# Consolidated Financial Statements

– for the year 2014

Arion Bank

# CONTENTS

# ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

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

**Outlook**

The outlook for the Icelandic economy is very positive.  Economic growth, which slowed somewhat in the latter half of 2014, is expected to resume the 3% level in 2015 and beyond. Unemployment has levelled at around 3.5%. Investment is expected to gradually increase, especially business investment, and inflation, which currently stands at around 1% is expected to gradually increase to 3% in the medium term. Housing prices have been rising slowly but the rate of increase is likely to slow down. The uncertainty regarding the economy mainly has to do with the expected lifting of the capital controls currently in place. The Government and the Central Bank, along with local and international advisors, are preparing a plan for the lifting of the controls. The increased foreign exchange reserves of the Central Bank, the successful re-entry of the Bank into the international capital markets and the improved terms of trade for Iceland should contribute to a favorable outcome.

Arion Bank is a leading universal bank on the Icelandic market and has as such actively contributed to the recovery of the Icelandic economy. The Bank further strengthens it's franchise through strategic subsidiaries, which all are leading in their respective businesses. OKKAR líf is a leading life insurance company in the Icelandic market, Stefnir is the largest fund management entity in the country and Valitor is the largest card processing company. The Bank enjoys a strong position in all its business segments, i.e. Asset Management, Corporate Banking, Investment Banking and Retail Banking, providing a platform for continued growth in the medium term. In recent years Arion Bank has systematically reduced risk in the Bank's loan portfolio by increasing the proportion of loans to individuals, most of which have been first lien mortgages. Loans are now evenly split between individuals and corporate. Furthermore, the distribution of the corporate loan book reflects the relative size of sectors in the Icelandic economy. Work on restructuring the loan portfolio taken over when the Bank was established has largely been concluded. The quality of the loan portfolio has continued to improve and the ratio of problem loans is now close to levels seen at banks in the other Nordic countries, especially when measured as a proportion of equity.

The Bank has strategically positioned itself as  a market leader in Iceland in loans to new businesses in the export sector, health care and energy-intensive industries. The Bank aims to further strainghten its position in these areas. The Bank has also augmented its international loan portfolio by lending to businesses involved in fish-processing and the fisheries in neighboring countries, thus supporting growth while at the same time reducing geographical risk.

The main focus in the near term will be on further strengthening the Bank’s core business and reducing operating expenses by continued streamlining in the support units and in the branch network. The Bank is on the forefront in digital banking in Iceland, a trend which is fundamentally changing retail banking. The Bank has successfully sold a number of shareholdings acquired by the Bank while restructuring the finances of some of its corporate clients. The Bank has, furthermore, actively managed a small number of such holdings and now aims to concentrate on selling such remaining shareholdings. The Bank is financially robust as demonstrated by the new Leverage Ratio of 15.4% (see Note 44) which the Bank will disclose going forward.  The Bank’s capital strength, the positive outlook assigned by S&P and planned new funding enables Arion Bank to provide financial backing for its retail and corporate customers as their business expands, both domestically as well as internationally.

**Operations during the year**

Net earnings amounted to ISK 28,594 million for the year ended 31 December 2014. The Group’s equity amounted to ISK 162,212 million at year end. The capital adequacy ratio of the Group, calculated according to the Financial Undertakings Act, was 26.3% and Tier 1 capital was 21.8%, which comfortably meets the requirements set by law and the Financial Supervisory Authority ("FME"). The liquidity position was also strong at year end and well above the regulatory minimum.

The Board proposes that 45% of the annual net earnings be paid out as dividends in 2015 in respect of 2014. The Group performed well during the year and operations were characterized by greater stability. Net interest income remained stable between years despite the fact that the ISK strengthened and inflation was lower than in the previous year. Net commission income increased substantially between years, or by 19%, the increase generated across the Bank. The net valuation change on loans was positive by ISK 2.1 billion, which bears witness to the successful restructuring of the loan portfolio. Net financial income totals ISK 7.3 billion, a significant proportion of this relating to the holding in HB Grandi hf. following the company's listing on NASDAQ Iceland. The Bank's equities and bond portfolios also performed well during the year.

# ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The sale and listing of HB Grandi hf. had a significant impact on the Group's results. In April the Bank sold an 18.8% share in the company when it was listed on NASDAQ Iceland. Before the sale the Bank owned 31% of the company and this asset was classified as an asset held for sale. Realized gains on the sale totaled ISK 6.3 billion and this is recognized as disposal groups and unrealized gains are recognized as financial income. The Bank's holding in HB Grandi hf. at the end of the year is recognized as financial instruments in the balance sheet.

The structure of the Group's assets has changed little since last year. Loans to customers remain virtually unchanged between years, with the significant amount of new loans issued being counterbalanced by the substantial amount of older loans paid off. In June the Bank sold its subsidiary Landfestar hf. (commercial real estate company) to Eik fasteignafélag ehf., another commercial real estate company and subsequently acquired a 44% share in Eik fasteignafélag ehf. In the second half of the year the Bank sold shares in Eik fasteignafélag ehf and remains with a 14% shareholding which is recognized as financial instruments at the end of the year. The main effect on the Group of the sale of Landfestar hf. was a decrease in investment property. At the end of the year Arion Bank's subsidiary Valitor Holding hf. acquired the Danish company AltaPay A/S. The aim of the acquisition was to support Valitor's growing business in the Nordic region. This mainly involves intangible assets, i.e. goodwill, business relationships and software, and a total of ISK 4,217 billion is capitalized in this respect. In May 2014 Arion Bank paid ISK 7,811 million in dividends to shareholders.

During the year the Bank continued to diversify the Bank's funding. The Bank issued indexed and fixed rate covered bonds in the domestic market and at the end of the year began to issue 6-month Commercial Paper to bring further diversification to the funding profile. The Bank's objective is to issue a benchmark bond on the international capital market subject to market conditions. The Bank established a Euro Medium Term Note (EMTN) programme last spring which gives the Bank the opportunity to issue bonds on the international market at short notice. In January 2014 Standard & Poor's assigned Arion Bank a credit rating of BB+ with a stable outlook which is just one notch below the rating of the Icelandic government. The outlook was changed to positive in the autumn in line with Standard & Poor's change in outlook on the Icelandic sovereign rating.

The Bank has invested heavily in the introduction of a lean management system it calls A Plus. The system is designed to ensure efficiency throughout the Bank with the ultimate goal of strengthening relationships and improving the level of service to customers. By the end of 2015 it is expected that A Plus will have been implemented through most of the Bank and it will enhance the Bank's ability to compete for years to come.

At the end of the year Arion Bank hf. and Valitor hf., as well as the other two main banks and the other main payment card company, reached a settlement with the Icelandic Competition Authority on the arrangement of a payment card system which was introduced 30 years ago. The issue revolves around changes to the way interchange fees, which acquirers pay to the banks, are determined and also a new arrangement for the conferring of award points. Under the settlement the Bank and Valitor agreed to abide by certain conditions in their operations. A fine of ISK 670 million was imposed on the Group and changes to the ownership structure of Icelandic payment card companies were also made. Arion Bank acquired Landsbankinn's 38% share in Valitor Holding hf. and Arion Bank now owns 98.8% in the company. With the changes introduced now to interchange fees, award points and the ownership structure of card companies a settlement has been reached on the structure of the payment card system in Iceland.

The Group had 1,139 full-time equivalent positions at the end of the year, compared with 1,145 at the end of 2013; 865 of these positions were at Arion Bank, compared with 911 at the end of 2013.

**Group 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 Icelandic State Financial Investments on behalf of the Icelandic government.

The Board of Directors has seven members, four of whom are women. The ratio of men to women is therefore in compliance with the law which states that companies with more than 50 people should ensure that the ratio of either sex on the board of directors should not be less than 40%. Six Directors are appointed by Kaupskil hf. and one by Icelandic State Financial Investments.

# ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

**Risk management**

The Group faces various risks arising from its day-to-day operations as a financial institution. 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. The Group's risk management, its structure and main risk factors are described in the notes, starting at Note 40.

**Corporate governance**

The Board of Directors of Arion Bank is committed to good corporate governance and endeavors to promote responsible behavior and corporate culture within Arion Bank for the benefit of all the Bank's stakeholders. Arion Bank has to this end devised a corporate governance statement which is designed to help foster open and honest communication between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public.

The Board of Directors is the supreme authority in the affairs of the Bank between shareholders' meetings. The Board tends to those operations of the Bank which are not considered part of the day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. One of the main duties of the Board of Directors is to appoint a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The CEO hires the Executive Management. There are three Board subcommittees: the Board Audit and Risk Committee, the Board Credit Committee and the Board Remuneration Committee. The committee members are all Directors and there is one expert member on the Board Audit and Risk Committee.

