4,394	1	3,362	7,915
Transportation	67	456	51	1,284	1,858
Services	163	2,589	73	1,721	4,546
Public administration, human health and social activities	30	3,188	-	101	3,319
Agriculture and forestry	5	1,378	-	84	1,467
Financial instruments	1,341	-	-	68,617	69,958
Collateral held against different types of financial assets	15,687	267,700	51,854	120,001	455,242

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

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

38. Credit risk, continued

<i>Credit quality by class of financial assets</i>	Neither past due nor impaired	Past due but not impaired	Individu- ally impaired*	Total
31.3.2014				
Cash and balances with Central Bank	18,744	-	-	18,744
Loans to credit institutions	95,158	-	-	95,158
Loans to customers				
Loans to corporates	299,368	19,244	11,788	330,400
Loans to individuals	261,695	40,700	9,546	311,941
Financial instruments	74,228	-	-	74,228
Other assets with credit risk	6,802	-	-	6,802
Credit quality of loans	755,995	59,944	21,334	837,273
31.12.2013				
Cash and balances with Central Bank	37,999	-	-	37,999
Loans to credit institutions	102,307	-	-	102,307
Loans to customers				
Loans to corporates	304,880	9,789	10,614	325,283
Loans to individuals	268,485	34,607	7,399	310,491
Financial instruments	63,731	-	-	63,731
Other assets with credit risk	5,746	-	-	5,746
Credit quality of loans	783,148	44,396	18,013	845,557
31.3.2013				
Cash and balances with Central Bank	28,099	-	-	28,099
Loans to credit institutions	103,444	-	-	103,444
Loans to customers				
Loans to corporates	274,222	16,602	27,457	318,281
Loans to individuals	206,777	29,361	11,107	247,245
Financial instruments	127,574	-	-	127,574
Other assets with credit risk	5,708	-	-	5,708
Credit quality of loans	745,824	45,963	38,564	830,351

* 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.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

38. Credit risk, continued

Neither past due nor impaired loans

The Bank uses internal credit rating models to monitor the development of credit risk and to estimate customers' probability of default (PD). The Bank rates customers with one of three models. For large corporates the Bank uses quantitative information based on financial statements as well as qualitative data. Credit ratings of individuals and SMEs are based on statistical models using historical information which has been found to be predictive.

The table below shows loans to customers which are neither past due nor impaired, broken down by the Bank's classification scale, where 5 denotes the highest risk. Comparative figures are not available for 31 March 2013.

31.3.2014	Risk classification					Not rated	Total
	1	2	3	4	5		
Individuals	10,676	64,747	119,341	53,759	7,367	10,616	266,506
Real estate activities and construction	1,743	5,054	24,906	6,446	193	44,034	82,375
Fishing industry	26,225	7,557	9,565	11,122	643	3,553	58,665
Information and communication technology	18,766	2,616	913	272	2	845	23,415
Wholesale and retail trade	12,478	9,347	16,789	4,312	1,462	2,188	46,576
Financial and insurance activities	2	8,482	1,237	224	-	11,233	21,178
Industry, energy and manufacturing	4,314	12,888	3,760	629	365	753	22,708
Transportation	172	16,906	649	404	97	236	18,464
Services	1,211	10,138	3,328	725	14	394	15,810
Public sector	135	3,145	787	584	38	967	5,655
Agriculture and forestry	153	543	1,557	663	0	652	3,569
Neither past due nor impaired loans	75,875	141,424	182,831	79,140	10,179	75,473	564,921
31.12.2013							
Individuals	12,201	68,291	120,751	53,841	9,978	3,422	268,484
Real estate activities and construction	1,889	4,924	37,703	6,848	708	27,612	79,684
Fishing industry	26,962	6,070	7,193	10,865	3,162	3,707	57,959
Information and communication technology	19,242	2,802	1,065	294	2	1,011	24,416
Wholesale and retail trade	12,130	9,550	18,057	3,384	1,644	6,395	51,160
Financial and insurance activities	102	9,178	1,429	211	-	12,721	23,641
Industry, energy and manufacturing	4,610	12,193	2,979	580	550	758	21,670
Transportation	197	17,404	573	458	87	244	18,963
Services	117	10,198	3,288	914	110	442	15,069
Public sector	85	3,335	917	178	38	4,052	8,605
Agriculture and forestry	162	480	1,636	769	11	656	3,714
Neither past due nor impaired loans	77,697	144,425	195,591	78,342	16,290	61,020	573,365

