Interim Consolidated Financial Statements

1 January - 30 June 2014

Arion Bank
Borgartún 19
105 Reykjavík
Iceland

Reg. no. 581008 - 0150

CONTENTS

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The Interim Consolidated Financial Statements of Arion Bank for the period ended 30 June 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 17,409 million for the period ended 30 June 2014. The Group's equity amounted to ISK 154,543 million at the end of the period. The capital adequacy ratio of the Group, calculated according to the Financial Undertakings Act, was 25.6% and comfortably meets the requirements set by law and the Financial Supervisory Authority ("FME"). The liquidity position was strong at the end of the period and well above the regulatory minimum.

The Group performed well during the period. The strengthening of the Icelandic krona and lower inflation reduced net interest income slightly compared to the same period in the previous year but Fee and commission income increased substantially, with investment banking and credit card operations being the main drivers of the increase. Net impairment of loans and other assets is positive by ISK 2.0 billion, reflecting a successful closure of loan restructuring during the period. The Bank levy is several times higher than the same period in the previous year.

The sale and listing of shares in HB Grandi hf. had a significant influence on the Group's performance in the second quarter. In April 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 hf. and classified the shareholding as Non-current assets and disposal groups held for sale. The realised gain from the sale, amounting to ISK 6,290 million, is recognised as Net gain from discontinued operations but the unrealised gain is included in the Net financial income. The remaining shareholding in HB Grandi hf. as at 30 June is classified as Financial instruments.

The Financial position of the Group at the end of June has changed slightly from the position at year end. The changes in Balances with Central Bank, Loans to credit institutions and Financial instruments are the results of the Bank's liquidity management. In June the Bank sold its subsidiary Landfestar ehf. to Eik fasteignafélag hf. and in return the Bank received a 44 % shareholding in Eik fasteignafélag hf. The main effects of the sale on the financial position of the Group is a decrease in Investment property and increase in Investment in associates. In May Arion Bank paid ISK 7,811 million dividend to its shareholders.

The Group had 1,118 full-time equivalent positions at the end of the period, compared with 1,145 at the end of 2013, and 887 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. Over the last few years the Bank has reduced the risk in its loan portfolio by increasing the share of retail mortgage loans, mainly through aqusition of mortgage portfolios. The loan portfolio now comprises loans to individuals and companies in equal measure. Asset quality has continued to improve and problem loans as a percentage of equity are now starting to resemble those of other Nordic banks. The Bank has taken a leading position in the Icelandic market as regards lending to new export revenue generating industries both in the health care sector as well as in power intensive industries. The Banks objective is to further strengthen this position. The Bank has furthermore increased its international loan portfolio by lending to the fishing- and marine industries in the neighbouring countries, thus achieving targets for diversification and growth.

Arion Bank has improved the quality of its funding. The Bank has focused on extending the maturities of its deposit base as demonstrated by very strong LCR. In February the international credit rating agency Standard & Poor's assigned the Bank a rating of BB+ with a stable outlook. This is the same rating the Icelandic Republic had at the time. The Icelandic Republic is currently on a positive outlook. Following the credit rating the Bank undertook a roadshow in Europe, where the reception was excellent and demand for the Bank's paper is evident. The Bank aims to issue a benchmark bond in the near future, thus further diversifying its investor base.

The core of the Bank's business is traditional banking activities. The focus in the near future will be to further improve operations and to take advantage of the foundations already in place to continue to build a strong deversified bank with healthy returns. In June a new main Branch was opened in Borgartún 18, where user friendly technology is introduced to the customer to a greater extent than before. This is 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 30 June 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 30 June 2014 and its financial position as at 30 June 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 30 June 2014 and confirm them by means of their signatures.

Reykjavík, 27 August 2014

Board of Directors

Monica Caneman
Chairman

Benedikt Olgeirsson

Guðrún Johnsen

Måns Höglund

Björgvin Skúli Sigurðsson

Kirstín Þ. Flygenring

Þóra Hallgrímsdóttir

Chief Executive Officer

Höskuldur H. Ólafsson

REPORT ON REVIEW OF INTERIM CONSOLIDATED FINANCIAL STATEMENTS

To the Board of Directors and Shareholders of Arion Bank.

Introduction

We have reviewed the accompanying Interim Consolidated Financial Statements of Arion Bank and its subsidiaries (the "Group"), which comprise the Interim Consolidated Statement of Comprehensive Income, the Interim Consolidated Statement of Financial Position as at 30 June 2014, the Interim Consolidated Statement of Changes in Equity and the Interim Consolidated Statement of Cash Flows for the six-month period then ended, and explanatory notes. Management is responsible for the preparation and fair presentation of these Interim Consolidated Financial Statements in accordance with International Financial Reporting Standard IAS 34, "Interim Financial Reporting" as adopted by the EU. Our responsibility is to express a conclusion on these Interim Consolidated Financial Statements based on our review.

Scope of review

We conducted our review in accordance with the International Standard on Review Engagements 2410, "Review of Interim Financial Information Performed by the Independent Auditor of the Entity". A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying Interim Consolidated Financial Statements are not prepared, in all material respects, in accordance with IAS 34 "Interim Financial Reporting" as adopted by the EU.

Reykjavík, 27 August 2014

Ernst & Young ehf.

Margrét Pétursdóttir

Margrét Pétursdóttir, Partner

INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2014

	Notes	2014 1.1.-30.6	2013 1.1.-30.6.	2014 1.4.-30.6.	2013 1.4.-30.6.
Interest income		26,881	30,049	13,990	13,577
Interest expense		(14,915)	(17,382)	(7,507)	(7,198)
Net interest income	6	11,966	12,667	6,483	6,379
Fee and commission income		8,917	7,740	4,653	4,080
Fee and commission expense		(2,324)	(2,442)	(1,208)	(1,231)
Net fee and commission income	7	6,593	5,298	3,445	2,849
Net financial income	8	3,867	296	4,439	1,123
Other operating income	9	3,274	2,425	2,356	1,249
Operating income		25,700	20,686	16,723	11,600
Salaries and related expense	10	(7,164)	(6,679)	(3,714)	(3,357)
Other operating expense	11	(5,811)	(6,228)	(3,064)	(2,951)
Net impairment	12	2,001	134	34	456
Earnings before tax		14,726	7,913	9,979	5,748
Income tax expense	13	(2,467)	(1,749)	(1,152)	(1,163)
Bank levy	14	(1,375)	(188)	(715)	(97)
Net earnings from continuing operations		10,884	5,976	8,112	4,488
Net gain (loss) from discontinued operations, net of tax	15	6,525	(65)	6,433	14
Net earnings		17,409	5,911	14,545	4,502
Attributable to					
Shareholders of Arion Bank		17,263	6,137	14,455	4,440
Non-controlling interest		146	(226)	90	62
Net earnings		17,409	5,911	14,545	4,502
Other comprehensive income					
Exchange difference on translating foreign subsidiaries	31	(2)	(1)	(4)	-
Total comprehensive income for the period		17,407	5,910	14,541	4,502
Earnings per share from continuing operations					
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	16	5.37	3.10	4.01	2.21

The half-year results were reviewed by the Bank's auditor. The quarterly statements and the split between quarters were not audited or reviewed by the Bank's auditor.

The notes on pages 11 to 55 are an integral part of these Interim Consolidated Financial Statements.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 6 Amounts are in ISK millions

INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 2014

Assets	Notes	30.06.2014	31.12.2013	30.06.2013
Cash and balances with Central Bank	17	17,361	37,999	25,717
Loans to credit institutions	18	139,838	102,307	109,732
Loans to customers	19	637,085	635,774	567,257
Financial instruments	20-22	99,271	86,541	153,771
Investment property	22	6,020	28,523	28,911
Investments in associates	24	25,128	17,929	14,424
Intangible assets		5,375	5,383	5,283
Tax assets	25	734	818	495
Other assets	26	18,181	23,576	23,440
Total Assets		948,993	938,850	929,030
Liabilities				
Due to credit institutions and Central Bank	21	29,277	28,000	25,727
Deposits	21	474,229	471,866	466,834
Financial liabilities at fair value	21	7,646	8,960	10,005
Tax liabilities	25	4,995	4,924	4,049
Other liabilities	27	47,232	43,667	50,024
Borrowings	21.28	199,882	204,568	203,100
Subordinated liabilities	21.29	31,189	31,918	32,503
Total Liabilities		794,450	793,903	792,242
Equity				
Share capital and share premium	31	75,861	75,861	75,861
Other reserves	31	1,635	1,637	1,638
Retained earnings		72,043	62,591	55,709
Total Shareholders' Equity		149,539	140,089	133,208
Non-controlling interest		5,004	4,858	3,580
Total Equity		154,543	144,947	136,788
Total Liabilities and Equity		948,993	938,850	929,030

The notes on pages 11 to 55 are an integral part of these Interim Consolidated Financial Statements.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 7 Amounts are in ISK millions

INTERIM CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 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 30 June 2014						
Equity 1 January 2014	75,861	1,637	62,591	140,089	4,858	144,947
Total comprehensive income for the period		(2)	17,263	17,261	146	17,407
Dividend paid			(7,811)	(7,811)		(7,811)
Equity 30 June 2014	75,861	1,635	72,043	149,539	5,004	154,543
Changes in equity from 1 January to 30 June 2013						
Equity 1 January 2013	75,861	1,639	49,572	127,072	3,806	130,878
Total comprehensive income for the period		(1)	6,137	6,136	(226)	5,910
Equity 30 June 2013	75,861	1,638	55,709	133,208	3,580	136,788