One of the main roles of the Board is to oversee the implementation of the Bank's strategy, financial affairs and accounting and to ensure that appropriate internal controls are in place. The Board ensures that the Bank has active Internal Audit, Compliance and Risk Management departments. The Internal Auditor is appointed by the Board of Directors and works independently of other departments of the Bank. The Internal Auditor provides independent and objective assurance and advice designed to add value and improve the Bank's operations. The Compliance Officer, who reports directly to the CEO, works independently within the Bank in accordance with a charter from the Board of Directors. The chief role of Compliance is to ensure that the Bank and its employees fulfil their obligations under the Securities Transactions Act and the Act on Measures against Money Laundering and Terrorist Financing.

The Corporate Governance Statement of Arion Bank hf. is based on legislation, regulations and recognized guidelines in force when the Bank's annual accounts are approved by Board of Directors. This statement is prepared in accordance with Article 19 (3) of the Financial Undertakings Act No. 161/2002 and Guidelines on Corporate Governance, 4th edition, issued by the Icelandic Chamber of Commerce, NASDAQ Iceland and the Confederation of Icelandic Employers in March 2012. Arion Bank's corporate governance policy can be found on its website: www.arionbanki.is.

# ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

**Endorsement of the Board of Directors and the Chief Executive Officer**

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2014 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions, where applicable, to the extent that they are not inconsistent with the requirements of IFRS as adopted by the EU.

It is our opinion that the Consolidated Financial Statements give a true and fair view of the financial performance of the Group for the year 2014 and its financial position as at 31 December 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 describe the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the Consolidated Financial Statements of Arion Bank for the year 2014 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 24 February 2015

**Board of Directors**

Monica Caneman
Chairman

Benedikt Olgeirsson
Guðrún Johnsen
Måns Höglund

Brynjólfur Bjarnason
Kirstín Þ. Flygenring
Þóra Hallgrímsdóttir

**Chief Executive Officer**

Höskuldur H. Ólafsson

# INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Shareholders of Arion Bank.

We have audited the accompanying Consolidated Financial Statements of Arion Bank and its subsidiaries ("the Group"), which comprise the Consolidated Statement of Comprehensive Income, Consolidated Statement of Financial Position as at 31 December 2014, Consolidated Statement of Changes in Equity and Consolidated Statement of Cash Flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

**Management's Responsibility for the Consolidated Financial Statements**
Management is responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions, where applicable, and for such internal control as management determines is necessary to enable the preparation of Consolidated Financial Statements that are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**
Our responsibility is to express an opinion on these Consolidated Financial Statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Consolidated Financial Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Consolidated Financial Statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the Consolidated Financial Statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the Consolidated Financial Statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Consolidated Financial Statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**
In our opinion, the Consolidated Financial Statements give a true and fair view of the financial position of the Group as at 31 December 2014, of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with the International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions, where applicable.

**Confirmation of Endorsement and Statement by the Board of Directors and the CEO**
Pursuant to the requirement of Paragraph 2 Article 104 of the Icelandic Financial Statement Act no. 3/2006, we confirm to the best of our knowledge that the accompanying Endorsement and Statement by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statements Act that is not disclosed elsewhere in the Consolidated Financial Statements.

Reykjavík, 24 February 2015

**Ernst & Young ehf.**

Margrét Pétursdóttir

Margrét Pétursdóttir, Partner

# CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR 2014

| | Notes | 2014 | 2013 |
|---|---|---|---|
| Interest income | | 50,872 | 56,867 |
| Interest expense | | (26,652) | (33,067) |
| **Net interest income** | 6 | 24,220 | 23,800 |
| Fee and commission income | | 18,447 | 16,443 |
| Fee and commission expense | | (5,138) | (5,220) |
| **Net fee and commission income** | 7 | 13,309 | 11,223 |
| Net financial income | 8 | 7,290 | 1,675 |
| Other operating income | 9 | 9,171 | 7,650 |
| **Operating income** | | 53,990 | 44,348 |
| Salaries and related expense | 10 | (13,979) | (13,537) |
| Other operating expense | 11 | (13,063) | (11,858) |
| Net impairment | 12 | 2,135 | (680) |
| **Earnings before tax** | | 29,083 | 18,273 |
| Income tax expense | 13 | (4,679) | (3,143) |
| Bank levy | 14 | (2,643) | (2,872) |
| **Net earnings from continuing operations** | | 21,761 | 12,258 |
| Net gain from discontinued operations, net of tax | 15 | 6,833 | 399 |
| **Net earnings** | | 28,594 | 12,657 |
| ***Attributable to*** | | | |
| Shareholders of Arion Bank | | 28,465 | 13,019 |
| Non-controlling interest | | 129 | (362) |
| **Net earnings** | | 28,594 | 12,657 |
| **Other comprehensive income** | | | |
| Exchange difference on translating foreign subsidiaries | 32 | (5) | (2) |
| **Total comprehensive income for the year** | | 28,589 | 12,655 |
| **Earnings per share from continuing operations** | | | |
| Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK) | 16 | 10.82 | 6.31 |

*The notes on pages 13 to 77 are an integral part of these Financial Statements.*

*Arion Bank Consolidated Financial Statements 2014* 8 *Amounts are in ISK millions*

# CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2014

| Assets | Notes | 2014 | 2013 |
|---|---|---|---|
| Cash and balances with Central Bank | 17 | 21,063 | 37,999 |
| Loans to credit institutions | 18 | 108,792 | 102,307 |
| Loans to customers | 19 | 647,508 | 635,774 |
| Financial instruments | 20-22 | 101,828 | 86,541 |
| Investment property | 22 | 6,842 | 28,523 |
| Investments in associates | 24 | 21,966 | 17,929 |
| Intangible assets | 25 | 9,596 | 5,383 |
| Tax assets | 26 | 655 | 818 |
| Other assets | 27 | 15,486 | 23,576 |
| **Total Assets** | | 933,736 | 938,850 |
| **Liabilities** | | | |
| Due to credit institutions and Central Bank | 21 | 22,876 | 28,000 |
| Deposits | 21 | 454,973 | 471,866 |
| Financial liabilities at fair value | 21 | 9,143 | 8,960 |
| Tax liabilities | 26 | 5,123 | 4,924 |
| Other liabilities | 28 | 47,190 | 43,667 |
| Borrowings | 21,29 | 200,580 | 204,568 |
| Subordinated liabilities | 21,30 | 31,639 | 31,918 |
| **Total Liabilities** | | 771,524 | 793,903 |
| **Equity** | | | |
| Share capital and share premium | 32 | 75,861 | 75,861 |
| Other reserves | 32 | 1,632 | 1,637 |
| Retained earnings | | 83,218 | 62,591 |
| **Total Shareholders' Equity** | | 160,711 | 140,089 |
| Non-controlling interest | | 1,501 | 4,858 |
| **Total Equity** | | 162,212 | 144,947 |
| **Total Liabilities and Equity** | | 933,736 | 938,850 |

*The notes on pages 13 to 77 are an integral part of these Financial Statements.*

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# CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR 2014

| | Share capital and share premium | Other reserves | Retained earnings | **Total Share-holders' equity** | Non-controlling interest | **Total equity** |
|---|---|---|---|---|---|---|
| **2014** | | | | | | |
| Equity 1 January 2014 | 75,861 | 1,637 | 62,591 | 140,089 | 4,858 | 144,947 |
| Total comprehensive income for the year | | (5) | 28,465 | 28,460 | 129 | 28,589 |
| Dividend paid | | | (7,811) | (7,811) | | (7,811) |
| Increase in non-controlling interests due to purchase of subsidiary | | | | | 10 | 10 |
| Decrease due to purchase of non-controlling interest | | | (27) | (27) | (3,496) | (3,523) |
| **Equity 31 December 2014** | 75,861 | 1,632 | 83,218 | 160,711 | 1,501 | 162,212 |
| **2013** | | | | | | |
| Equity 1 January 2013 | 75,861 | 1,639 | 49,572 | 127,072 | 3,806 | 130,878 |
| Total comprehensive income for the year | | (2) | 13,019 | 13,017 | (362) | 12,655 |
| Increase in non-controlling interests during the year | | | | | 1,533 | 1,533 |
| Decrease of non-controlling interest due to dividend payment from subsidiary | | | | | (119) | (119) |
| **Equity 31 December 2013** | 75,861 | 1,637 | 62,591 | 140,089 | 4,858 | 144,947 |

*The notes on pages 13 to 77 are an integral part of these Financial Statements.*

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# CONSOLIDATED STATEMENT OF CASH FLOWS
# FOR THE YEAR 2014

| | 2014 | 2013 |
|---|---|---|
| **Operating activities** | | |
| Net earnings | 28,594 | 12,657 |
| Non-cash items included in net earnings and other adjustments | (36,549) | (20,930) |
| Changes in operating assets and liabilities | (4,608) | (3,728) |
| Interest received | 45,020 | 46,141 |
| Interest paid* | (23,403) | (26,683) |
| Dividend received | 875 | 46 |
| Income tax and Bank levy paid | (6,545) | (2,149) |
| Net cash from operating activities | 3,384 | 5,354 |
| **Investing activities** | | |
| Net investment in associated companies | 4,496 | (40) |
| Acqusition of subsidiary | (3,100) | - |
| Net investment in property and equipment and intangible assets | (1,906) | (2,837) |
| Net cash used in investing activities | (510) | (2,877) |
| **Financing activities** | | |
| Dividend paid to shareholders of Arion Bank | (7,811) | - |
| Dividend paid to non-controlling interest | - | (119) |
| Acquisition of non-controlling interest | (3,516) | - |
| Net cash used in financing activities | (11,327) | (119) |
| Net (decrease) increase in cash and cash equivalents | (8,453) | 2,358 |
| Cash and cash equivalents at beginning of the year | 99,683 | 105,173 |
| Cash and cash equivalents acquired through business combinations | 9 | - |
| Effect of exchange rate changes on cash and cash equivalents | 476 | (7,848) |
| **Cash and cash equivalents at the end of the year** | 91,715 | 99,683 |
| **Non-cash investing and financing transactions** | | |
| Assets acquired through foreclosure on collateral from customers with view to resale | 1,617 | 9,017 |
| Settlement of loans through foreclosure on collateral from customers with view to resale | (1,617) | (9,017) |
| **Changes due to the sale of Landfestar** | | |
| Changes in investment property | (23,131) | - |
| Changes in investment in associates | 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 year.