Exposures that are 'Not Rated' are primarily due to newly formed entities and entities for which the Bank's rating models are deemed unreliable, e.g. some public sector entities and some holding companies.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

38. Credit risk, continued

<i>Past due but not impaired loans by class of loans</i>	More				Total
	Up to 30 days	31 to 60 days	61 to 90 days	than 90 days	
31.3.2014					
Loans to corporates	15,752	601	314	2,578	19,244
Loans to individuals	16,256	6,264	2,792	15,388	40,700
Past due but not impaired loans	32,008	6,864	3,105	17,966	59,944
31.12.2013					
Loans to corporates	6,100	923	111	2,655	9,789
Loans to individuals	11,224	3,751	543	19,089	34,607
Past due but not impaired loans	17,325	4,673	655	21,744	44,396
31.3.2013					
Loans to corporates	5,687	1,388	357	9,170	16,602
Loans to individuals	11,977	4,835	2,770	9,779	29,361
Past due but not impaired loans	17,664	6,223	3,127	18,949	45,963

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

Collateral repossessed

During the period, the Group took possession of real estates with the carrying value of ISK 295 million, all which the Group is in the process of selling, see Note 26.

Impaired loans to customers specified by sector

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings		Total im- pairment amount	Total loan carrying amount
	Impair- ment amount	Loan carrying amount	Impair- ment amount	Loan carrying amount		
31.3.2014						
Individuals	13,977	23,201	130	452	14,107	23,653
Real estate activities and construction	1,825	3,522	25	82	1,850	3,604
Fishing industry	700	2,011	461	1,618	1,161	3,629
Information and communication technology	171	197	-	-	171	197
Wholesale and retail trade	2,182	5,807	-	-	2,182	5,807
Financial and insurance activities	4,328	5,891	-	-	4,328	5,891
Industry, energy and manufacturing	502	927	17	33	519	960
Transportation	66	362	-	-	66	362
Services	787	1,895	21	21	808	1,916
Public administration, human health and social activities	8	35	-	-	8	35
Agriculture and forestry	367	847	-	-	367	847
	24,913	44,695	654	2,206	25,567	46,901

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

38. Credit risk, continued

	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings		Total impairment amount	Total loan carrying amount
	Impairment amount	Loan carrying amount	Impairment amount	Loan carrying amount		
31.12.2013						
Individuals	11,538	18,496	173	614	11,711	19,110
Real estate activities and construction	1,726	3,755	37	113	1,763	3,868
Fishing industry	617	1,899	612	1,870	1,229	3,769
Information and communication technology	164	190	-	-	164	190
Wholesale and retail trade	4,020	5,941	14	44	4,034	5,985
Financial and insurance activities	4,513	6,080	-	-	4,513	6,080
Industry, energy and manufacturing	446	996	17	33	463	1,029
Transportation	65	356	6	9	71	365
Services	775	1,865	43	53	818	1,918
Public administration, human health and social activities	8	35	-	-	8	35
Agriculture and forestry	352	790	-	-	352	790
	<u>24,224</u>	<u>40,403</u>	<u>902</u>	<u>2,736</u>	<u>25,126</u>	<u>43,139</u>
31.3.2013						
Individuals	12,207	19,476	1,401	5,239	13,608	24,715
Real estate activities and construction	4,623	10,313	748	1,939	5,371	12,252
Fishing industry	3,120	6,696	1,785	4,604	4,905	11,300
Information and communication technology	7,559	11,338	108	132	7,667	11,470
Wholesale and retail trade	5,181	8,892	2,226	4,136	7,407	13,028
Financial and insurance activities	6,725	8,538	1,054	1,375	7,779	9,913
Industry, energy and manufacturing	533	1,184	222	444	755	1,628
Transportation	34	39	21	42	55	81
Services	931	1,759	325	542	1,256	2,301
Public administration, human health and social activities	29	38	91	141	120	179
Agriculture and forestry	762	1,174	187	395	949	1,569
	<u>41,704</u>	<u>69,447</u>	<u>8,168</u>	<u>18,989</u>	<u>49,872</u>	<u>88,436</u>