The notes on pages 11 to 55 are an integral part of these Interim Consolidated Financial Statements.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 8 Amounts are in ISK millions

INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2014

	2014 1.1.-30.6	2013 1.1.-30.6
Operating activities		
Net earnings	17,409	5,911
Non-cash items included in net earnings and other adjustments	(19,812)	(10,623)
Changes in operating assets and liabilities	(3,881)	(6,700)
Interest received	16,852	17,281
Interest paid*	(7,539)	(4,940)
Dividend received	658	46
Income tax and Bank levy paid	(1,192)	(969)
Net cash from operating activities	2,495	6
Investing activities		
Net investment in associated companies	16	(25)
Net investment in property and equipment and intangible assets	(865)	(2,160)
Net cash used in investing activities	(849)	(2,185)
Financing activities		
Dividend paid to shareholders of Arion Bank	(7,811)	-
Net cash used in financing activities	(7,811)	-
Net decrease in cash and cash equivalents	(6,165)	(2,179)
Cash and cash equivalents at beginning of the period	99,683	105,173
Effect of exchange rate changes on cash and cash equivalents	(623)	(5,099)
Cash and cash equivalents at the end of the period	92,895	97,895
Non-cash investing and financing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	644	8,117
Settlement of loans through foreclosure on collateral from customers with view to resale	(644)	(8,117)
Changes due to the sale of Landfestar:		
Changes in Investment property	(23,131)	-
Changes in investment in asscociates	7,242	-
Changes in borrowings	14,769	-
Changes in tax liabilities	1,120	-

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

The notes on pages 11 to 55 are an integral part of these Interim Consolidated Financial Statements.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 9 Amounts are in ISK millions

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 30 JUNE 2014

	2014 1.1.-30.6.	2013 1.1.-30.6.
Non-cash items included in net earnings and other adjustments		
Net interest income	(11,965)	(12,667)
Net impairment	(2,001)	322
Income tax expense	2,467	1,749
Bank levy	1,375	188
Net foreign exchange (gain)loss	(152)	1,248
Net loss (gain) on financial instruments	(3,057)	(1,544)
Depreciation and amortisation	669	550
Share of loss of associates and fair value change	80	12
Investment property, fair value change	(932)	(307)
Net gain on disposal of property and equipment	-	(1)
Net gain on disposal of investment property	(6)	(108)
Net gain from discontinued operations, net of tax	(6,290)	(65)
Non-cash items included in net earnings and other adjustments	(19,812)	(10,623)
Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	(230)	(367)
Loans to credit institutions	(24,173)	(11,888)
Loans to customers	5,507	(15,048)
Financial instruments	(8,084)	(17,180)
Investment property	310	569
Other assets	10,737	1,045
Due to credit institutions and Central Bank	1,269	(7,263)
Deposits	40	21,403
Borrowings	8,555	13,156
Other liabilities	2,188	8,873
Changes in operating assets and liabilities	(3,881)	(6,700)
Cash and cash equivalents comprises		
Cash in hand and demand deposits	17,361	25,717
Due from credit institutions	84,751	81,282
Mandatory reserve with Central Bank	(9,217)	(9,104)
Cash and cash equivalents at the end of the period	92,895	97,895

The notes on pages 11 to 55 are an integral part of these Interim Consolidated Financial Statements.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 10 Amounts are in ISK millions

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS CONTENTS

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 30 June 2014 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Interim 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 27 August 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;
- financial assets and financial liabilities at fair value are measured at fair value;
- investment properties are measured at fair value; and
- 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 112.60 and 154.10 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 Interim Consolidated 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;
- assets classified as held for sale; and
- investments in associates.

3. The Group

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

			Equity interest		
	Country	Currency	30.6.2014	31.12.2013	30.6.2013
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 slhf., 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., Álfheimar 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., Álfheimar 74, Reykjavík	Iceland	ISK	-	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., Dalshraun 3, Hafnarfjörður	Iceland	ISK	60.8%	60.8%	60.8%

At the end of June the Bank sold its subsidiary Landfestar ehf. to Eik fasteignafélag hf. The main effects on the Interim Consolidated Statement of Financial Position is a decrease in Investment property by ISK 23.1 billion. The total effects of Landfestar ehf. on the Interim Consolidated Statement of Comprehensive Income is approximately ISK 850 million net income during the period.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 13 Amounts are in ISK millions

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 customers. 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 26 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 customers according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir 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 customers 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 customers. Research publishes regular analyses of listed securities, the major business sectors, markets and the Icelandic economy and also produces economic forecasts. Investment Banking’s customers 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. (sold 30 June 2014), Okkar líftryggingar hf., Valitor holding hf. and other smaller entities of the Group.

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

4. The Group's business segments

1.1.-30.6.2014	Corporate Banking	Retail Banking	Asset Management and Stefnir	Investment Banking	Treasury	Other divisions and Subsidiaries	Headquarters and Elimination	Total
Net interest income	3,546	6,361	307	117	2,322	(670)	(17)	11,966
Other income	772	1,292	1,859	5,485	(990)	4,358	958	13,734
Operating income	4,318	7,653	2,166	5,602	1,332	3,688	941	25,700
Operating expense	(321)	(2,951)	(719)	(375)	(140)	(2,560)	(5,909)	(12,975)
Net impairment	2,214	(885)	-	(8)	691	(44)	33	2,001
Earnings before tax	6,211	3,817	1,447	5,219	1,883	1,084	(4,935)	14,726
Net seg. rev. from ext. customers	8,376	12,686	1,096	5,752	(7,745)	4,618	917	25,700
Net seg. rev. from other segments	(4,058)	(5,033)	1,070	(150)	9,077	(930)	24	-
Operating income	4,318	7,653	2,166	5,602	1,332	3,688	941	25,700
Depreciation and amortisation	-	143	-	-	-	158	368	669
Total assets	238,184	401,183	4,858	30,783	191,420	60,121	22,444	948,993
Total liabilities	200,072	359,370	2,466	25,858	155,015	30,174	21,495	794,450
Allocated equity	38,112	41,813	2,392	4,925	36,405	29,947	949	154,543

1.1.-30.6.2013	Corporate Banking	Retail Banking	Asset Management and Stefnir	Investment Banking	Treasury	Other divisions and Subsidiaries	Headquarters and Elimination	Total
Net interest income	4,508	5,644	310	80	2,837	(817)	105	12,667
Other income	278	1,192	1,497	1,460	(553)	3,739	406	8,019
Operating income	4,786	6,836	1,807	1,540	2,284	2,922	511	20,686
Operating expense	(326)	(2,849)	(635)	(323)	(120)	(2,843)	(5,811)	(12,907)
Net impairment	390	(2,156)	(3)	1,902	41	(33)	(7)	134
Earnings before tax	4,850	1,831	1,169	3,119	2,205	46	(5,307)	7,913
Net seg. rev. from ext. customers	9,049	11,636	537	1,476	(6,253)	4,245	(4)	20,686
Net seg. rev. from other segments	(4,263)	(4,800)	1,270	64	8,537	(1,323)	515	-
Operating income	4,786	6,836	1,807	1,540	2,284	2,922	511	20,686
Depreciation and amortisation	-	88	-	-	-	102	360	550
Total assets	241,404	332,237	4,180	32,080	231,025	80,717	7,387	929,030
Total liabilities	202,780	302,964	2,042	26,947	199,017	51,991	6,501	792,242
Allocated equity	38,624	29,273	2,138	5,133	32,008	28,726	886	136,788

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.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 15 Amounts are in ISK millions

QUARTERLY STATEMENTS

5. Operations by quarters

2014	Q2	Q1	Total
Net interest income	6,483	5,483	11,966
Net fee and commission income	3,445	3,148	6,593
Net financial income (expense)	4,439	(572)	3,867
Other operating income	2,356	918	3,274
Operating income	16,723	8,977	25,700
Salaries and related expense	(3,714)	(3,450)	(7,164)
Other operating expense	(3,064)	(2,747)	(5,811)
Net impairment	34	1,967	2,001
Earnings before tax	9,979	4,747	14,726
Tax expense	(1,867)	(1,975)	(3,842)
Net earnings from continuing operations	8,112	2,772	10,884
Net gain (loss) from discontinued operations, net of tax	6,433	92	6,525
Net earnings	14,545	2,864	17,409

2013			
Net interest income	6,379	6,288	12,667
Net fee and commission income	2,849	2,449	5,298
Net financial income (expense)	1,123	(827)	296
Other operating income	1,249	1,176	2,425
Operating income	11,600	9,086	20,686
Salaries and related expense	(3,357)	(3,322)	(6,679)
Other expense	(2,951)	(3,277)	(6,228)
Net impairment	456	(322)	134
Earnings before tax	5,748	2,165	7,913
Tax expense	(1,260)	(677)	(1,937)
Net earnings from continuing operations	4,488	1,488	5,976
Net gain (loss) from discontinued operations, net of tax	14	(79)	(65)
Net earnings	4,502	1,409	5,911

The half-year results were reviewed by the Bank's auditor. The quarterly statements and the split between quarters were not audited or reviewed by the Bank's auditor.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 16 Amounts are in ISK millions