*The notes on pages 13 to 77 are an integral part of these Financial Statements.*

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# NOTES TO THE CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR 2014

| | 2014 | 2013 |
|---|---|---|
| **Non-cash items included in net earnings and other adjustments** | | |
| Net interest income | (24,220) | (23,799) |
| Net impairment | (2,135) | 680 |
| Income tax expense | 4,679 | 3,143 |
| Bank levy | 2,643 | 2,872 |
| Net foreign exchange (gain) loss | (813) | 1,766 |
| Net gain on financial instruments | (5,602) | (3,395) |
| Depreciation and amortisation | 2,034 | 1,788 |
| Share of profit of associates and fair value change | (3,498) | (1,986) |
| Investment property, fair value change | (2,026) | (1,219) |
| Net gain on disposal of assets other than held for sale | (482) | (9) |
| Net gain on disposal of investment property | (296) | (372) |
| Net gain from discontinued operations, net of tax | (6,833) | (399) |
| **Non-cash items included in net earnings and other adjustments** | (36,549) | (20,930) |
| **Changes in operating assets and liabilities** | | |
| Mandatory reserve with Central Bank | 52 | (250) |
| Loans to credit institutions, excluding bank accounts | 1,251 | (15,225) |
| Loans to customers | (7,488) | (31,027) |
| Financial instruments and financial liabilities at fair value | (4,626) | (14,373) |
| Investment property | 3,425 | 2,132 |
| Other assets | 14,013 | 3,363 |
| Due to credit institutions and Central Bank | (5,094) | (4,569) |
| Deposits | (16,361) | 44,551 |
| Borrowings | 6,785 | 11,633 |
| Other liabilities | 3,435 | 37 |
| **Changes in operating assets and liabilities** | (4,608) | (3,728) |
| **Cash and cash equivalents comprises** | | |
| Cash in hand and demand deposits | 21,063 | 37,999 |
| Due from credit institutions | 79,587 | 70,671 |
| Mandatory reserve with Central Bank | (8,935) | (8,987) |
| **Cash and cash equivalents at the end of the year** | 91,715 | 99,683 |

*The notes on pages 13 to 77 are an integral part of these Financial Statements.*

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# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
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# NOTES TO THE 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 Financial Statements for the year ended 31 December 2014 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

### 1. Basis of preparation

*Statement of compliance*

The Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions, where applicable, to the extent that they are not inconsistent with the requirements of IFRS as adopted by the EU.

The Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 24 February 2015.

*Basis of measurement*

The 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 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 year the exchange rate of the ISK against the USD was 127.46 and 154.28 for the EUR (2013: USD 115.09 and EUR 158.49).

### 2. Significant accounting estimates and judgements in applying accounting policies

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

Estimates and underlying assumptions are reviewed on an ongoing 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; and
- investments in associates.

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

### 3. The Group

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

| | Operating activity | Currency | Equity interest 2014 | 2013 |
|---|---|---|---|---|
| AFL - sparisjóður, Aðalgata 34, Siglufjörður, Iceland | Retail banking | ISK | 99.3% | 99.3% |
| Arion Bank Mortgages Institutional Investor Fund, Borgartún 19, Reykjavík, Iceland | Retail banking | ISK | 100.0% | 100.0% |
| BG12 slhf., Katrínartún 2, Reykjavík, Iceland | Holding company | ISK | 62.0% | 62.0% |
| EAB 1 ehf., Borgartún 19, Reykjavík, Iceland | Holding company | ISK | 100.0% | 100.0% |
| Eignabjarg ehf., Borgartún 19, Reykjavík, Iceland | Holding company | ISK | 100.0% | 100.0% |
| Eignarhaldsfélagið Landey ehf., Grófinni 1, Reykjavík, Iceland | Real estate | ISK | 100.0% | 100.0% |
| Landfestar ehf., Álfheimar 74, Reykjavík, Iceland | Real estate | ISK | - | 100.0% |
| Okkar líftryggingar hf., Sóltún 26, Reykjavík, Iceland | Life insurance | ISK | 100.0% | 100.0% |
| Stefnir hf., Borgartún 19, Reykjavík, Iceland | Asset management | ISK | 100.0% | 100.0% |
| Valitor Holding hf., Dalshraun 3, Hafnarfjörður, Iceland | Payment solutions | ISK | 98.8% | 60.8% |

At the end of June 2014 the Bank sold its subsidiary Landfestar ehf. to Eik fasteignafélag hf. The main effects on the Statement of Financial Position was a decrease in Investment property and an increase in Investments in associates as the Bank received 44.1% shareholding in Eik fasteignafélag hf. in return for the shareholding in Landfestar ehf. In the second half of 2014 the Bank reduced its shareholding in Eik fasteignafélag hf. as further described in Note 24. The total effects of Landfestar ehf.'s operation, excluding fair valuation changes, on the Statement of Comprehensive Income is ISK 409 million net income in the first half of 2014 and ISK 1.042 million in 2013.

In December 2014 the Bank increased its shareholding in Valitor Holding hf. when it purchased 38.0% shareholding from the non-controlling party Landsbankinn hf. At year end the Bank's shareholding in Valitor Holding hf. is 98.8%.

In December 2014 Valitor Holding hf. purchased group of undertakings in Denmark. The main effect on the Statement of Financial position is an increase in Intangible assets as further described in Note 25. The effects on the Statement of Financial Position is as follows:

| | |
|---|---|
| Loans to credit institutions | (1,992) |
| Financial instruments | (1,100) |
| Intangible assets | 4,217 |
| Tax liabilities | (458) |
| Other liabilities | (667) |
| | - |

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# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## OPERATING SEGMENT REPORTING

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

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

**Operating segments**

The Group comprises six main operating segments:

**Asset Management** 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. Asset Management also administers pension funds. 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.

**Corporate Banking** provides comprehensive financial services and customized solutions to larger corporate clients in Iceland. Corporate Banking provides a full range of conventional lending products, deposit accounts as well as value added electronic corporate solutions to meet the needs of each customer.

**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.

**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 25 branches all around Iceland are over 100,000.

**Treasury** is responsible for the Bank’s liquidity management as well as currency and interest rate management for the Bank. 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., BG12 slhf., EAB 1 ehf. and other smaller entities of the Group.

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

## 4. Operating segments

| 2014 | Asset Manage-ment and Stefnir | Corporate Banking | Investment Banking | Retail Banking | Treasury | Other divisions and Sub-sidiaries | Head-quarters and Elimination | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 449 | 7,001 | 135 | 12,612 | 4,871 | 191 | (1,039) | 24,220 |
| Other income | 3,695 | 2,480 | 7,505 | 2,665 | (417) | 11,895 | 1,947 | 29,770 |
| **Operating income** | 4,144 | 9,481 | 7,640 | 15,277 | 4,454 | 12,086 | 908 | 53,990 |
| Operating expense | (1,409) | (570) | (722) | (6,047) | (268) | (5,226) | (12,800) | (27,042) |
| Net impairment | - | 3,392 | (497) | (1,037) | 295 | (45) | 27 | 2,135 |
| **Earnings before tax** | 2,735 | 12,303 | 6,421 | 8,193 | 4,481 | 6,815 | (11,865) | 29,083 |
| Net seg. rev. from ext. customers | 2,349 | 17,762 | 8,146 | 23,614 | (12,087) | 12,043 | 2,163 | 53,990 |
| Net seg. rev. from other segments | 1,795 | (8,281) | (506) | (8,337) | 16,541 | 43 | (1,255) | - |
| **Operating income** | 4,144 | 9,481 | 7,640 | 15,277 | 4,454 | 12,086 | 908 | 53,990 |
| Depreciation and amortisation | - | - | - | 458 | - | 339 | 1,237 | 2,034 |
| **Total assets** | 5,230 | 231,575 | 33,730 | 416,912 | 160,210 | 65,459 | 20,620 | 933,736 |
| **Total liabilities** | 2,415 | 188,374 | 28,333 | 364,266 | 129,928 | 40,131 | 18,077 | 771,524 |
| **Allocated equity** | 2,815 | 43,201 | 5,397 | 52,646 | 30,282 | 25,328 | 2,543 | 162,212 |