This note separates impairments that are due to the uncertainty related to foreign currency loans from impairments that are due to borrower credit quality. At year end 2013, a provision for losses due to court rulings for illegal FX loans was ISK 902 million, in addition to liability to customers of ISK 4,524 million. The provision is reduced to ISK 654 million at 31 March 2014. Recalculation during the period resulted in an additional ISK 984 million impairment and ISK 1,232 write-off or repayments.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

38. Credit risk, continued

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's capital base net of eligible collateral according to FME rules No 625/2013.

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 30 billion (31.12.2013: ISK 29 billion and 31.3.2013: ISK 30 billion) before taking account of eligible collateral. The Group has four large exposures at the end of the period (31.12.2013: three exposures and 31.3.2013: four exposures) net of eligible collateral.

no.	31.3.2014		31.12.2013		31.3.2013	
	Gross	Net	Gross	Net	Gross	Net
Drómi*	-	-	-	-	44%	-
1	18%	18%	17%	17%	18%	18%
2	16%	16%	16%	16%	19%	19%
3	13%	12%	12%	12%	13%	13%
4	12%	12%	-	-	-	-
<10%	< 5%	< 5%	10%	<10%	<10%	<10%
<10%	< 2%	< 2%	10%	<10%	11%	11%
Sum of large exposure gross and net > 10%	59%	58%	65%	45%	105%	61%

*See note 21 for information regarding the settlement of the Drómi bond.

No large exposure exceeds the legal limit of 25% of the Group's capital base at the end of the period.

The sum of exposures exceeding 10% of capital base is 59% of the Group's capital base before collateral mitigation or 58% net of eligible collateral, which is well below the 400% legal maximum.

39. 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.

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 liabilities, 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.

31.3.2014	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	(34)	(757)	19	(277)	(1,297)
ISK, Non Indexed linked	(155)	(569)	(29)	(29)	(18)
EUR	51	(1)	-	-	-
Other	(8)	-	-	-	-
31.12.2013					
ISK, CPI Indexed linked	(44)	(823)	32	(557)	(1,129)
ISK, Non Indexed linked	(103)	(480)	(28)	(29)	(17)
EUR	63	(1)	-	-	-
Other	(36)	-	-	-	-

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Market risk, continued

31.3.2013	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	(24)	(618)	(268)	(1,976)	762
ISK, Non Indexed linked	(120)	(434)	33	(27)	(16)
EUR	54	(2)	-	-	-
Other	13	(5)	-	-	-

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.

31.3.2014	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	(7)	3	(75)	-	(56)
ISK, Non Indexed linked	34	52	(60)	2	-
EUR	(1)	-	-	-	-
Other	1	-	-	-	-

31.12.2013

ISK, CPI Indexed linked	(11)	2	(0)	(34)	(92)
ISK, Non Indexed linked	(1)	(8)	(61)	(92)	-
EUR	1	-	-	-	-
Other	1	-	-	-	-

31.3.2013

ISK, CPI Indexed linked	-	(14)	(129)	(32)	(294)
ISK, Non Indexed linked	(56)	(13)	(52)	(5)	-
EUR	(1)	-	-	-	-
Other	(1)	-	-	-	-