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

6. Net interest income

	2014 1.1.-30.6.	2013 1.1.-30.6.	2014 1.4.-30.6.	2013 1.4.-30.6.
Cash and balances with Central Bank	332	288	154	136
Loans	24,274	24,893	12,657	11,006
Securities	1,979	4,484	1,008	2,206
Other	296	384	171	229
Interest income	26,881	30,049	13,990	13,577
Deposits	(8,784)	(9,906)	(4,336)	(4,346)
Borrowings	(5,463)	(6,772)	(2,834)	(2,507)
Subordinated liabilities	(650)	(662)	(326)	(327)
Other	(18)	(42)	(11)	(18)
Interest expense	(14,915)	(17,382)	(7,507)	(7,198)
Net interest income	11,966	12,667	6,483	6,379
Net interest income from assets and liabilities at fair value	1,979	4,484	1,008	2,206
Interest income from assets not at fair value	24,902	25,565	12,983	11,371
Interest expense from liabilities not at fair value	(14,915)	(17,382)	(7,508)	(7,198)
Net interest income	11,966	12,667	6,483	6,379

7. Net fee and commission income

	2014 1.1.-30.6.	2013 1.1.-30.6.	2014 1.4.-30.6.	2013 1.4.-30.6.
Fee and commission income				
Asset management	1,980	1,720	971	847
Cards	4,152	3,556	2,146	1,871
Collection and payment services	599	552	322	302
Investment banking	1,052	631	660	417
Interbank clearing	122	352	-	179
Lending and guarantees	615	388	387	202
Other fee and commission income	397	541	167	262
Fee and commission income	8,917	7,740	4,653	4,080
Fee and commission expense				
Asset management	(90)	(96)	(7)	(49)
Cards	(1,725)	(1,720)	(917)	(857)
Collection and payment services	(42)	(9)	(17)	(5)
Investment banking	(24)	(22)	(10)	(10)
Interbank clearing	(122)	(352)	-	(179)
Other fee and commission expense	(321)	(243)	(257)	(131)
Fee and commission expense	(2,324)	(2,442)	(1,208)	(1,231)
Net fee and commission income	6,593	5,298	3,445	2,849

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.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 17 Amounts are in ISK millions

8. Net financial income

	2014 1.1.-30.6.	2013 1.1.-30.6.	2014 1.4.-30.6.	2013 1.4.-30.6.
Dividend income	658	46	59	42
Net gain (loss) on financial assets and financial liabilities classified as held for trading	(373)	197	(12)	75
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	3,430	1,301	3,764	857
Net foreign exchange gain (loss)	152	(1,248)	628	149
Net financial income	3,867	296	4,439	1,123

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

Net gain (loss) on equity instruments and related derivatives	(81)	329	35	113
Net gain (loss) on interest rate instruments and related derivatives	(130)	(16)	(9)	(18)
Net gain (loss) on other derivatives	(162)	(116)	(38)	(20)
Net gain (loss) on financial assets and financial liabilities classified as held for trading	(373)	197	(12)	75

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	4,058	764	4,311	427
Net gain (loss) on interest rate instruments designated at fair value	(628)	537	(547)	430
Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss	3,430	1,301	3,764	857

9. Other operating income

Share of profit (loss) of associates	(80)	(12)	(16)	(12)
Rental income from investment property	1,171	1,113	583	554
Fair value changes on investment property	932	307	932	307
Realised gain on investment property	6	108	5	(25)
Earned premiums, net of reinsurance	492	533	265	278
Net gain on disposals of assets other than held for sale	449	5	441	-
Other income	304	371	146	147
Other operating income	3,274	2,425	2,356	1,249

10. Personnel and salaries

Number of employees

Average number of full time equivalent positions during the period	1,133	1,177	1,128	1,182
Full time equivalent positions at the end of the period	1,118	1,153	1,118	1,153

The Bank's number of employees

Average number of full time equivalent positions during the period	900	939	893	929
Full time equivalent positions at the end of the period	887	918	887	918

Salaries and related expense

Salaries	5,521	5,095	2,863	2,557
Defined contribution pension plans	777	664	402	322
Salary related expense	866	920	449	478
Salaries and related expense	7,164	6,679	3,714	3,357

Arion Bank Interim Consolidated Financial Statements 30 June 2014 18 Amounts are in ISK millions

10. Personnel and salaries, continued

Salaries and related expense for the Bank

	2014 1.1.-30.6.	2013 1.1.-30.6.	2014 1.4.-30.6.	2013 1.4.-30.6.
Salaries	4,323	4,043	2,230	2,034
Defined contribution pension plans	590	527	295	256
Salary related expense	723	735	383	374
Salaries and related expense	5,636	5,305	2,908	2,664

During the first six months of 2014 the Group made a provision of ISK 159 million (H1 2013: nil) for performance plan payments, including salary related expense. During the first six months the Bank made a provision of ISK 131 million (H1 2013: nil). Forty percent 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 442 million (31.12.2013: ISK 494 million and 30.6.2013: nil). The Bank had made a provision of ISK 369 million at the end of the period (31.12.2013: ISK 452 million and 30.6.2013: nil).

11. Other operating expense

	2014 1.1.-30.6.	2013 1.1.-30.6.	2014 1.4.-30.6.	2013 1.4.-30.6.
Administration expense	4,271	4,869	2,258	2,264
Depositors' and investors' guarantee fund	415	379	212	192
Depreciation of property and equipment	470	499	249	230
Amortisation of intangible assets	199	51	101	58
Direct operating expense derived from rental-earning investment properties	280	256	143	115
Claims incurred, net of reinsurance	173	171	100	89
Other expense	3	3	1	3
Other operating expense	5,811	6,228	3,064	2,951

12. Net impairment

Increase in book value of loans to corporates	1,654	6,705	1,066	4,471
Increase in book value of loans to individuals	310	93	107	(46)
Increase in book value of other assets	683	-	-	-
Reversal of impairment (impairment) of loans to corporates	227	(5,303)	(1,167)	(3,317)
Reversal of impairment of loans to credit institutions	-	23	-	(8)
(Impairment) reversal of impairment of loans to individuals	(935)	(1,716)	89	(1,101)
Collective reversal (impairment)	62	332	(61)	457
Net impairment	2,001	134	34	456

13. Income tax expense

Current tax expense	2,074	2,109	967	1,215
Deferred tax expense	393	(360)	185	(52)
Income tax expense	2,467	1,749	1,152	1,163

Reconciliation of effective tax rate	1.1.-30.6.2014		1.1.-30.6.2013	
Earnings before tax		14,726		7,913
Income tax using the Icelandic corporation tax rate	20.0%	2,945	20.0%	1,583
Additional 6% tax on financial institutions	3.3%	490	6.0%	478
Non-deductible expenses	0.2%	33	1.7%	135
Tax exempt revenue	(6.2%)	(920)	(3.7%)	(296)
Tax incentives not recognised in the Statement of Comprehensive Income	0.0%	-	(1.9%)	(154)
Other changes	(0.6%)	(81)	0.0%	3
Effective tax rate	16.8%	2,467	22.1%	1,749

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

Arion Bank Interim Consolidated Financial Statements 30 June 2014 19 Amounts are in ISK millions

14. Bank levy

The Bank 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. The tax rate for Bank levy increased at the end of 2013. Prior to the increase the tax rate was 0.041%.

15. Net gain from discontinued operations, net of tax

	2014 1.1.-30.6.	2013 1.1.-30.6.	2014 1.4.-30.6.	2013 1.4.-30.6.
Net gain (loss) from legal entities	-	11	-	(1)
Net gain (loss) from associated companies	6,290	-	6,290	-
Net gain (loss) from real estate	233	(76)	144	15
Net gain (loss) from other assets	2	-	(1)	-
Net gain from discontinued operations, net of tax	6,525	(65)	6,433	14

Net gain (loss) from associated companies comprises the realised gain from sale of the Bank's 18.8% share in HB Grandi hf. in connection with the listing of the company on NASDAQ OMX Iceland.

16. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2014 1.1.-30.6.	2013 1.1.-30.6.	2014 1.1.-30.6.	2013 1.1.-30.6.
Net earnings attributable to the shareholders of Arion Bank	10,738	6,202	17,263	6,137
Weighted average number of outstanding shares for the year, million	2,000	2,000	2,000	2,000
Basic earnings per share	5.37	3.10	8.63	3.07

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

Arion Bank Interim Consolidated Financial Statements 30 June 2014 20 Amounts are in ISK millions

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION

17. Cash and balances with Central Bank

	30.6.2014	31.12.2013	30.6.2013
Cash on hand	3,995	4,099	3,558
Cash with Central Bank	4,149	24,912	13,055
Mandatory reserve deposit with Central Bank	9,217	8,987	9,104
Cash and balances with Central Bank	17,361	37,999	25,717

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

18. Loans to credit institutions

Loans to credit institutions			
Bank accounts	84,751	70,671	81,282
Money market loans	54,741	26,197	25,409
Other loans	346	5,439	3,822
Provision on loans	-	-	(781)
Loans to credit institutions	139,838	102,307	109,732

Changes in the provision for losses on loans to credit institutions			
Balance at the beginning of the period	-	804	804
Provision for losses (reversal)	-	-	(23)
Write-offs	-	(804)	-
Provision for losses on loans to credit institutions at the end of the period	-	-	781

19. Loans to customers

30.6.2014	Individuals	Corporates	Total
Overdrafts	18,044	23,444	41,488
Credit cards	9,084	716	9,800
Mortgage loans	259,118	9,199	268,317
Subordinated loans	-	453	453
Other loans	40,477	303,871	344,348
Provision on loans	(12,685)	(14,636)	(27,321)
Loans to customers	314,038	323,047	637,085

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

Arion Bank Interim Consolidated Financial Statements 30 June 2014 21 Amounts are in ISK millions

19. Loans to customers, continued

30.06.2013	Individuals	Corporates	Total
Overdrafts	17,927	18,771	36,698
Credit cards	10,421	855	11,276
Mortgage loans	201,381	5,932	207,313
Subordinated loans	-	545	545
Other loans	38,636	316,133	354,769
Provision on loans	(14,497)	(28,847)	(43,344)
Loans to customers	253,868	313,389	567,257