| 2013 | Asset Manage-ment and Stefnir | Corporate Banking | Investment Banking | Retail Banking | Treasury | Other divisions and Sub-sidiaries | Head-quarters and Elimination | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 560 | 8,630 | 120 | 12,058 | 3,813 | (1,473) | 92 | 23,800 |
| Other income | 3,141 | 685 | 4,302 | 2,507 | (1,103) | 10,264 | 752 | 20,548 |
| **Operating income** | 3,701 | 9,315 | 4,422 | 14,565 | 2,710 | 8,791 | 844 | 44,348 |
| Operating expense | (774) | (658) | (596) | (5,518) | (244) | (5,409) | (12,196) | (25,395) |
| Net impairment | (3) | 3,789 | 1,738 | (5,694) | 420 | (311) | (619) | (680) |
| **Earnings before tax** | 2,924 | 12,446 | 5,564 | 3,353 | 2,886 | 3,071 | (11,971) | 18,273 |
| Net seg. rev. from ext. customers | 1,462 | 16,780 | 4,087 | 24,805 | (13,995) | 11,616 | (407) | 44,348 |
| Net seg. rev. from other segments | 2,239 | (7,465) | 335 | (10,240) | 16,705 | (2,825) | 1,251 | - |
| **Operating income** | 3,701 | 9,315 | 4,422 | 14,565 | 2,710 | 8,791 | 844 | 44,348 |
| Depreciation and amortisation | - | - | - | 166 | - | 281 | 1,341 | 1,788 |
| **Total assets** | 4,840 | 248,082 | 34,799 | 397,721 | 168,334 | 77,150 | 7,924 | 938,850 |
| **Total liabilities** | 1,781 | 208,389 | 29,231 | 356,086 | 148,696 | 42,746 | 6,974 | 793,903 |
| **Allocated equity** | 3,059 | 39,693 | 5,568 | 41,635 | 19,638 | 34,404 | 950 | 144,947 |

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

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

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## QUARTERLY STATEMENTS

### 5. Operations by quarters

| 2014 | Q4 | Q3 | Q2 | Q1 | Total |
|---|---|---|---|---|---|
| Net interest income | 5,911 | 6,343 | 6,483 | 5,483 | 24,220 |
| Net fee and commission income | 3,190 | 3,526 | 3,445 | 3,148 | 13,309 |
| Net financial income (expense) | 1,429 | 1,994 | 4,439 | (572) | 7,290 |
| Other operating income | 5,208 | 689 | 2,356 | 918 | 9,171 |
| **Operating income** | 15,738 | 12,552 | 16,723 | 8,977 | 53,990 |
| Salaries and related expense | (3,953) | (2,862) | (3,714) | (3,450) | (13,979) |
| Other operating expense | (4,465) | (2,787) | (3,064) | (2,747) | (13,063) |
| Net impairment | (742) | 876 | 34 | 1,967 | 2,135 |
| **Earnings before tax** | 6,578 | 7,779 | 9,979 | 4,747 | 29,083 |
| Income tax expense and bank levy | (858) | (2,622) | (1,867) | (1,975) | (7,322) |
| **Net earnings from continuing operations** | 5,720 | 5,157 | 8,112 | 2,772 | 21,761 |
| Net gain from discontinued operations, net of tax | 241 | 67 | 6,433 | 92 | 6,833 |
| **Net earnings** | 5,961 | 5,224 | 14,545 | 2,864 | 28,594 |

| 2013 | Q4 | Q3 | Q2 | Q1 | Total |
|---|---|---|---|---|---|
| Net interest income | 5,487 | 5,646 | 6,379 | 6,288 | 23,800 |
| Net fee and commission income | 2,939 | 2,986 | 2,849 | 2,449 | 11,223 |
| Net financial income (expense) | 721 | 658 | 1,123 | (827) | 1,675 |
| Other operating income | 3,615 | 1,610 | 1,249 | 1,176 | 7,650 |
| **Operating income** | 12,762 | 10,900 | 11,600 | 9,086 | 44,348 |
| Salaries and related expense | (4,098) | (2,760) | (3,357) | (3,322) | (13,537) |
| Other expense | (3,114) | (2,516) | (2,951) | (3,277) | (11,858) |
| Net impairment | (561) | (253) | 456 | (322) | (680) |
| **Earnings before tax** | 4,989 | 5,371 | 5,748 | 2,165 | 18,273 |
| Income tax expense and bank levy | (2,864) | (1,214) | (1,260) | (677) | (6,015) |
| **Net earnings from continuing operations** | 2,125 | 4,157 | 4,488 | 1,488 | 12,258 |
| Net gain from discontinued operations, net of tax | 402 | 62 | 14 | (79) | 399 |
| **Net earnings** | 2,527 | 4,219 | 4,502 | 1,409 | 12,657 |

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.

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## NOTES TO THE CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

### 6. Net interest income

| | 2014 | 2013 |
|---|---|---|
| *Interest income* | | |
| Cash and balances with Central Bank | 703 | 628 |
| Loans | 45,810 | 48,932 |
| Securities | 3,664 | 6,630 |
| Other | 695 | 677 |
| **Interest income** | 50,872 | 56,867 |
| *Interest expense* | | |
| Deposits | (15,982) | (19,108) |
| Borrowings | (9,270) | (12,568) |
| Subordinated liabilities | (1,291) | (1,334) |
| Other | (109) | (57) |
| **Interest expense** | (26,652) | (33,067) |
| **Net interest income** | 24,220 | 23,800 |
| Net interest income from assets and liabilities at fair value | 3,664 | 6,630 |
| Interest income from assets not at fair value | 47,208 | 50,237 |
| Interest expense from liabilities not at fair value | (26,652) | (33,067) |
| **Net interest income** | 24,220 | 23,800 |
| Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets) | 2.8% | 2.9% |

### 7. Net fee and commission income

| 2014 | Income | Expense | Net income |
|---|---|---|---|
| Asset management | 3,863 | (162) | 3,701 |
| Cards | 9,223 | (4,150) | 5,073 |
| Collection and payment services | 1,288 | (93) | 1,195 |
| Investment banking | 1,886 | (40) | 1,846 |
| Lending and guarantees | 1,430 | - | 1,430 |
| Other | 757 | (693) | 64 |
| **Net fee and commission income** | 18,447 | (5,138) | 13,309 |

| 2013 | | | |
|---|---|---|---|
| Asset management | 3,388 | (138) | 3,250 |
| Cards | 7,895 | (3,648) | 4,247 |
| Collection and payment services | 1,157 | (56) | 1,101 |
| Investment banking | 1,266 | (175) | 1,091 |
| Lending and guarantees | 986 | - | 986 |
| Other | 1,751 | (1,203) | 548 |
| **Net fee and commission income** | 16,443 | (5,220) | 11,223 |

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.

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## 8. Net financial income

| | 2014 | 2013 |
|---|---|---|
| Dividend income | 875 | 46 |
| Net gain (loss) on financial assets and financial liabilities classified as held for trading | (150) | 475 |
| Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss | 5,752 | 2,920 |
| Net foreign exchange gain (loss) | 813 | (1,766) |
| **Net financial income** | 7,290 | 1,675 |

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

| | | |
|---|---|---|
| Equity instruments designated at fair value | 5,963 | 2,232 |
| Interest rate instruments designated at fair value | (211) | 688 |
| **Net gain (loss) on financial assets and financial liabilities designated at fair value through profit or loss** | 5,752 | 2,920 |

## 9. Other operating income

| | | |
|---|---|---|
| Share of profit of associates and reversal of impairment | 3,498 | 1,986 |
| Rental income from investment property | 1,236 | 2,303 |
| Fair value changes on investment property | 1,091 | 1,219 |
| Realised gain on investment property | 1,231 | 372 |
| Earned premiums, net of reinsurance | 1,005 | 1,073 |
| Net gain on disposals of assets other than held for sale | 482 | 9 |
| Other income | 628 | 688 |
| **Other operating income** | 9,171 | 7,650 |

## 10. Personnel and salaries

*Number of employees*

| | | |
|---|---|---|
| Average number of full time equivalent positions during the year | 1,128 | 1,159 |
| Full time equivalent positions at the end of the year | 1,139 | 1,145 |

*The Bank's number of employees*

| | | |
|---|---|---|
| Average number of full time equivalent positions during the year | 890 | 923 |
| Full time equivalent positions at the end of the year | 865 | 911 |

*Salaries and related expense*

| | | |
|---|---|---|
| Salaries | 10,903 | 10,289 |
| Defined contribution pension plans | 1,539 | 1,436 |
| Salary related expense | 1,537 | 1,812 |
| **Salaries and related expense** | 13,979 | 13,537 |