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Market risk, continued

Group's assets and liabilities at carrying amount by residual maturity

31.3.2014	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	18,744	9,627	-	9,117	-	-	-
Loans to credit institutions	95,158	40,139	55,019	-	-	-	-
Loans to customers	642,341	4,290	74,284	76,814	201,445	285,508	-
Financial instruments	99,710	7,248	5,868	19,534	38,495	3,083	25,482
<i>Derivatives - assets leg</i>	28,516	442	14,168	2,333	11,573	-	-
<i>Derivatives - liabilities leg</i>	(27,476)	-	(13,897)	(2,125)	(11,454)	-	-
Investment property	28,503	-	-	-	-	-	28,503
Investments in associates	17,785	-	-	-	-	-	17,785
Intangible assets	5,371	-	-	-	-	-	5,371
Tax assets	409	-	-	-	409	-	-
Other assets	25,124	40	5,424	307	1,019	12	18,322
Assets 31.3.2014	933,145	61,344	140,595	105,772	241,368	288,603	95,463
Liabilities							
Due to credit institutions and Central Bank	25,915	16,651	5,545	3,669	50	-	-
Deposits	470,665	245,033	157,146	42,523	22,567	3,396	-
Financial liabilities at fair value	9,145	-	9,050	5	90	-	-
<i>Assets leg</i>	(10,090)	-	(8,846)	(46)	(1,198)	-	-
<i>Liabilities leg</i>	10,636	-	9,297	51	1,288	-	-
<i>Short position bonds and derivatives</i>	4,521	-	4,521	-	-	-	-
<i>Short position bonds used for hedging</i>	4,079	-	4,079	-	-	-	-
Tax liabilities	5,263	-	1,060	3,179	1,024	-	-
Other liabilities	39,821	345	22,475	6,535	2,678	788	7,000
Borrowings	203,226	-	1,813	2,352	28,421	170,640	-
Subordinated liabilities	31,297	-	-	-	-	31,297	-
Liabilities 31.3.2014	785,332	262,029	197,089	58,263	54,830	206,121	7,000
Off-balance sheet items							
Guarantees	9,262	2,166	2,222	2,066	1,730	1,078	-
Unused overdraft	37,677	398	10,052	14,668	12,505	54	-
Loan commitments	56,381	640	18,791	25,058	11,892	-	-
Off-balance sheet items	103,320	3,204	31,065	41,792	26,127	1,132	-
Net interest sensitivity gap	44,493	(203,889)	(87,559)	5,717	160,411	81,350	88,463

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Market risk, continued

31.12.2013	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	37,999	28,666	-	9,333	-	-	-
Loans to credit institutions	102,307	47,197	55,110	-	-	-	-
Loans to customers	635,774	2,151	56,696	85,340	221,979	269,608	-
Financial instruments	86,541	6,889	1,240	13,349	38,569	3,684	22,810
<i>Derivatives - assets leg</i>	23,567	447	8,008	4,094	11,018	-	-
<i>Derivatives - liabilities leg</i>	(22,497)	-	(7,918)	(3,893)	(10,686)	-	-
Investment property	28,523	-	-	-	-	-	28,523
Investments in associates	17,929	-	-	-	-	-	17,929
Intangible assets	5,383	-	-	-	-	-	5,383
Tax assets	818	-	-	-	-	818	-
Other assets	23,576	53	4,014	693	973	13	17,830
Assets 31.12.2013	938,850	84,956	117,060	108,715	261,521	274,123	92,475
Liabilities							
Due to credit institutions and Central Bank	28,000	17,692	3,622	6,636	50	-	-
Deposits	471,866	246,160	126,784	74,426	21,693	2,803	-
Financial liabilities at fair value	8,960	-	8,757	161	42	-	-
<i>Assets leg</i>	(18,830)	-	(16,322)	(911)	(1,597)	-	-
<i>Liabilities leg</i>	19,592	-	16,881	1,072	1,639	-	-
<i>Short position bonds and derivatives</i>	2,837	-	2,837	-	-	-	-
<i>Short position bonds used for hedging</i>	5,362	-	5,362	-	-	-	-
Tax liabilities	4,924	-	924	2,774	1,226	-	-
Other liabilities	43,666	371	28,344	5,098	2,671	263	6,919
Borrowings	204,568	-	1,868	2,319	27,779	172,602	-
Subordinated liabilities	31,918	-	-	-	-	31,918	-
Liabilities 31.12.2013	793,902	264,223	170,299	91,414	53,461	207,586	6,919
Off-balance sheet items							
Guarantees	9,922	2,216	2,698	2,650	1,106	1,252	-
Unused overdraft	37,371	949	8,909	16,108	11,345	60	-
Loan commitments	48,585	3,301	25,011	14,198	6,075	-	-
Off-balance sheet items	95,878	6,466	36,618	32,956	18,526	1,312	-
Net interest sensitivity gap	49,070	(185,733)	(89,857)	(15,655)	189,534	65,225	85,556