The total book value of pledged loans that were pledged against amounts borrowed was ISK 178 billion at the end of the period (31.12.2013: ISK 173 billion and 30.6.2013: 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.-30.06.2014	Specific	FX rulings	Collective	Total
Balance at the beginning of the period	24,224	902	4,100	29,226
Provision for losses	(658)	715	(94)	(37)
Write-offs	(1,625)	(1,031)	(16)	(2,672)
Payment of loans previously written off	804	-	-	804
Balance at the end of the period	22,745	586	3,990	27,321

1.1.-31.12.2013				
Balance at the beginning of the year	41,498	14,942	3,341	59,781
Provision for losses	6,041	1,952	947	8,940
Write-offs	(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.-30.06.2013				
Balance at the beginning of the period	41,498	14,942	3,341	59,781
Provision for losses	3,130	3,897	(340)	6,687
Write-offs	(10,661)	(9,674)	(17)	(20,352)
Transferred to liabilities	-	(2,974)	-	(2,974)
Payment of loans previously written off	201	-	-	201
Balance at the end of the period	34,169	6,191	2,984	43,344

20. Financial instruments

	30.6.2014	31.12.2013	30.6.2013
Bonds and debt instruments	66,227	62,171	132,744
Shares and equity instruments with variable income	24,000	17,449	16,735
Derivatives	1,298	1,070	832
Securities used for hedging	7,746	5,851	3,460
Financial instruments	99,271	86,541	153,771

Arion Bank Interim Consolidated Financial Statements 30 June 2014 22 Amounts are in ISK millions

21. Financial assets and financial liabilities

30.06.2014	Amortised		Designated at fair	
Loans	cost	Trading	value	Total
Cash and balances with Central Bank	17,361	-	-	17,361
Loans to credit institutions	139,838	-	-	139,838
Loans to customers	637,085	-	-	637,085
Loans	794,284	-	-	794,284
Bonds and debt instruments				
Listed	-	3,451	61,043	64,494
Unlisted	-	45	1,688	1,733
Bonds and debt instruments	-	3,496	62,731	66,227
Shares and equity instruments with variable income				
Listed	-	2,217	8,002	10,219
Unlisted	-	1,360	10,550	11,910
Bond funds with variable income	-	642	1,229	1,871
Shares and equity instruments with variable income	-	4,219	19,781	24,000
Derivatives				
OTC derivatives	-	1,298	-	1,298
Derivatives	-	1,298	-	1,298
Securities used for hedging				
Bonds and debt instruments	-	1,622	-	1,622
Shares and equity instruments with variable income	-	6,124	-	6,124
Securities used for hedging	-	7,746	-	7,746
Other financial assets	5,527	-	-	5,527
Financial assets	799,811	16,759	82,512	899,082
Liabilities at amortised cost				
Due to credit institutions and Central Bank	29,277	-	-	29,277
Deposits	474,229	-	-	474,229
Borrowings	199,882	-	-	199,882
Subordinated liabilities	31,189	-	-	31,189
Liabilities at amortised cost	734,577	-	-	734,577
Financial liabilities at fair value				
Short position in bonds	-	7,164	-	7,164
Derivatives	-	482	-	482
Financial liabilities at fair value	-	7,646	-	7,646
Other financial liabilities	39,630	-	-	39,630
Financial liabilities	774,207	7,646	-	781,853

Arion Bank Interim Consolidated Financial Statements 30 June 2014 23 Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

31.12.2013	Amortised cost	Trading	Designated at fair value	Total
Loans				
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
Bonds and debt instruments				
Listed	-	4,708	55,625	60,333
Unlisted	-	49	1,789	1,838
Bonds and debt instruments	-	4,757	57,414	62,171
Shares and equity instruments with variable income				
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
Derivatives				
OTC derivatives	-	1,070	-	1,070
Derivatives	-	1,070	-	1,070
Securities used for hedging				
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
Liabilities at amortised cost				
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
Financial liabilities at fair value				
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

Arion Bank Interim Consolidated Financial Statements 30 June 2014 24 Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

30.06.2013 *Loans*	Amortised cost	Trading	Designated at fair value	Total
Cash and balances with Central Bank	25,717	-	-	25,717
Loans to credit institutions	109,732	-	-	109,732
Loans to customers	567,257	-	-	567,257
Loans	702,706	-	-	702,706
Bonds and debt instruments				
Listed	-	4,418	41,372	45,790
Unlisted	-	143	86,811	86,954
Bonds and debt instruments	-	4,561	128,183	132,744
Shares and equity instruments with variable income				
Listed	-	1,062	2,562	3,624
Unlisted	-	1,226	8,329	9,555
Bond funds with variable income	-	2,018	1,538	3,556
Shares and equity instruments with variable income	-	4,306	12,429	16,735
Derivatives				
OTC derivatives	-	832	-	832
Derivatives	-	832	-	832
Securities used for hedging				
Bonds and debt instruments	-	526	-	526
Shares and equity instruments with variable income	-	2,934	-	2,934
Securities used for hedging	-	3,460	-	3,460
Other financial assets	4,459	-	-	4,459
Financial assets	707,165	13,159	140,612	860,936
Liabilities at amortised cost				
Due to credit institutions and Central Bank	25,727	-	-	25,727
Deposits	466,834	-	-	466,834
Borrowings	203,100	-	-	203,100
Subordinated liabilities	32,503	-	-	32,503
Liabilities at amortised cost	728,164	-	-	728,164
Financial liabilities at fair value				
Short position in bonds	-	9,150	-	9,150
Derivatives	-	855	-	855
Financial liabilities at fair value	-	10,005	-	10,005
Other financial liabilities	43,187	-	-	43,187
Financial liabilities	771,351	10,005	-	781,356

Included in unlisted Bonds and debt instruments designated at fair value at 30 June 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.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 25 Amounts are in ISK millions

21. Financial assets and financial liabilities, continued

Bonds and debt instruments designated at fair value specified by issuer	30.6.2014	31.12.2013	30.6.2013
Financial and insurance activities	1,264	1,363	70,238
Public administration, human health and social activities	60,453	55,007	56,862
Corporates	1,014	1,044	1,083
Bonds and debt instruments designated at fair value	62,731	57,414	128,183

The total amount of pledged bonds at the end of the period was ISK 17.6 billion (31.12.2013: ISK 18.4 billion and 30.6.2013: ISK 19.1 billion). Pledged bonds comprised Icelandic Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

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 bond was fully settled in April 2014 through this agreement.

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

30.6.2014	Level 1	Level 2	Level 3	Total
Assets at fair value				
Bonds and debt instruments	26,488	38,592	1,147	66,227
Shares and equity instruments with variable income	9,752	13,883	365	24,000
Derivatives	-	1,298	-	1,298
Securities used for hedging	6,187	1,559	-	7,746
Investment property	-	-	6,020	6,020
Assets at fair value	42,427	55,332	7,532	105,291
Liabilities at fair value				
Short position in bonds	7,164	-	-	7,164
Derivatives	-	482	-	482
Liabilities at fair value	7,164	482	-	7,646

Arion Bank Interim Consolidated Financial Statements 30 June 2014 26 Amounts are in ISK millions

22. Fair value hierarchy, continued

31.12.2013	Level 1	Level 2	Level 3	Total
Assets at fair value				
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
Liabilities at fair value				
Short position in bonds	8,199	-	-	8,199
Derivatives	-	761	-	761
Liabilities at fair value	8,199	761	-	8,960

30.6.2013	Level 1	Level 2	Level 3	Total
Assets at fair value				
Bonds and debt instruments	5,747	125,817	1,180	132,744
Shares and equity instruments with variable income	2,897	13,482	356	16,735
Derivatives	-	832	-	832
Securities used for hedging	2,305	1,155	-	3,460
Investment property	-	-	28,911	28,911
Assets at fair value	10,949	141,286	30,447	182,682
Liabilities at fair value				
Short position in bonds	9,150	-	-	9,150
Derivatives	-	855	-	855
Liabilities at fair value	9,150	855	-	10,005

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.

Movements in Level 3 assets measured at fair value	Investment property		Financial assets		Total	
	30.6.2014	31.12.2013	30.6.2014	31.12.2013	30.6.2014	31.12.2013
Balance at the beginning of the period	28,523	28,919	1,667	1,935	30,190	30,854
Effects recognised in Statement of Comprehensive Income	932	1,219	(155)	231	777	1,450
Additions	167	1,804	-	-	167	1,804
Disposal	(23,602)	(3,419)	-	(407)	(23,602)	(3,826)
Transfers out of Level 3	-	-	-	(92)	-	(92)
Balance at the end of the period	6,020	28,523	1,512	1,667	7,532	30,190

On 30 June the Bank sold its subsidiary Landfestar ehf. resulting in a total decrease in investment property by ISK 23.1 billion.