*Salaries and related expense for the Bank*

| | | |
|---|---|---|
| Salaries | 8,458 | 8,117 |
| Defined contribution pension plans | 1,164 | 1,133 |
| Salary related expense | 1,393 | 1,406 |
| **Salaries and related expense** | 11,015 | 10,656 |

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### 10. Personnel and salaries, continued

In 2014 the Group made a provision of ISK 542 million (2013: ISK 494 million) for performance plan payments, including salary related expense, thereof the Bank made a provision of ISK 477 million (2013: ISK 452 million). 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 year the Group's accrual for performance plan payments amounts to ISK 741 million (31.12.2013: ISK 494 million), thereof the Bank's accrual amounts to ISK 639 million (31.12.2013: ISK 452 million).

| *Compensation of key management personnel* | 2014 Fixed remuner-ation* | 2014 Additional remuner-ation** | 2014 Total | 2013 Fixed remuner-ation* | 2013 Additional remuner-ation** | 2013 Total |
|---|---|---|---|---|---|---|
| Monica Caneman, Chairman of the Board ............................ | 17.7 | 2.2 | 19.9 | 16.8 | 1.8 | 18.6 |
| Guðrún Johnsen, Vice-Chairman of the Board ...................... | 6.6 | 5.4 | 12.0 | 6.3 | 3.6 | 9.9 |
| Benedikt Olgeirsson, Director .............................................. | 4.4 | 1.4 | 5.8 | - | - | - |
| Brynjólfur Bjarnason, Director from 20.11.2014 ................... | 0.6 | - | 0.6 | - | - | - |
| Kirstín Þ. Flygenring, Director from 20.3.2014 ...................... | 3.4 | 1.4 | 4.8 | - | - | - |
| Måns Höglund, Director ....................................................... | 8.9 | 4.0 | 12.9 | 8.4 | 3.6 | 12.0 |
| Þóra Hallgrímsdóttir, Director .............................................. | 4.4 | 3.6 | 8.0 | 3.5 | 1.1 | 4.6 |
| Agnar Kofoed-Hansen, Director until 20.3.2014 ................... | 1.1 | 0.9 | 2.0 | 4.2 | 3.6 | 7.8 |
| Björgvin Skúli Sigurðsson, Director until 9.10.2014 .............. | 3.4 | 0.9 | 4.3 | - | - | - |
| Freyr Þórðarson, Director .................................................... | - | - | - | 1.6 | 0.9 | 2.5 |
| Jón G. Briem, Director .......................................................... | - | - | - | 4.2 | 2.3 | 6.5 |
| Alternate directors of the Board .......................................... | 1.6 | 0.9 | 2.5 | 8.2 | 3.5 | 11.7 |
| **Total remuneration** ............................................................. | 52.1 | 20.7 | 72.8 | 53.2 | 20.4 | 73.6 |

| | 2014 Salaries | 2014 Performance based payments | 2013 Salaries | 2013 Performance based payments |
|---|---|---|---|---|
| Höskuldur H. Ólafsson, CEO ........................................................................................ | 52.2 | 6.3 | 50.7 | - |
| Nine managing directors of the Bank's divisions being members of the Bank's Executive Committee ........................................................... | 227.5 | 24.0 | 219.9 | - |

Performance based payments in 2014 are based on the Group's performance in 2013.

Board Members receive remuneration for their involvement in board committees. In addition to 11 Board meetings (2013: 13), during the year 12 Board Credit Committee meetings (2013: 14), 5 Board Audit and Risk Committee meetings (2013: 6) and 7 Board Remuneration Committee meetings (2013: 5) were held. Four committee meetings with alternate directors of the Board were held in 2014 (2013: 5).

The 2014 Annual General Meeting of the Bank held on 20 March 2014 approved the monthly salaries for 2014 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 750,000, ISK 562,500 and ISK 375,000 (2013: ISK 700,000; 525,000; 350,000) respectively. It was also approved that the salary of Alternate Board Members would be ISK 187,500 (2013: ISK 175,000) per meeting, up to a maximum of ISK 375,000 (2013: ISK 350,000) per month. For foreign Board Members, the aforementioned figures are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 150,000 (2013: ISK 150,000) per month for each committee they serve on and the Chairman of the board committees ISK 195,000 (2013: ISK 150.000).

* Fixed remuneration represents Board Member compensation for their attendance at meetings of the Board of Directors.
** Additional remuneration represents Board Member compensation for their participation in Board Committees.

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

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## 11. Other operating expense

| | 2014 | 2013 |
|---|---|---|
| Administration expense | 9,532 | 8,398 |
| Depositors' and investors' guarantee fund | 829 | 791 |
| Depreciation of property and equipment | 1,456 | 1,228 |
| Amortisation of intangible assets | 578 | 560 |
| Direct operating expense derived from rental-earning investment properties | 320 | 547 |
| Claims incurred, net of reinsurance | 341 | 323 |
| Other expense | 7 | 11 |
| **Other operating expense** | 13,063 | 11,858 |

*Auditor's fee*

| | | |
|---|---|---|
| Audit and review of the Financial Statements | 171 | 148 |
| Other audit related services | 16 | 27 |
| **Auditor's fee** | 187 | 175 |
| Thereof fee to others than the auditor of the Parent company | 8 | 7 |

## 12. Net impairment

| | | |
|---|---|---|
| Increase in book value of loans to corporates | 2,448 | 7,769 |
| Increase in book value of loans to individuals | 1,907 | 1,330 |
| Increase in book value of other assets | 715 | - |
| Impairment of loans to corporates | (148) | (3,093) |
| Impairment of loans to individuals | (2,391) | (4,900) |
| Collective impairment | (367) | (947) |
| Impairment of intangible assets | (29) | (839) |
| **Net impairment** | 2,135 | (680) |

## 13. Income tax expense

| | | |
|---|---|---|
| Current tax expense | 4,474 | 3,627 |
| Deferred tax expense | 205 | (484) |
| **Income tax expense** | 4,679 | 3,143 |

| *Reconciliation of effective tax rate* | 2014 | | 2013 | |
|---|---|---|---|---|
| Earnings before tax | | 29,083 | | 18,273 |
| Income tax using the Icelandic corporation tax rate | 20.0% | 5,817 | 20.0% | 3,655 |
| Additional 6% tax on financial institutions | 3.1% | 894 | 4.7% | 865 |
| Non-deductible expenses | 0.7% | 201 | 1.7% | 305 |
| Tax exempt revenue | (7.0%) | (2,047) | (6.5%) | (1,183) |
| Tax incentives not recognised in the Statement of Comprehensive Income | 0.0% | - | (3.5%) | (641) |
| Other changes | (0.6%) | (186) | 0.8% | 142 |
| **Effective tax rate** | 16.1% | 4,679 | 17.2% | 3,143 |

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

Tax exempt revenues consist mainly of profit from equity positions.

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### 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.

### 15. Net gain from discontinued operations, net of tax

| | 2014 | 2013 |
|---|---|---|
| Net gain from associated companies | 6,290 | 250 |
| Net gain from real estates and other assets | 543 | 149 |
| **Net gain from discontinued operations, net of tax** | 6,833 | 399 |

Profit from the sale of equity holdings is tax exempt revenue.

Net gain from associated companies comprises the realised gain from sale of the Bank's 18.8% share in HB Grandi hf. in 2014 in connection with the listing of the company on NASDAQ Iceland.

### 16. Earnings per share

| | Discontinued operations | | | |
|---|---|---|---|---|
| | Excluded | | Included | |
| | 2014 | 2013 | 2014 | 2013 |
| Net earnings attributable to the shareholders of Arion Bank | 21,632 | 12,620 | 28,465 | 13,019 |
| Weighted average number of outstanding shares for the year, million | 2,000 | 2,000 | 2,000 | 2,000 |
| Basic earnings per share | 10.82 | 6.31 | 14.23 | 6.51 |

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

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## NOTES TO THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

### 17. Cash and balances with Central Bank

| | 2014 | 2013 |
|---|---|---|
| Cash on hand | 5,255 | 4,099 |
| Cash with Central Bank | 6,873 | 24,913 |
| Mandatory reserve deposit with Central Bank | 8,935 | 8,987 |
| **Cash and balances with Central Bank** | 21,063 | 37,999 |

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

### 18. Loans to credit institutions

| | 2014 | 2013 |
|---|---|---|
| Bank accounts | 79,587 | 70,671 |
| Money market loans | 23,007 | 26,197 |
| Other loans | 6,198 | 5,439 |
| **Loans to credit institutions** | 108,792 | 102,307 |

### 19. Loans to customers

| 2014 | Individuals | Corporates | Total |
|---|---|---|---|
| Overdrafts | 17,955 | 24,420 | 42,375 |
| Credit cards | 11,065 | 943 | 12,008 |
| Mortgage loans | 271,639 | 10,406 | 282,045 |
| Capital lease | 2,469 | 3,607 | 6,076 |
| Other loans | 31,294 | 300,391 | 331,685 |
| Provision on loans | (13,111) | (13,570) | (26,681) |
| **Loans to customers** | 321,311 | 326,197 | 647,508 |

| 2013 | | | |
|---|---|---|---|
| Overdrafts | 18,205 | 19,669 | 37,874 |
| Credit cards | 11,296 | 878 | 12,174 |
| Mortgage loans | 258,065 | 8,103 | 266,168 |
| Capital lease | 1,513 | 1,404 | 2,917 |
| Other loans | 34,620 | 311,247 | 345,867 |
| Provision on loans | (13,208) | (16,018) | (29,226) |
| **Loans to customers** | 310,491 | 325,283 | 635,774 |

The total book value of pledged loans that were pledged against amounts borrowed was ISK 197 billion at the end of the year (31.12.2013: ISK 173 billion). Pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies.