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Market risk, continued

31.3.2013	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	28,099	19,549	-	8,550	-	-	-
Loans to credit institutions	103,444	72,055	31,140	-	249	-	-
Loans to customers	565,526	4,083	56,102	80,897	205,861	218,583	-
Financial instruments	145,533	8,959	769	6,273	69,223	42,351	17,958
<i>Derivatives - assets leg</i>	30,960	-	14,058	-	11,274	5,628	-
<i>Derivatives - liabilities leg</i>	(29,781)	-	(13,305)	-	(11,053)	(5,423)	-
Investment property	28,112	-	-	-	-	-	28,112
Investments in associates	7,061	-	-	-	-	-	7,061
Intangible assets	5,108	-	-	-	-	-	5,108
Tax assets	507	-	3	9	495	-	-
Other assets	24,075	89	3,828	668	1,104	18	18,368
Assets 31.3.2013	907,465	104,735	91,842	96,397	276,932	260,952	76,607
Liabilities							
Due to credit institutions and Central Bank	21,617	10,818	4,186	6,564	49	-	-
Deposits	462,255	259,156	135,307	37,498	24,516	5,778	-
Financial liabilities at fair value	11,298	8	11,284	6	-	-	-
<i>Assets leg</i>	(10,316)	8	(10,013)	(311)	-	-	-
<i>Liabilities leg</i>	10,503	-	10,186	317	-	-	-
<i>Short position bonds and derivatives</i>	4,540	-	4,540	-	-	-	-
<i>Short position bonds used for hedging</i>	6,571	-	6,571	-	-	-	-
Tax liabilities	3,483	-	601	1,803	1,079	-	-
Other liabilities	40,080	306	23,219	5,914	3,186	162	7,293
Borrowings	204,394	-	1,838	2,376	27,146	173,034	-
Subordinated liabilities	32,052	-	-	-	-	32,052	-
Liabilities 31.3.2013	775,179	270,288	176,435	54,161	55,976	211,026	7,293
Off-balance sheet items							
Guarantees	9,557	1,851	1,961	3,509	1,017	1,219	-
Unused overdraft	35,108	713	8,519	10,261	15,535	80	-
Loan commitments	37,944	-	13,813	13,015	11,116	-	-
Off-balance sheet items	82,609	2,564	24,293	26,785	27,668	1,299	-
Net interest sensitivity gap	49,677	(168,117)	(108,886)	15,451	193,288	48,627	69,314

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Market risk, continued

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 295.6 billion (31.12.2013: ISK 291.6 billion and 31.3.2013: ISK 261.0 billion) and the total amount of indexed liabilities amount to ISK 224.1 billion (31.12.2013: ISK 223.7 billion and 31.3.2013: ISK 219.2 billion).

The following table shows the transaction maturity profile of indexed assets and liabilities. In previous statements, the profile was based on residual maturity. The 31.3.2013 figures have therefore been updated to cash flow basis for accurate comparison. Financial instruments held for proprietary trading or for liquidity purposes are assumed to be on demand.

31.3.2014	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI indexed linked				
Loans to customers	14,017	70,777	203,203	287,997
Financial instruments	2,865	-	-	2,865
Off-balance sheet position	2,415	2,331	-	4,746
Assets, CPI indexed linked	19,297	73,108	203,203	295,608
Liabilities, CPI indexed linked				
Deposits	68,417	20,561	2,606	91,584
Borrowings	1,837	10,944	119,777	132,558
Liabilities, CPI indexed linked	70,254	31,505	122,383	224,142
Net on-balance sheet position	(53,372)	39,272	80,820	66,720
Net off-balance sheet position	2,415	2,331	-	4,746
CPI Balance 31.3.2014	(50,957)	41,603	80,820	71,466
CPI Balance 31.12.2013	(51,197)	46,693	72,380	67,876
CPI Balance 31.3.2013	(35,441)	31,546	45,723	41,828

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 a substantial part of the Group's assets consist of foreign currency denominated loans to customers. Net exposures per currency are monitored centrally in the Bank.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Market risk, continued