The effects of Level 3 assets recognised in the Interim Consolidated Statement of Comprehensive Income are included in the following line items:

	2014	2013
	1.1.-30.6.	1.1.-31.12.
Net interest income	34	82
Net financial income	(189)	149
Other operating income	932	1,219
Effects through the Consolidated Statement of Comprehensive Income	777	1,450

Arion Bank Interim Consolidated Financial Statements 30 June 2014 27 Amounts are in ISK millions

22. Fair value hierarchy, continued

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

30.6.2014	Carrying value	Fair value	Unrealised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central bank	17,361	17,361	-
Loans to credit institutions	139,838	139,838	-
Loans to customers	637,085	646,458	9,373
Other financial assets	5,527	5,527	-
Financial assets not carried at fair value	799,811	809,184	9,373
Financial liabilities not carried at fair value			
Due to credit institutions and Central bank	29,277	29,277	-
Deposits	474,229	474,396	(167)
Borrowings	199,882	187,542	12,340
Subordinated loans	31,189	31,189	-
Other financial liabilities	39,630	39,630	-
Financial liabilities not carried at fair value	774,207	762,034	12,173

31.12.2013			
Financial assets not carried at fair value			
Cash and balances with Central bank	37,999	37,999	-
Loans to credit institutions	102,307	102,307	-
Loans to customers	635,774	643,994	8,220
Other financial assets	5,746	5,746	-
Financial assets not carried at fair value	781,826	790,046	8,220
Financial liabilities not carried at fair value			
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

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.

Retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account mortgaging. Defaulted loans are estimated at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value. Other loans, including corporate loans, are estimated at book value as they are generally of a shorter duration than retail mortgages and the interest rate risk on them is therefore limited.

The estimate of the fair value of loans has changed from last year, as the Bank now uses improved methodology. When the methodology was updated it took into account recent transactions with the ESÍ loan portfolio.

Comparative figures year end 2013 have been changed but figures for 30. June 2013 are not available.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 28 Amounts are in ISK millions

22. Fair value hierarchy, continued

Derivatives	Fair value	
30.6.2014	Assets	Liabilities
Forward exchange rate agreements, unlisted	92	17
Interest rate and exchange rate agreements, unlisted	368	87
Bond swap agreements, unlisted	19	54
Share swap agreements, unlisted	380	304
Options - purchased agreements, unlisted	439	20
Derivatives	1,298	482

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

30.6.2013		
Forward exchange rate agreements, unlisted	119	53
Interest rate and exchange rate agreements, unlisted	200	484
Bond swap agreements, unlisted	26	309
Share swap agreements, unlisted	31	9
Options - purchased agreements, unlisted	456	-
Derivatives	832	855

Arion Bank Interim Consolidated Financial Statements 30 June 2014 29 Amounts are in ISK millions

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 9,697 millions (31.12.2013: ISK 10,381 millions) to meet short positions on derivative contracts amounting to ISK 7,164 millions (31.12.2013: ISK 8,199 millions). Derivatives are similar to year end nettings. Due to the settlement of Drómi bond there is no netting of Deposits against Other assets at the end of the period.

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

24. Investments in associates

The Group's interest in its principal associates	30.6.2014	31.12.2013	30.6.2013
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%
Eik fasteignafélag hf., Sóltún 26, 105 Reykjavík, Iceland	44.1%	-	-
Farice ehf., Smáratorg 3, 201 Kópavogur, Iceland	39.3%	39.3%	43.5%
GO fjárfesting ehf., Undirheimar, 845 Flúðir, Iceland	-	30.0%	30.0%
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%	38.2%
SMI ehf., Smáratorg 3, 200 Kópavogur, Iceland	-	-	39.1%

Investments in associates			
Carrying amount at the beginning of the period	17,929	7,050	7,050
Additions	7,240	8,903	7,386
Dividend	(16)	(10)	-
Exchange difference	55	-	-
Share of profit (loss) of associates and reversal of impairment	(80)	1,986	(12)
Investment in associates	25,128	17,929	14,424

At the end of June the Bank sold all shares in the subsidiary Landfestar ehf. to Eik fasteignafélag hf. and in return the Bank received 44.1% share in Eik fasteignafélag hf.

On 27 June the Bank sold its shareholding in GO fjárfesting ehf. The sale had no effects on the Interm Consolidated Statement of Comprehensive income.

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.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 30 Amounts are in ISK millions

25. Tax assets and tax liabilities

	30.6.2014		31.12.2013		30.6.2013	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Current tax	-	4,580	-	3,698	-	3,022
Deferred tax	734	415	818	1,226	495	1,027
Tax assets and tax liabilities	734	4,995	818	4,924	495	4,049

26. Other assets

	30.6.2014	31.12.2013	30.6.2013
Non-current assets and disposal groups held for sale	4,329	10,046	10,086
Property and equipment	7,147	6,943	7,433
Accounts receivable	2,772	4,610	2,676
Prepaid expenses	1,007	690	1,283
Accrued income	727	619	563
Unsettled securities trading	1,197	255	757
Sundry assets	1,002	413	642
Other assets	18,181	23,576	23,440

Non-current assets and disposal groups held for sale			
Legal entities	-	300	302
Associates	-	5,457	5,820
Real estates	4,298	4,150	3,727
Other assets	31	139	237
Non-current assets and disposal groups held for sale	4,329	10,046	10,086

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

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. The financial effects from the sale is recognised in the Interim Consolidated Statement of Comprehensive Income. The shareholding in HB Grandi hf. as at 30 June is classified as listed shares designated at fair value among Financial instruments.

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

	30.6.2014	31.12.2013	30.6.2013
Liabilities associated with the legal entities held for sale	568	567	614

27. Other liabilities

Accounts payable	20,199	19,264	18,949
Provision for settled FX loans	3,363	4,524	7,600
Unsettled securities trading	1,930	144	7,787
Depositors' and investors' guarantee fund	2,877	2,886	2,874
Insurance claim	2,327	2,266	2,208
Withholding tax	1,916	1,552	450
Non-current liabilities and disposal groups held for sale	568	567	614
Bank levy	4,255	2,835	512
Sundry liabilities	9,797	9,629	9,030
Other liabilities	47,232	43,667	50,024

Arion Bank Interim Consolidated Financial Statements 30 June 2014 31 Amounts are in ISK millions

28. Borrowings

	Issued	Maturity	Maturity type	Terms of interest	30.6.2014	31.12.2013	30.6.2013
Covered bond in ISK	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,507	4,453	-
Covered bond in ISK	2012	2015	At maturity	Fixed, 6.50%	4,377	4,378	4,379
Covered bond in ISK	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	2,587	2,603	2,611
Covered bond in ISK	2008	2045	Amortizing	Fixed, CPI linked, 4.00%	21,426	21,361	21,249
Covered bond in ISK	2008	2031	Amortizing	Fixed, CPI linked, 4.00%	4,887	4,934	4,967
Covered bond in ISK	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	78,179	77,894	77,419
Covered bond in ISK	2005	2033	Amortizing	Fixed, CPI linked, 3.75%	17,758	17,873	17,941
Covered bonds					133,722	133,496	128,566
Senior unsecured bond in NOK	2013	2016	At maturity	Floating, NIBOR + 5.00%	9,100	9,356	9,991
Senior unsecured bond in ISK	2010	2018	Amortizing	Floating, REIBOR + 1.00%	2,364	2,662	2,929
Senior unsecured bond in EUR	2009	2018	Amortizing	Floating, EURIBOR +1.00%	1,926	2,202	2,460
Secured bond, Landfestar in ISK	2010	2044	Amortizing	Fixed, CPI linked, 4.70%	-	2,932	2,911
Bonds issued					13,390	17,152	18,291
Central Bank, secured, various curr. ..	2010	2022	At maturity	Floating, LIBOR + 3.00%	52,445	52,998	55,692
Other					326	922	551
Other loans					52,771	53,920	56,243
Borrowings					199,883	204,568	203,100

Book value of listed bonds was ISK 20,929 million (31.12.2013: ISK 23,770 million and 30.6.2013: ISK 9,901 million) at the end of the period. Market value of those bonds was ISK 21,022 million (31.12.2013: ISK 24,472 million and 30.6.2013: ISK 10,126 million).

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

At the end of June the Bank sold its subsidiary Landfestar ehf. as described in Note 3.

29. Subordinated liabilities

	Issued	Maturity	Maturity type	Terms of interest	30.6.2014	31.12.2013	30.6.2013
Tier II capital in various currencies	2010	2020	At maturity	Floating, LIBOR + 4.00%*	31,189	31,918	32,503
Subordinated liabilities					31,189	31,918	32,503

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

Arion Bank Interim Consolidated Financial Statements 30 June 2014 32 Amounts are in ISK millions

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

30. Pledged assets

Pledged assets against liabilities	30.6.2014	31.12.2013	30.6.2013
Assets, pledged as collateral against borrowings	233,726	258,762	257,358
Assets, pledged as collateral against loans from credit institutions and short positions	17,643	18,440	19,152
Pledged assets against liabilities	251,369	277,202	276,510

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 234 billion at the end of the period (31.12.2013: ISK 259 billion and 30.6.2013: ISK 257 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 186 billion at the end of the period (31.12.2013: ISK 190 billion and 30.6.2013: ISK 184 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.

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)	30.6.2014	Number (million)	31.12.2013	Number (million)	30.6.2013
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.

Other reserves	30.6.2014	31.12.2013	30.6.2013
Statutory reserve	1,637	1,637	1,637
Foreign currency translation reserve	(2)	-	1
Other reserves	1,635	1,637	1,638

OFF BALANCE SHEET INFORMATION

32. Obligations

Guarantees, unused overdraft and loan commitments the Group has granted its customers	30.6.2014	31.12.2013	30.6.2013
Guarantees	10,759	9,922	10,515
Unused overdrafts	39,300	37,371	36,990
Loan commitments	64,032	48,585	41,566

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

	30.6.2014	31.12.2013	30.6.2013
Assets under management	914,595	895,457	873,802
Assets under custody	1,412,956	1,490,888	1,374,997

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 Kortaþjónustan 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.