Further analysis of loans is provided in Risk Management Disclosures.

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## 19. Loans to customers, continued

*Changes in the provision for losses on loans to customers*

| 2014 | Specific | Collective | Total |
|---|---|---|---|
| Balance at the beginning of the year | 25,126 | 4,100 | 29,226 |
| Provision for losses | 2,539 | 367 | 2,906 |
| Write-offs | (5,937) | - | (5,937) |
| Payment of loans previously written off | 486 | - | 486 |
| **Balance at the end of the year** | 22,214 | 4,467 | 26,681 |

| 2013 | | | |
|---|---|---|---|
| Balance at the beginning of the year | 56,440 | 3,341 | 59,781 |
| Provision for losses | 7,993 | 947 | 8,940 |
| Write-offs | (36,236) | (188) | (36,424) |
| Transferred to liabilities | (3,984) | - | (3,984) |
| Payment of loans previously written off | 913 | - | 913 |
| **Balance at the end of the year** | 25,126 | 4,100 | 29,226 |

*Significant accounting estimates and judgements*

Key sources of estimation uncertainty are impairment losses on loans.

The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 53. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the Credit Risk function.

## 20. Financial instruments

| | 2014 | 2013 |
|---|---|---|
| Bonds and debt instruments | 66,466 | 62,171 |
| Shares and equity instruments with variable income | 25,232 | 17,449 |
| Derivatives | 1,026 | 1,070 |
| Securities used for hedging | 9,104 | 5,851 |
| **Financial instruments** | 101,828 | 86,541 |

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## 21. Financial assets and financial liabilities

| 2014 | Amortised cost | Trading | Designated at fair value | Total |
|---|---|---|---|---|
| *Loans* | | | | |
| Cash and balances with Central Bank | 21,063 | - | - | 21,063 |
| Loans to credit institutions | 108,792 | - | - | 108,792 |
| Loans to customers | 647,508 | - | - | 647,508 |
| **Loans** | 777,363 | - | - | 777,363 |
| *Bonds and debt instruments* | | | | |
| Listed | - | 3,157 | 61,421 | 64,578 |
| Unlisted | - | 36 | 1,852 | 1,888 |
| **Bonds and debt instruments** | - | 3,193 | 63,273 | 66,466 |
| *Shares and equity instruments with variable income* | | | | |
| Listed | - | 1,538 | 7,079 | 8,617 |
| Unlisted | - | 1,613 | 13,901 | 15,514 |
| Bond funds with variable income, unlisted | - | 928 | 173 | 1,101 |
| **Shares and equity instruments with variable income** | - | 4,079 | 21,153 | 25,232 |
| *Derivatives* | | | | |
| OTC derivatives | - | 1,026 | - | 1,026 |
| **Derivatives** | - | 1,026 | - | 1,026 |
| *Securities used for hedging* | | | | |
| Bonds and debt instruments, listed | - | 3,212 | - | 3,212 |
| Shares and equity instruments with variable income, listed | - | 4,911 | - | 4,911 |
| Shares and equity instruments with variable income, unlisted | - | 981 | - | 981 |
| **Securities used for hedging** | - | 9,104 | - | 9,104 |
| Other financial assets | 3,514 | - | - | 3,514 |
| **Financial assets** | 780,877 | 17,402 | 84,426 | 882,705 |
| *Liabilities at amortised cost* | | | | |
| Due to credit institutions and Central Bank | 22,876 | - | - | 22,876 |
| Deposits | 454,973 | - | - | 454,973 |
| Borrowings | 200,580 | - | - | 200,580 |
| Subordinated liabilities | 31,639 | - | - | 31,639 |
| **Liabilities at amortised cost** | 710,068 | - | - | 710,068 |
| *Financial liabilities at fair value* | | | | |
| Short position in bonds | - | 8,238 | - | 8,238 |
| Derivatives | - | 905 | - | 905 |
| **Financial liabilities at fair value** | - | 9,143 | - | 9,143 |
| Other financial liabilities | 39,032 | - | - | 39,032 |
| **Financial liabilities** | 749,100 | 9,143 | - | 758,243 |

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### 21. Financial assets and financial liabilities, continued

| 2013<br>*Loans* | Amortised cost | Trading | Designated at fair value | Total |
|---|---|---|---|---|
| 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, unlisted | - | 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, listed | - | 490 | - | 490 |
| Shares and equity instruments with variable income, listed | | 4,472 | | 4,472 |
| Shares and equity instruments with variable income, unlisted | - | 889 | - | 889 |
| **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 |

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### 21. Financial assets and financial liabilities, continued

| *Bonds and debt instruments designated at fair value specified by issuer* | 2014 | 2013 |
|---|---|---|
| Financial and insurance activities | 3,403 | 1,363 |
| Public sector | 58,730 | 55,007 |
| Corporates | 1,140 | 1,044 |
| **Bonds and debt instruments designated at fair value** | 63,273 | 57,414 |

The total amount of pledged bonds at the end of the year was ISK 18.0 billion (31.12.2013: ISK 18.4 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.

### 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*

| 2014 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| *Assets at fair value* | | | | |
| Bonds and debt instruments | 26,677 | 38,611 | 1,178 | 66,466 |
| Shares and equity instruments with variable income | 8,072 | 17,062 | 98 | 25,232 |
| Derivatives | - | 1,026 | - | 1,026 |
| Securities used for hedging | 7,789 | 1,315 | - | 9,104 |
| Investment property | - | - | 6,842 | 6,842 |
| **Assets at fair value** | 42,538 | 58,014 | 8,118 | 108,670 |
| | | | | |
| *Liabilities at fair value* | | | | |
| Short position in bonds | 8,238 | - | - | 8,238 |
| Derivatives | - | 905 | - | 905 |
| **Liabilities at fair value** | 8,238 | 905 | - | 9,143 |

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### 22. Fair value hierarchy, continued

| 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 | 1,355 | - | 5,850 |
| 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 |

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

*Fair value of assets and liabilities*

The fair value of assets and liabilities is the amount at which the asset and liability could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Group to measure assets and liabilities. If quoted prices for a asset fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

*Methods for establishing fair value*

*Level 1: Fair value established from quoted market prices*

The best evidence of the fair value of a asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of a asset in Note 21 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from the market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

*Level 2: Fair value established using valuation techniques with observable market information*

For assets and liabilities, for which the market is not active, the Group applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable and willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

For assets and liabilities for which quoted prices on active markets are not available, the fair value is derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

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### 22. Fair value hierarchy, continued

In most cases the valuation is based on theoretical financial models, such as the Black Scholes model or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

The fair value for deposits with stated maturities is calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Statement of Financial Position.

*Level 3: Fair value established using valuation techniques with significant unobservable market information*

In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of assets with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organisations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

The Group applies management valuation for determining fair value of investment properties. Management valuation is either based on recent transactions and offers for similar assets or present value calculations which involve estimation of future cash flow and the assessment of appropriate discount rate.

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

| *Movements in Level 3 assets measured at fair value* | Investment property | | Financial assets | | Total | |
|---|---|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Balance at the beginning of the year | 28,523 | 28,919 | 1,667 | 1,935 | 30,190 | 30,854 |
| Recognised in Statement of Comprehensive Income | 1,091 | 1,219 | (373) | 231 | 718 | 1,450 |
| Additions | 2,148 | 1,804 | 5 | - | 2,153 | 1,804 |
| Disposal | (25,503) | (3,419) | (23) | (407) | (25,526) | (3,826) |
| Transfers into Level 3 | 583 | - | - | - | 583 | - |
| Transfers out of Level 3 | - | - | - | (92) | - | (92) |
| **Balance at the end of the year** | 6,842 | 28,523 | 1,276 | 1,667 | 8,118 | 30,190 |

On 30 June 2014 the Bank sold its subsidiary Landfestar ehf. resulting in a total decrease in investment property by ISK 23.1 billion.

| *Line items where effects of Level 3 assets are recognised in the Statement of Comprehensive Income* | 2014 | 2013 |
|---|---|---|
| Net interest income | 74 | 82 |
| Net financial income | (447) | 149 |
| Other operating income | 2,322 | 1,591 |
| **Effects recognised in the Statement of Comprehensive Income** | 1,949 | 1,822 |

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### 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 Financial Statements. The table does not include the fair values of non-financial assets and non-financial liabilities.*

| 2014 | Carrying value | Fair value | Unrealised gain (loss) |
|---|---|---|---|
| *Financial assets not carried at fair value* | | | |
| Cash and balances with Central bank | 21,063 | 21,063 | - |
| Loans to credit institutions | 108,792 | 108,792 | - |
| Loans to customers | 647,508 | 657,261 | 9,753 |
| Other financial assets | 3,514 | 3,514 | - |
| **Financial assets not carried at fair value** | 780,877 | 790,630 | 9,753 |
| *Financial liabilities not carried at fair value* | | | |
| Due to credit institutions and Central bank | 22,876 | 22,876 | - |
| Deposits | 454,973 | 455,133 | (160) |
| Borrowings | 200,580 | 197,115 | 3,465 |
| Subordinated loans | 31,639 | 31,639 | - |
| Other financial liabilities | 39,032 | 39,032 | - |
| **Financial liabilities not carried at fair value** | 749,100 | 745,795 | 3,305 |

| 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 presented 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 presented 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 prior year as the Group now uses improved methodology. When the methodology was updated it took into account recent transactions with the ESÍ loan portfolio. Comparative figures for 2013 have been changed accordingly.