Breakdown of assets and liabilities by currency at the end of the period

31.3.2014

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash and balances with Central Bank	16,777	110	390	538	402	194	333	18,744
Loans to credit institutions	19,871	12,958	12,988	2,114	18,143	6,889	22,195	95,158
Loans to customers	526,312	47,165	25,609	11,251	7,073	5,905	19,026	642,341
Financial instruments	79,114	14,058	3,640	5	50	2	2,841	99,710
Investment property	28,503	-	-	-	-	-	-	28,503
Investments in associates	12,190	-	-	-	5,595	-	-	17,785
Intangible assets	5,371	-	-	-	-	-	-	5,371
Tax assets	409	-	-	-	-	-	-	409
Other assets	23,835	392	639	-	91	-	167	25,124
Assets 31.3.2014	712,382	74,683	43,266	13,908	31,354	12,990	44,562	933,145

Liabilities	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Due to credit inst. and Central Bank ..	20,830	1,884	565	947	4	1,685	-	25,915
Deposits	391,037	25,158	14,631	132	11,641	878	27,188	470,665
Financial liabilities at fair value	9,119	3	-	1	-	-	22	9,145
Tax liabilities	5,263	-	-	-	-	-	-	5,263
Other liabilities	34,500	1,866	1,039	81	398	401	1,536	39,821
Borrowings	139,568	2,171	19,870	14,636	8,335	9,334	9,312	203,226
Subordinated liabilities	-	25,299	2,255	-	3,743	-	-	31,297
Equity	147,813	-	-	-	-	-	-	147,813
Liabilities 31.3.2014	748,130	56,381	38,360	15,797	24,121	12,298	38,058	933,145

Net on-balance sheet position	(35,748)	18,302	4,906	(1,889)	7,233	692	6,504
Net off-balance sheet position	14,471	(14,848)	296	2,028	932	-	(2,879)
Net position 31.3.2014	(21,277)	3,454	5,202	139	8,165	692	3,625

31.12.2013

Net on-balance sheet position	(45,886)	28,979	5,378	(2,327)	6,955	706	6,195
Net off-balance sheet position	14,256	(17,076)	924	3,569	1,069	792	(3,534)
Net position 31.12.2013	(31,630)	11,903	6,302	1,242	8,024	1,498	2,661

31.3.2013

Net on-balance sheet position	(32,950)	25,090	2,470	(960)	(3,343)	1,008	8,685
Net off-balance sheet position	14,153	(13,867)	2,707	(259)	5,992	(1,245)	(7,481)
Net position 31.3.2013	(18,797)	11,223	5,177	(1,219)	2,649	(237)	1,204

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Liquidity risk

Liquidity risk is defined as the risk that the Group, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

Liquidity coverage ratio

On 1 December 2013 new liquidity rules issued by the Central Bank of Iceland took effect, overriding rules on liquidity and cash ratios that have previously been reported by the Group. The new rules are based on liquidity standards introduced in the Basel III Accord which are to be implemented in 2015 on a global level. The standard defines the Liquidity Coverage Ratio (LCR), which is the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

The criteria for liquid assets used to meet unexpected outflow is stricter for the new liquidity measure. The assets must be non-pledged, liquid and easily priced on the market, repoable at the Central Bank and not issued by the Group or related entities.

The Central Bank has set a guideline for minimum Liquidity Coverage Ratio. As at 1 January 2014, the LCR requirement is 100% in foreign currency and 70% in total (ISK and foreign currency). The latter benchmark increases by 10% every year until a 100% requirement is implemented in 2017.

Liquidity coverage ratio	31.3.2014	31.12.2013
FX	194%	274%
Total	130%	123%

No comparison is available for 31.3.2013 figures as the new LCR rules took effect 1 December 2013.

LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Liquidity risk, continued

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. Some similar categories are grouped together.