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.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 34 Amounts are in ISK millions

34. Legal matters, continued

In 2012 Kortaþjónustan hf. filed a suit against Valitor claiming damages for the alleged loss suffered by Kortaþjónustan 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 Kortaþjónustan 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 Kortaþjónustan 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. With a judgment of the District Court of Reykjavík on 20 December 2013 the Group was acquitted. The judgment 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.

Legal proceedings regarding damages

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., have filed two cases against the Bank claiming damages which they believe they suffered because of the conduct of the Bank's employees in connection with the bankruptcy of BM Vallá and its subsidiary, Fasteignafélagið Ártún ehf. In the two cases the plaintiffs claim in total damages in the amount of over four billion ISK plus further specified interests. The plaintiffs claim that the Bank caused them, as shareholders of BM Vallá and Fasteignafélagið Ártún, damage by not granting the companies financial restructuring and thereby forcing the companies into bankruptcy. The Bank believes more than less likely that it will be acquitted of the plaintiff's claims in both cases and has therefore made no provision.

ii) Other legal matters

Legal proceedings regarding CPI loans

In 2013 the Supreme Court of Iceland requested an Advisory Opinion from the EFTA Court in two separate cases regarding the interpretation of certain provisions of EC directives, in cases where the disagreement is whether the CPI-indexation of a consumer loan and its presentation is in accordance with certain provisions of Icelandic law on contracts and consumer loans. An Advisory Opinion in one of those cases will be published 28 August 2014. The other case was presented to the EFTA Court 11 June 2014 but it is not known when the Advisory Opinion will be published. It is difficult to predict the likely outcome in these cases. 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.

Act no 35/2014 on "adjustment" of CPI-indexed mortgage loans

In May 2014 the Icelandic Parliament passed a bill on adjustment of CPI-indexed mortgage loans, Act no 35/2014. The Act entails that all individuals who had indexed mortgage loans in 2008-2009 can apply to have their loans reduced by the amount corresponding to the difference between real inflation compensation and adjusted inflation compensation. The adjusted figure can be a maximum of ISK 4 million for each household and if borrowers have already had some of their mortgage written down, that amount will be subtracted from the figure being adjusted. When the amount has been adjusted, the current loans of the borrower in question will be reduced by that amount and moved into a special "adjusted loan". The Treasury will pay the adjusted part of the loan over the next four years, provided that funding is obtained from the Parliament each year. The applications period is to 1st of September 2014 and the extent of the adjustment will be clearer after that date. In Article 2 of the Act it is expected that the Treasury will reach an agreement with the Bank on the execution and settlement of the adjustment and that the aim should be not to create any profit or loss to the Bank. Negotiation between the concerned parties has not been concluded.

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 22.2 billion of which ISK 18.3 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 July 2014 the Bank sold 20% share in Eik fasteignafélag hf. After the sale the Bank holds 24% of issued shares of Eik fasteignafélag hf. The sale of this shareholding will have no effects on the Interim Statement of Comprehensive Income.

In July 2014 Arion bank repurchased structured long term inflation linked covered bonds, bearing 4.0% interest, for ISK 20 billion. The repurchase was financed by ISK 10 billion cash consideration and the remaining ISK 10 billion was financed by issuance of covered bonds in series ARION CB15, with maturity in May 2015.

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			Net
30.6.2014	Assets	Liabilities	balance
Shareholders with control over the Group	572	(67,950)	(67,378)
Board of Directors and key Management personnel	182	(67)	115
Associates and other related parties	49,320	(19,693)	29,627
Balances with related parties	50,074	(87,710)	(37,636)
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)
30.6.2013			
Shareholders with control over the Group	567	(62,918)	(62,351)
Shareholders with influence over the Group	-	(9,501)	(9,501)
Board of Directors and key Management personnel	174	(94)	80
Associates and other related parties	49,153	(22,077)	27,076
Balances with related parties	49,894	(94,590)	(44,696)

Through the ownership of ISFI the Group has a related party relationship with Landsbanki Íslands hf. Landsbanki Íslands hf. provides banking services to the Bank's subsidiary Valitor hf. The Group holds assets amounting to ISK 12,739 million (31.12.2013: ISK 12,185 million and 30.06.2013: ISK 11,416 million) by Landsbanki Íslands hf. and liabilities amounting to ISK 5,802 million (31.12.2013: ISK 7,234 million and 30.06.2013: ISK 5,278 million). Those amounts are not included in the table above.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 37 Amounts are in ISK millions

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

	30.6.2014	31.12.2013	30.6.2013
Cash and balances with Central Bank	17,361	37,999	25,717
Loans to credit institutions	139,838	102,307	109,732
Loans to customers	637,085	635,774	567,257
Financial instruments	69,147	63,731	134,102
Other assets with credit risk	5,527	5,746	4,459
Total on-balance sheet maximum exposure to credit risk	868,958	845,557	841,267

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

Financial guarantees	10,759	9,922	10,515
Unused overdrafts	39,300	37,371	36,990
Loan commitments	64,032	48,585	41,566
Total off-balance sheet maximum exposure to credit risk	114,091	95,878	89,071
Maximum exposure to credit risk	983,049	941,435	930,338

Arion Bank Interim Consolidated Financial Statements 30 June 2014 38 Amounts are in ISK millions

38. Credit risk, continued

Loans to customers specified by sectors	30.6.2014	31.12.2013	30.6.2013
Individuals	49.3%	48.8%	44.5%
Real estate activities and construction	14.4%	13.1%	13.1%
Fishing industry	10.6%	9.6%	11.2%
Information and communication technology	3.7%	3.8%	4.4%
Wholesale and retail trade	7.9%	8.7%	9.0%
Financial and insurance activities	4.5%	4.3%	4.5%
Industry, energy and manufacturing	3.7%	3.5%	4.0%
Transportation	0.9%	3.0%	3.5%
Services	3.2%	3.1%	3.3%
Public administration, human health and social activities	1.0%	1.4%	1.6%
Agriculture and forestry	0.8%	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

30.6.2014	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	507	276,306	57	593	277,463
Real estate activities and construction	1,284	62,973	12	1,047	65,316
Fishing industry	45	2,505	54,411	2,711	59,672
Information and communication technology	37	1,753	-	20,393	22,183
Wholesale and retail trade	2,941	13,259	5	28,581	44,786
Financial and insurance activities	10,711	714	-	7,426	18,851
Industry, energy and manufacturing	543	9,710	48	9,285	19,586
Transportation	67	560	55	3,441	4,123
Services	583	3,612	99	9,142	13,436
Public administration, human health and social activities	44	3,629	-	212	3,885
Agriculture and forestry	5	2,253	-	132	2,390
Financial instruments	3,601	-	-	-	3,601
Collateral held against different types of financial assets	20,368	377,274	54,687	82,963	535,292

Arion Bank Interim Consolidated Financial Statements 30 June 2014 39 Amounts are in ISK millions

38. Credit risk, continued

31.12.2013	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
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

30.6.2013	Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	595	213,165	48	805	214,613
Real estate activities and construction	815	51,641	5	415	52,876
Fishing industry	1,933	2,496	53,063	5,798	63,290
Information and communication technology	26	816	-	22,017	22,859
Wholesale and retail trade	2,357	14,092	7	26,040	42,496
Financial and insurance activities	17,462	1,588	-	966	20,016
Industry, energy and manufacturing	177	7,283	1	10,584	18,045
Transportation	69	523	51	4,020	4,663
Services	275	3,173	71	2,686	6,205
Public administration, human health and social activities	32	3,663	-	146	3,841
Agriculture and forestry	10	2,230	-	153	2,393
Financial instruments	1,779	-	-	68,987	70,766
Collateral held against different types of financial assets	25,530	300,670	53,246	142,617	522,063

Information on collateral held at subsidiaries is not available.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 40 Amounts are in ISK millions

38. Credit risk, continued

Credit quality by class of financial assets	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired*	Total
30.6.2014				
Cash and balances with Central Bank	17,361	-	-	17,361
Loans to credit institutions	139,838	-	-	139,838
Loans to customers				
Loans to corporates	300,525	11,575	10,947	323,047
Loans to individuals	272,704	31,143	10,191	314,038
Financial instruments	69,147	-	-	69,147
Other assets with credit risk	5,527	-	-	5,527
Credit quality of loans	805,102	42,718	21,138	868,958
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
30.6.2013				
Cash and balances with Central Bank	25,717	-	-	25,717
Loans to credit institutions	109,732	-	-	109,732
Loans to customers				
Loans to corporates	272,853	18,358	22,178	313,389
Loans to individuals	218,833	25,658	9,377	253,868
Financial instruments	134,102	-	-	134,102
Other assets with credit risk	4,459	-	-	4,459
Credit quality of loans	765,696	44,016	31,555	841,267

* 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.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 41 Amounts are in ISK millions

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 30 June 2013.