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### 22. Fair value hierarchy, continued

| *Derivatives* | Fair value | |
|---|---|---|
| 2014 | Assets | Liabilities |
| Forward exchange rate agreements, unlisted | 63 | 172 |
| Interest rate and exchange rate agreements, unlisted | 215 | 271 |
| Bond swap agreements, unlisted | 40 | 34 |
| Share swap agreements, unlisted | 230 | 397 |
| Options - purchased agreements, unlisted | 478 | 31 |
| **Derivatives** | 1,026 | 905 |

| 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 |

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### 23. Offsetting financial assets and financial liabilities

*Financial assets subject to enforceable master netting arrangements and similar arrangements*

| | Assets subject to netting arrangements | | | Netting potential not recognized in the balance sheet | | | | |
|---|---|---|---|---|---|---|---|---|
| 2014 | Gross assets before balance sheet nettings | Balance sheet nettings with gross liabilities | Assets recognised on balance sheet, net | Financial liabilities | Collateral received | Assets after consideration of netting potential | Assets not subject to enforceable netting arr-angements | Total assets re-cognised on balance sheet |
| Reverse repurchase agreements ....... | 10,044 | - | 10,044 | (8,238) | - | 1,806 | - | 10,044 |
| Derivatives ...................................... | 117 | - | 117 | (1) | - | 116 | 909 | 1,026 |
| **Total assets .................................** | 10,161 | - | 10,161 | (8,239) | - | 1,922 | 909 | 11,070 |
| 2013 | | | | | | | | |
| Reverse repurchase agreements ....... | 10,381 | - | 10,381 | (8,199) | - | 2,182 | - | 10,381 |
| Derivatives ...................................... | 389 | - | 389 | (22) | - | 367 | 681 | 1,070 |
| Other assets netted by deposits ........ | 17,049 | (15,374) | 1,675 | - | - | 1,675 | - | 1,675 |
| **Total assets .................................** | 27,819 | (15,374) | 12,445 | (8,221) | - | 4,224 | 681 | 13,126 |

*Financial liabilities subject to enforceable master netting arrangements and similar arrangements*

| | Liabilities subject to netting arrangements | | | Netting potential not recognized in the balance sheet | | | | |
|---|---|---|---|---|---|---|---|---|
| 2014 | Gross liabilities before balance sheet nettings | Balance sheet nettings with gross assets | Liabilities recognised on balance sheet, net | Financial assets | Collateral pledged | Liabilities after consideration of netting potential | Liabilities not subject to enforceable netting arr-angements | Total liabilities recognised on balance sheet |
| Repurchase agreements ................... | 8,238 | - | 8,238 | (8,238) | - | - | - | 8,238 |
| Derivatives ...................................... | 1 | - | 1 | (1) | - | - | 904 | 905 |
| **Total liabilities .............................** | 8,239 | - | 8,239 | (8,239) | - | - | 904 | 9,143 |
| 2013 | | | | | | | | |
| Repurchase agreements ................... | 8,199 | - | 8,199 | (8,199) | - | - | - | 8,199 |
| Derivatives ...................................... | 39 | - | 39 | (22) | - | 17 | 722 | 761 |
| Deposits netted against other assets | 15,374 | (15,374) | - | - | - | - | - | - |
| **Total liabilities .............................** | 23,612 | (15,374) | 8,238 | (8,221) | - | 17 | 722 | 8,960 |

Accounting policies for offsetting are provided in Note 53.

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## 24. Investments in associates

| *The Group's interest in its principal associates* | 2014 | 2013 |
|---|---|---|
| Auðkenni hf., Borgartún 31, Reykjavík, Iceland | 21.0% | 20.0% |
| Bakkavör Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom | 45.8% | 45.8% |
| Farice ehf., Smáratorg 3, Kópavogur, Iceland | 39.3% | 39.3% |
| Klakki ehf., Ármúli 3, Reykjavík, Iceland | 31.8% | 31.8% |
| Reiknistofa bankanna hf., Katrínartúni 2, Reykjavík, Iceland | 21.7% | 21.7% |
| Reitir fasteignafélag hf., Kringlan 4-12, Reykjavík, Iceland | 25.6% | 42.7% |
| Skipti hf., Ármúla 25, Reykjavík, Iceland | 38.3% | 38.3% |
| Urriðaland ehf., Laugavegi 182, Reykjavik, Iceland | 41.4% | 41.4% |

| *Investments in associates* | | |
|---|---|---|
| Carrying amount at the beginning of the year | 17,929 | 7,050 |
| Additions | 7,557 | 8,903 |
| Dividend | (16) | (10) |
| Transfers | (2,636) | - |
| Disposals | (4,603) | - |
| Exchange difference | 237 | - |
| Share of profit of associates and reversal of impairment | 3,498 | 1,986 |
| **Investment in associates** | 21,966 | 17,929 |

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. In the second half of 2014 the Bank reduced the shareholding in Eik fasteignafélag hf. and the remaining shareholding of 14.3% is classified as Financial instruments at the end of the year. The sale of the shareholding had minor effects on the Statement of Comprehensive Income.

*Significant accounting estimates and judgements*

The Group accounts for investments in associates based on the equity method less applicable impairment. The impairment testing uses management valuation techniques and assumptions such as EBITDA multiples. Alternative assumptions could potentially result in significantly different carrying values but management considers that the impaired value is based on the most probable outcomes under current market conditions.

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### 25. Intangible assets

Intangible assets comprise four categories: Goodwill, Infrastructure, Customer Relationship and Related Agreements and Software. Goodwill arises on the acquisition of subsidiaries. Infrastructure and Customer Relationship and Related Agreements originate as a premium in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Group's operations.

Towards the end of 2014 Valitor Holding hf. acquired the Danish group AltaPay A/S. The acquisition is designed to support Valitor's strategy to expand its online business in the Nordic region. The purchase price of the shareholding in the company totalled ISK 4.2 billion, thereof paid ISK 3.1 billion. Total of ISK 4,217 million intangible assets is recognized, of which ISK 2,171 million is goodwill. Goodwill chiefly refers to the expertise of the employees of AltaPay A/S and the business opportunities inherent in a rapidly growing market, and the synergy which Valitor hf. is expected to benefit from subsequent to the acquisition. When breaking down the purchase price into separate assets the free cash flow method and management forecasts on the operations of AltaPay A/S were used. The main intangible assets are trademarks, business relationships and software. Trademarks and business relationships are recognized in the category Business relationships and related agreements.

The allocation of assets has not been completed but Valitor Holding hf. will complete this work within a year of the acquisition. The entry of AltaPay A/S into Arion Bank Group has no effect on operations in 2014.

Infrastructure, which is capitalized as an intangible asset, is connected to two business segments at the Bank, namely Asset Management within the Bank and within the Bank's subsidiary Stefnir hf. and Credit card operation at the Bank's subsidiary Valitor Holding hf. In both cases the business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as is described below.

Customer Relationship and Related Agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries and agreements bought. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationship related to individual customers by SPRON and the subsidiary Okkar líftryggingar. The customer relationship is tested for impairment and related agreements are amortised over a period of 5 years.

Software is acquired computer software licenses and is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-8 years.

## 25. Intangible assets, continued

| 2014 | Goodwill | Infra- structure | Customer relation- ship and Related Agreements | Software | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year | - | 3,075 | 1,144 | 1,164 | 5,383 |
| Acquisition through business combination | 2,171 | - | 598 | 1,448 | 4,217 |
| Additions | - | - | - | 603 | 603 |
| Impairment | - | (29) | - | - | (29) |
| Amortisation | - | - | (203) | (375) | (578) |
| **Intangible assets** | 2,171 | 3,046 | 1,539 | 2,840 | 9,596 |

| 2013 | | | | | |
|---|---|---|---|---|---|
| Balance at the beginning of the year | - | 3,914 | 144 | 883 | 4,941 |
| Additions | - | - | 1,000 | 841 | 1,841 |
| Impairment | - | (839) | - | - | (839) |
| Amortisation | - | - | - | (560) | (560) |
| **Intangible assets** | - | 3,075 | 1,144 | 1,164 | 5,383 |

*Impairment testing*

The methodology for impairment testing on the Infrastructure, which is part of intangible assets, is based on discounted cash flow model which uses inputs that consider features of the business and the environment.