LCR categorization - amounts and LCR outflow weights

31.3.2014	Deposits maturing within 30 days				Term deposits*	Total deposits
	Less Stable	Weight (%)	Stable	Weight (%)		
Retail	76,240	10%	31,776	5%	33,317	141,333
SME	33,745	10%	3,531	5%	6,782	44,057
Operational relationship	10	25%	-	5%	1,154	1,164
Corporations	53,656	40%	768	20%	12,696	67,119
Sovereigns, central-banks and PSE	9,696	40%	-	-	18,198	27,894
Financial entities being wound up	12,456	100%	-	-	63,611	76,067
Deposit pension funds	2,680	100%	-	-	22,800	25,480
Pension funds	42,442	100%	-	-	20,168	62,610
Domestic financial entities	28,344	100%	-	-	11,814	40,158
Foreign financial entities	2,877	100%	-	-	502	3,379
Other foreign parties	2,148	100%	620	25%	368	3,136
Total	264,293		36,695		191,409	492,397

31.12.2013	Deposits maturing within 30 days				Term deposits*	Total deposits
	Less Stable	Weight (%)	Stable	Weight (%)		
Retail	75,385	10%	33,971	5%	30,224	139,580
SME	32,496	10%	3,723	5%	6,675	42,894
Operational relationship	847	25%	-	5%	530	1,377
Corporations	49,841	40%	742	20%	12,977	63,560
Sovereigns, central-banks and PSE	19,104	40%	-	-	7,206	26,310
Financial entities being wound up	17,616	100%	-	-	59,675	77,291
Deposit pension funds	4,346	100%	-	-	20,639	24,985
Pension funds	46,420	100%	-	-	20,299	66,719
Domestic financial entities	26,652	100%	-	-	13,636	40,288
Foreign financial entities	2,135	100%	-	-	495	2,630
Other foreign parties	3,830	100%	626	25%	250	4,706
Total	278,672		39,062		172,606	490,340

*No outflow assumed from term deposits.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Capital management

The capital base at 31 March 2014 amounts to ISK 165,279 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 22.5%, 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 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 (2013: the same).

Group's RWA calculations

	31.3.2014	31.12.2013	31.3.2013
Capital Base			
Share capital and share premium	75,861	75,861	75,861
Other reserves	1,639	1,637	1,638
Retained earnings	65,400	62,591	51,269
Non-controlling interests	4,913	4,858	3,518
Total Equity	147,813	144,947	132,286
Intangible assets	(5,371)	(5,383)	(5,108)
Tax assets	(409)	(818)	(507)
Other statutory deductions	(7,931)	(119)	(15)
Total Tier 1 capital	134,102	138,627	126,656
Subordinated liabilities	31,297	31,918	32,052
Other statutory deductions	(120)	(106)	(14)
Total Capital base	165,279	170,439	158,694
Risk weighted assets			
Credit risk	618,188	608,029	560,844
Market risk FX	21,548	31,703	21,278
Market risk other	5,932	4,993	8,303
Operational risk	76,097	76,097	72,329
Total risk weighted assets	721,765	720,822	657,763
Tier 1 ratio	18.6%	19.2%	19.1%
Capital adequacy ratio	22.9%	23.6%	23.9%
Official Tier 1 ratio*	18.2%	19.2%	18.9%
Official Capital adequacy ratio*	22.5%	23.6%	23.7%

* Official capital ratio is based on audited retained earnings at 31 December 2013.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

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 2013.

IFRS 10 Consolidated Financial Statements. IFRS 10 replaces the portion of IAS 27 Consolidated and Separate Financial Statements that addresses the accounting for consolidated financial statements. IFRS 10 establishes a single control model that applies to all entities including special purpose entities. The changes introduced by IFRS 10 requires management to exercise significant judgement to determine which entities are controlled, and therefore, are required to be consolidated by a parent, compared with the requirements that were in IAS 27. This standard has been endorsed by the EU and became effective for annual periods beginning on or after 1 January 2014. Adoption of the standard did not have impacts on the financial position or performance of the Group during the period.

IFRS 12 Disclosure of Interests in Other Entities. IFRS 12 includes all of the disclosures that were previously in IAS 27 related to consolidated financial statements, as well as all of the disclosures that were previously included in IAS 31 and IAS 28. These disclosures relate to an entity's interests in subsidiaries, joint arrangements, associates and structured entities. A number of new disclosures are also required. This standard has been endorsed by the EU and became effective for annual periods beginning on or after 1 January 2014. The standard has no impacts on the financial position or performance of the Group during the period.

45. Going concern assumption

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