	Risk classification						
30.6.2014	1	2	3	4	5	Not rated	Total
Individuals	11,523	68,516	120,498	57,587	9,945	3,480	271,549
Real estate activities and construction	1,358	25,344	27,887	7,080	150	25,643	87,462
Fishing industry	30,918	15,621	6,895	7,145	846	2,205	63,630
Information and communication technology	18,681	857	3,497	239	27	114	23,415
Wholesale and retail trade	7,688	15,102	17,294	3,494	1,735	2,950	48,263
Financial and insurance activities	-	856	11,182	383	2,577	6,366	21,364
Industry, energy and manufacturing	4,199	4,750	11,337	1,007	407	1,817	23,517
Transportation	199	1,658	682	791	3	2,104	5,437
Services	318	10,005	3,411	1,324	43	3,080	18,181
Public sector	104	2,985	1,095	456	44	1,375	6,059
Agriculture and forestry	96	408	1,405	1,460	159	824	4,352
Neither past due nor impaired loans	75,084	146,102	205,183	80,966	15,936	49,958	573,229
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.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 42 Amounts are in ISK millions

38. Credit risk, continued

Past due but not impaired loans by class of loans	Up to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
30.6.2014					
Loans to corporates	7,884	936	387	2,368	11,575
Loans to individuals	13,988	4,297	2,143	10,715	31,143
Past due but not impaired loans	21,872	5,233	2,530	13,083	42,718
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
30.6.2013					
Loans to corporates	7,026	1,314	1,071	8,947	18,358
Loans to individuals	11,583	4,562	1,713	7,800	25,658
Past due but not impaired loans	18,609	5,876	2,784	16,747	44,016

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 643 million and other assets with the value of ISK 1 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			
30.6.2014	Impair-ment amount	Loan carrying amount	Impair-ment amount	Loan carrying amount	Total im-pairment amount	Total loan carrying amount
Individuals	10,424	20,413	105	307	10,529	20,720
Real estate activities and construction	1,893	3,796	-	-	1,893	3,796
Fishing industry	428	1,760	460	1,583	888	3,343
Information and communication technology	179	180	-	-	179	180
Wholesale and retail trade	1,264	1,713	-	-	1,264	1,713
Financial and insurance activities	7,555	12,573	-	-	7,555	12,573
Industry, energy and manufacturing	432	561	-	-	432	561
Transportation	20	24	-	-	20	24
Services	444	853	21	21	465	874
Public administration, human health and social activities	8	35	-	-	8	35
Agriculture and forestry	98	650	-	-	98	650
	22,745	42,558	586	1,911	23,331	44,469

Arion Bank Interim Consolidated Financial Statements 30 June 2014 43 Amounts are in ISK millions

38. Credit risk, continued

31.12.2013	Loans impaired due to borrower credit quality		Loans impaired due to FX-loan court rulings			
	Impairment amount	Loan carrying amount	Impairment amount	Loan carrying amount	Total impairment amount	Total loan carrying amount
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
	24,224	40,403	902	2,736	25,126	43,139

30.6.2013	Impairment amount	Loan carrying amount	Impairment amount	Loan carrying amount	Total impairment amount	Total loan carrying amount
Individuals	12,172	18,995	901	3,455	13,073	22,450
Real estate activities and construction	4,627	9,593	870	1,773	5,497	11,366
Fishing industry	2,400	4,486	1,717	4,134	4,117	8,620
Information and communication technology	42	55	48	56	90	111
Wholesale and retail trade	5,188	8,700	855	1,819	6,043	10,519
Financial and insurance activities	7,044	10,029	999	1,377	8,043	11,406
Industry, energy and manufacturing	693	1,408	77	223	770	1,631
Transportation	23	24	331	2,201	354	2,225
Services	1,219	1,625	204	394	1,423	2,019
Public administration, human health and social activities	29	38	102	138	131	176
Agriculture and forestry	732	1,142	87	250	819	1,392
	34,169	56,095	6,191	15,820	40,360	71,915

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 586 million and the liability to customers is ISK 3,363 million at 30 June 2014. Recalculation during the period resulted in an additional ISK 715 million impairment and ISK 1,031 million write-off or repayments.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 44 Amounts are in ISK millions

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 the capital base and the sum of all large exposures cannot exceed 400% of the capital base.

The largest exposure to a group of connected clients at the end of the period was ISK 28 billion (31.12.2013: ISK 29 billion and 30.6.2013: ISK 29 billion) before taking account of eligible collateral. The Group has five large exposures at the end of the period (31.12.2013: three exposures and 30.06.2013: four exposures) net of eligible collateral.

	30.6.2014		31.12.2013		30.6.2013	
no.	Gross	Net	Gross	Net	Gross	Net
Drómi*	-	-	-	-	42%	0%
1	16%	15%	17%	17%	18%	18%
2	15%	15%	16%	16%	16%	16%
3	11%	11%	<1%	<1%	<1%	<1%
4	11%	11%	-	-	-	-
5	10%	10%	12%	12%	14%	14%
<10%	<5%	<5%	10%	<10%	<10%	<10%
<10%	<2%	<2%	10%	<10%	11%	11%
Sum of large exposure gross and net > 10%	63%	62%	65%	45%	101%	59%

* 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 63% of the Group's capital base before collateral mitigation or 62% net of eligible collateral, which is well below the 400% legal maximum.

39. Market risk

Market risk is the current or prospective risk where 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 the Group's net present value of interest bearing assets and liabilities to changes in interest rates by currencies and interest fixing periods. Amounts are in ISK millions. 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.

30.6.2014	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	(87)	(722)	17	(269)	(1,385)
ISK, Non Indexed linked	(67)	(593)	(23)	(27)	(17)
EUR	63	(3)	-	-	-
Other	(39)	-	-	-	-

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)	-	-	-	-

39. Market risk, continued

30.6.2013	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	(18)	(804)	(93)	(2,066)	1,441
ISK, Non Indexed linked	(164)	(418)	(34)	(27)	(17)
EUR	75	(2)	-	-	-
Other	11	(4)	-	-	-

Interest rate risk in the trading book

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

30.6.2014	0-1Y	1-5Y	5-10Y	10-20Y	>20Y
ISK, CPI Indexed linked	2	(3)	(52)	(19)	43
ISK, Non Indexed linked	48	2	21	(70)	-
EUR	5	-	-	-	-
Other	3	-	-	-	-

31.12.2013					
ISK, CPI Indexed linked	(11)	2	(0)	(34)	(92)
ISK, Non Indexed linked	(1)	(8)	(61)	(92)	-
EUR	1	-	-	-	-
Other	1	-	-	-	-

30.6.2013					
ISK, CPI Indexed linked	-	(11)	(38)	(26)	(241)
ISK, Non Indexed linked	(37)	17	(26)	16	-
EUR	1	-	-	-	-
Other	(1)	-	-	-	-

Arion Bank Interim Consolidated Financial Statements 30 June 2014 46 Amounts are in ISK millions

39. Market risk, continued

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

30.6.2014 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	17,361	8,226	-	9,135	-	-	-
Loans to credit institutions	139,838	53,051	86,787	-	-	-	-
Loans to customers	637,085	6,535	44,320	99,122	208,930	278,178	-
Financial instruments	99,271	6,667	3,646	4,318	48,344	6,172	30,124
Derivatives - assets leg	*30,718*	*435*	*16,310*	*7,628*	*6,345*	-	-
Derivatives - liabilities leg	*(29,420)*	-	*(15,673)*	*(7,518)*	*(6,229)*	-	-
Investment property	6,020	-	-	-	-	-	6,020
Investments in associates	25,128	-	-	-	-	-	25,128
Intangible assets	5,375	-	-	-	-	-	5,375
Tax assets	734	-	-	-	734	-	-
Other assets	18,181	34	4,082	314	1,083	14	12,654
Assets 30.6.2014	948,993	74,513	138,835	112,889	259,091	284,364	79,301
Liabilities							
Due to credit institutions and Central Bank	29,277	19,379	4,063	5,784	51	-	-
Deposits	474,229	303,449	106,489	36,659	24,575	3,057	-
Financial liabilities at fair value	7,646	-	7,553	21	72	-	-
Derivatives - assets leg	*(9,665)*	-	*(8,092)*	*(794)*	*(779)*	-	-
Derivatives - liabilities leg	*10,148*	-	*8,482*	*815*	*851*	-	-
Short position bonds and derivatives	*3,930*	-	*3,930*	-	-	-	-
Short position bonds used for hedging	*3,234*	-	*3,234*	-	-	-	-
Tax liabilities	4,995	-	1,145	3,435	415	-	-
Other liabilities	47,232	383	30,994	3,966	4,097	191	7,601
Borrowings	199,882	-	1,279	7,157	23,201	168,245	-
Subordinated liabilities	31,189	-	-	-	-	31,189	-
Liabilities 30.6.2014	794,450	323,211	151,523	57,022	52,411	202,682	7,601
Off-balance sheet items							
Guarantees	10,759	4,037	1,897	2,539	1,212	1,074	-
Unused overdraft	39,300	487	9,423	17,563	11,768	59	-
Loan commitments	64,032	4,194	14,174	23,242	22,422	-	-
Off-balance sheet items	114,091	8,718	25,494	43,344	35,402	1,133	-
Net interest sensitivity gap	40,452	(257,416)	(38,182)	12,523	171,278	80,549	71,700

Arion Bank Interim Consolidated Financial Statements 30 June 2014 47 Amounts are in ISK millions

39. Market risk, continued

31.12.2013 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	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
Derivatives - assets leg	*23,567*	*447*	*8,008*	*4,094*	*11,018*	-	-
Derivatives - liabilities leg	*(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	-	-
Derivatives - assets leg	*(18,830)*	-	*(16,322)*	*(911)*	*(1,597)*	-	-
Derivatives - liabilities leg	*19,592*	-	*16,881*	*1,072*	*1,639*	-	-
Short position bonds and derivatives	*2,837*	-	*2,837*	-	-	-	-
Short position bonds used for hedging	*5,362*	-	*5,362*	-	-	-	-
Tax liabilities	4,924	-	924	2,774	1,226	-	-
Other liabilities	43,667	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	793,903	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	49,069	(185,733)	(89,857)	(15,655)	189,534	65,225	85,556

Arion Bank Interim Consolidated Financial Statements 30 June 2014 48 Amounts are in ISK millions

39. Market risk, continued

30.6.2013 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	25,717	16,613	-	9,104	-	-	-
Loans to credit institutions	109,732	81,085	28,401	-	246	-	-
Loans to customers	567,257	11,002	34,951	107,562	199,789	213,953	-
Financial instruments	153,771	6,696	185	16,032	69,680	41,510	19,668
Derivatives - assets leg	*12,813*	*455*	*10,235*	*13*	*2,110*		-
Derivatives - liabilities leg	*(11,980)*	-	*(10,057)*	*(13)*	*(1,910)*		-
Investment property	28,911	-	-	-	-	-	28,911
Investments in associates	14,424	-	-	-	-	-	14,424
Intangible assets	5,283	-	-	-	-	-	5,283
Tax assets	495	-	-	-	495	-	-
Other assets	23,440	60	2,605	843	936	14	18,982
Assets 30.6.2013	929,030	115,456	66,142	133,541	271,146	255,477	87,268
Liabilities							
Due to credit institutions and Central Bank	25,727	14,671	5,129	-	5,927	-	-
Deposits	466,834	240,009	156,349	34,679	27,525	8,272	-
Financial liabilities at fair value	10,005	-	9,407	183	415	-	-
Derivatives - assets leg	*(25,763)*	-	*(11,375)*	*(2,426)*	*(11,962)*	-	-
Derivatives - liabilities leg	*26,618*	-	*11,632*	*2,609*	*12,377*	-	-
Short position bonds and derivatives	*4,174*	-	*4,174*	-	-	-	-
Short position bonds used for hedging	*4,976*	-	*4,976*	-	-	-	-
Tax liabilities	4,049	-	756	2,266	1,027	-	-
Other liabilities	50,024	515	39,076	201	3,184	211	6,837
Borrowings	203,100	-	1,578	2,868	28,975	169,679	-
Subordinated liabilities	32,503	-	-	-	-	32,503	-
Liabilities 30.6.2013	792,242	255,195	212,295	40,197	67,053	210,665	6,837
Off-balance sheet items							
Guarantees	10,515	2,239	1,859	4,077	1,083	1,257	-
Unused overdraft	36,990	702	9,128	15,956	11,127	77	-
Loan commitments	41,566	2,928	17,342	11,923	9,373	-	-
Off-balance sheet items	89,071	5,869	28,329	31,956	21,583	1,334	-
Net interest sensitivity gap	47,717	(145,608)	(174,482)	61,388	182,510	43,478	80,431

Arion Bank Interim Consolidated Financial Statements 30 June 2014 49 Amounts are in ISK millions

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 295.3 billion (31.12.2013: ISK 291.6 billion and 30.6.2013: ISK 256.7 billion) and the total amount of indexed liabilities amount to ISK 218,0 billion (31.12.2013: ISK 223.7 billion and 30.6.2013: ISK 215.8 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 30 June 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.

30.6.2014 Assets, CPI indexed linked	Up to 1 year	1 to 5 years	Over 5 years	Total
Loans to customers	25,387	70,312	193,456	289,155
Financial instruments	1,799	-	-	1,799
Off-balance sheet position	1,936	2,436	-	4,372
Assets, CPI indexed linked	29,122	72,748	193,456	295,326
Liabilities, CPI indexed linked				
Deposits	65,778	20,280	2,111	88,169
Borrowings	2,442	11,061	116,337	129,840
Liabilities, CPI indexed linked	68,220	31,341	118,448	218,009
Net on-balance sheet position	(41,034)	38,971	75,008	72,945
Net off-balance sheet position	1,936	2,436	-	4,372
CPI Balance 30.6.2014	(39,098)	41,407	75,008	77,317
CPI Balance 31.12.2013	(51,197)	46,693	72,380	67,876
CPI Balance 30.6.2013	(20,451)	32,433	28,925	40,907

Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Group is exposed to currency risk through a currency mismatch between assets and liabilities. ISK denominated deposits are a primary source of funding for the Group 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.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 50 Amounts are in ISK millions

39. Market risk, continued

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

30.6.2014

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash and balances with Central Bank	14,481	565	1,205	421	301	123	265	17,361
Loans to credit institutions	51,824	20,895	15,684	2,904	15,233	9,129	24,169	139,838
Loans to customers	533,916	44,275	22,407	7,170	6,037	4,727	18,553	637,085
Financial instruments	71,098	15,642	8,694	37	1,936	2	1,862	99,271
Investment property	6,020	-	-	-	-	-	-	6,020
Investments in associates	19,397	-	-	-	5,731	-	-	25,128
Intangible assets	5,375	-	-	-	-	-	-	5,375
Tax assets	734	-	-	-	-	-	-	734
Other assets	17,083	513	109	-	56	-	420	18,181
Assets 30.6.2014	719,928	81,890	48,099	10,532	29,294	13,981	45,269	948,993

Liabilities and equity	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Due to credit inst. and Central Bank ..	22,364	3,474	599	1,018	4	1,817	1	29,277
Deposits	385,469	31,869	14,970	1,056	11,639	1,690	27,536	474,229
Financial liabilities at fair value	7,628	1	17	-	-	-	-	7,646
Tax liabilities	4,995	-	-	-	-	-	-	4,995
Other liabilities	39,122	1,983	2,749	82	570	397	2,329	47,232
Borrowings	136,436	1,918	19,847	14,568	8,523	9,490	9,100	199,882
Subordinated liabilities	-	25,103	2,252	-	3,834	-	-	31,189
Equity	154,543	-	-	-	-	-	-	154,543
Liabilities and equity 30.6.2014	750,557	64,348	40,434	16,724	24,570	13,394	38,966	948,993

	ISK	EUR	USD	CHF	GBP	JPY	Other
Net on-balance sheet position	(30,629)	17,542	7,665	(6,192)	4,724	587	6,303
Net off-balance sheet position	14,374	(11,931)	(4,690)	6,757	-	-	(4,510)
Net position 30.6.2014	(16,255)	5,611	2,975	565	4,724	587	1,793

31.12.2013

	ISK	EUR	USD	CHF	GBP	JPY	Other
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

30.6.2013

	ISK	EUR	USD	CHF	GBP	JPY	Other
Net on-balance sheet position	(37,972)	31,676	3,141	(1,915)	(3,243)	2,604	5,709
Net off-balance sheet position	13,716	(15,062)	2,179	747	5,423	(972)	(6,031)
Net position 30.6.2013	(24,256)	16,614	5,320	(1,168)	2,180	1,632	(322)

Arion Bank Interim Consolidated Financial Statements 30 June 2014 51 Amounts are in ISK millions

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	30.6.2014	31.12.2013
FX	226%	274%
Total	184%	123%

No comparison is available for 30 June 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.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 52 Amounts are in ISK millions

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

30.6.2014	Deposits maturing within 30 days				Term	Total
	Less Stable	Weight (%)	Stable	Weight (%)	deposits*	deposits
Retail	78,211	10%	33,371	5%	55,422	167,004
SME	35,396	10%	3,722	5%	6,615	45,733
Operational relationship	1,124	25%	-	5%	3	1,127
Corporations	44,550	40%	826	20%	15,010	60,386
Sovereigns, central-banks and PSE	21,989	40%	-	-	5,149	27,138
Financial entities being wound up	23,665	100%	-	-	62,893	86,558
Pension funds	38,522	100%	-	-	20,847	59,369
Domestic financial entities	28,536	100%	-	-	13,615	42,151
Foreign financial entities	5,070	100%	-	-	511	5,581
Other foreign parties	1,670	100%	639	25%	363	2,672
Total	278,733		38,558		180,428	497,719

31.12.2013**	Deposits maturing within 30 days				Term	Total
	Less Stable	Weight (%)	Stable	Weight (%)	deposits*	deposits
Retail	79,688	10%	33,971	5%	50,732	164,391
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
Pension funds	46,463	100%	-	-	20,430	66,893
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

* Here term deposits refer to deposits with maturities greater than 30 days.

** Changes in LCR rules in Q2 resulted in deposit pension funds being re-classified as retail deposits. Here, 31.12.2013 figures have been revised accordingly to show comparable data. The official LCR figures for 31.12.2013 of 274% (FX) and 123% (Total) have not been adjusted accordingly.

Arion Bank Interim Consolidated Financial Statements 30 June 2014 53 Amounts are in ISK millions

41. Capital management

The capital base at 30 June 2014 amounts to ISK 179,413 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 25.6%, exceeding the minimum legal requirement of 8%.

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

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

Group's RWA calculations

Capital Base	30.6.2014	31.12.2013	30.6.2013
Share capital and share premium	75,861	75,861	75,861
Other reserves	1,635	1,637	1,638
Retained earnings	72,043	62,591	55,709
Non-controlling interests	5,004	4,858	3,580
Total Equity	154,543	144,947	136,788
Intangible assets	(5,375)	(5,383)	(5,283)
Tax assets	(734)	(818)	(495)
Other statutory deductions	(110)	(119)	(136)
Total Tier 1 capital	148,324	138,627	130,874
Subordinated liabilities	31,189	31,918	32,503
Other statutory deductions	(100)	(106)	(125)
Total Capital base	179,413	170,439	163,252
Risk weighted assets			
Credit risk	604,993	608,029	563,702
Market risk FX	16,317	31,703	28,472
Market risk other	4,362	4,993	6,339
Operational risk	76,097	76,097	72,329
Total risk weighted assets	701,769	720,822	670,842
Tier 1 ratio	21.1%	19.2%	19.5%
Capital adequacy ratio	25.6%	23.6%	24.3%

Arion Bank Interim Consolidated Financial Statements 30 June 2014 54 Amounts are in ISK millions

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.

42. 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.