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis impairment of ISK 29 million was recognized for infrastucture 2014 (2013: ISK 839 million).

| *Discount and growth rates* | 2014 Discount rates | 2014 Growth rates | 2013 Discount rates | 2013 Growth rates |
|---|---|---|---|---|
| Asset Management operation | 14.7% | 2.5% | 13.1% | 2.5% |
| Credit card operation | 14.7% | 3-14% | 15.1% | 4-10% |

## 26. Tax assets and tax liabilities

| | 2014 Assets | 2014 Liabilities | 2013 Assets | 2013 Liabilities |
|---|---|---|---|---|
| Current tax | - | 4,499 | - | 3,698 |
| Deferred tax | 655 | 624 | 818 | 1,226 |
| **Tax assets and tax liabilities** | 655 | 5,123 | 818 | 4,924 |

*Deferred tax assets and tax liabilities are attributable to the following:*

| | 2014 Assets | 2014 Liabilities | 2013 Assets | 2013 Liabilities |
|---|---|---|---|---|
| Foreign currency denominated assets and liabilities | 7 | (205) | 25 | (212) |
| Investment property and property and equipment | 95 | (333) | 144 | (1,770) |
| Financial assets | 564 | - | 580 | - |
| Other assets and liabilities | 188 | (529) | 514 | (90) |
| Deferred tax related to foreign exchange gain | - | (78) | 79 | - |
| Tax loss carry forward | 322 | - | 322 | - |
| | 1,176 | (1,145) | 1,664 | (2,072) |
| Set-off of deferred tax assets together with tax liabilities of the same taxable entities | (521) | 521 | (846) | 846 |
| **Deferred tax assets and tax liabilities** | 655 | (624) | 818 | (1,226) |

Subsidiaries own tax loss carry forward with asset value of the amount of ISK 726 million (31.12.2013: ISK 728 million) that is not recognised in the Financial Statements, due to uncertainty about the utilisation possibilities of the loss.

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## 26. Tax assets and tax liabilities, continued

*Changes in deferred tax assets and tax liabilities*

| 2014 | At 1 Jan. | Addition / disposal | Recognised in profit or loss | At 31 Dec. |
|---|---|---|---|---|
| Foreign currency denominated assets and liabilities | (187) | - | (11) | (198) |
| Investment property and property and equipment | (1,626) | 1,102 | 286 | (238) |
| Financial assets | 580 | - | (16) | 564 |
| Other assets and liabilities | 424 | (458) | (307) | (341) |
| Deferred foreign exchange differences | 79 | - | (157) | (78) |
| Tax loss carry forward | 322 | - | - | 322 |
| **Change in deferred tax assets and tax liabilities** | (408) | 644 | (205) | 31 |

| 2013 | | | | |
|---|---|---|---|---|
| Foreign currency denominated assets and liabilities | (248) | - | 61 | (187) |
| Investment property and property and equipment | (1,275) | - | (351) | (1,626) |
| Financial assets | 565 | - | 15 | 580 |
| Other assets and liabilities | 11 | - | 413 | 424 |
| Deferred foreign exchange differences | (696) | - | 775 | 79 |
| Tax loss carry forward | 751 | - | (429) | 322 |
| **Change in deferred tax assets and tax liabilities** | (892) | - | 484 | (408) |

## 27. Other assets

| | 2014 | 2013 |
|---|---|---|
| Non-current assets and disposal groups held for sale | 3,958 | 10,046 |
| Property and equipment | 7,080 | 6,943 |
| Accounts receivable | 2,474 | 4,610 |
| Sundry assets | 1,974 | 1,977 |
| **Other assets** | 15,486 | 23,576 |

| *Non-current assets and disposal groups held for sale* | | |
|---|---|---|
| Associates | - | 5,457 |
| Real estates | 3,919 | 4,150 |
| Other assets | 39 | 439 |
| **Non-current assets and disposal groups held for sale** | 3,958 | 10,046 |

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 Iceland. Prior to the sale the Bank held 31% share in HB Grandi hf. The financial effects from the sale is recognised in the Statement of Comprehensive Income. The shareholding in HB Grandi hf. at year end 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.

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### 27. Other assets, continued

| *Property and equipment* | Real estate | Equip-ment | Total 2014 | Total 2013 |
|---|---|---|---|---|
| Gross carrying amount at the beginning of the year | 5,853 | 5,051 | 10,904 | 9,117 |
| Additions | 654 | 1,212 | 1,866 | 2,181 |
| Disposals | (293) | (42) | (335) | (228) |
| Transfers to investment property | - | - | - | (166) |
| Gross carrying amount at the end of the year | 6,214 | 6,221 | 12,435 | 10,904 |
| Accumulated depreciation at the beginning of the year | (998) | (2,963) | (3,961) | (2,806) |
| Depreciation | (456) | (1,000) | (1,456) | (1,228) |
| Disposals | 46 | 16 | 62 | 52 |
| Transfers to investment property | - | - | - | 21 |
| Accumulated depreciation at the end of the year | (1,408) | (3,947) | (5,355) | (3,961) |
| **Property and equipment** | 4,806 | 2,274 | 7,080 | 6,943 |

The official real estate value (Registers Iceland) amounts to ISK 4,781 million at the end of the year (31.12.2013: ISK 5,025 million) and the insurance value amounts to ISK 9,479 million (31.12.2013: ISK 9,466 million).

### 28. Other liabilities

| | 2014 | 2013 |
|---|---|---|
| Accounts payable | 20,909 | 19,264 |
| Provision for settled FX loans | 2,791 | 4,524 |
| Depositors' and investors' guarantee fund | 2,880 | 2,886 |
| Insurance claim | 2,402 | 2,266 |
| Withholding tax | 1,507 | 1,552 |
| Bank levy | 2,688 | 2,835 |
| Sundry liabilities | 14,013 | 10,340 |
| **Other liabilities** | 47,190 | 43,667 |

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

## 29. Borrowings

| | Issued | Maturity | Maturity type | Terms of interest | 2014 | 2013 |
|---|---|---|---|---|---|---|
| Covered bond in ISK .......................... | 2012 | 2015 | At maturity | Fixed, 6.50% | 14,493 | 4,378 |
| Covered bond in ISK .......................... | 2013 | 2019 | At maturity | Fixed, CPI linked, 2,50% | 4,508 | 4,453 |
| Covered bond in ISK .......................... | 2014 | 2021 | At maturity | Fixed, CPI linked, 3,50% | 1,134 | - |
| Covered bond in ISK .......................... | 2014 | 2029 | At maturity | Fixed, CPI linked, 3,50% | 5,232 | - |
| Covered bond in ISK .......................... | 2008 | 2031 | Amortizing | Fixed, CPI linked, 4.00% | - | 4,934 |
| Covered bond in ISK .......................... | 2005 | 2033 | Amortizing | Fixed, CPI linked, 3.75% | 17,428 | 17,873 |
| Covered bond in ISK .......................... | 2012 | 2034 | Amortizing | Fixed, CPI linked, 3.60% | 2,541 | 2,603 |
| Covered bond in ISK .......................... | 2008 | 2045 | Amortizing | Fixed, CPI linked, 4.00% | 6,165 | 21,361 |
| Covered bond in ISK .......................... | 2006 | 2048 | Amortizing | Fixed, CPI linked, 3.75% | 77,557 | 77,894 |
| **Covered bonds** ........................................ | | | | | 129,058 | 133,496 |
| | | | | | | |
| Senior unsecured bond in NOK ......... | 2013 | 2016 | At maturity | Floating, NIBOR +5.00% | 8,478 | 9,356 |
| Senior unsecured bond in ISK ............ | 2010 | 2018 | Amortizing | Floating, REIBOR +1.00% | 2,130 | 2,662 |
| Senior unsecured bond in EUR .......... | 2009 | 2018 | Amortizing | Floating, EURIBOR +1.00% | 1,714 | 2,202 |
| Secured bond, Landfestar in ISK ........ | 2010 | 2044 | Amortizing | Fixed, CPI linked, 4.70% | - | 2,932 |
| **Bonds issued** ........................................ | | | | | 12,322 | 17,152 |
| | | | | | | |
| Central Bank, secured, various curr. .. | 2010 | 2022 | At maturity | Floating, LIBOR + 3.00% | 55,102 | 52,998 |
| Bills issued ........................................ | | | | | 3,186 | - |
| Other ........................................ | | | | | 912 | 922 |
| **Other loans/bills** ........................................ | | | | | 59,200 | 53,920 |
| | | | | | | |
| **Borrowings** ........................................ | | | | | 200,580 | 204,568 |

Book value of listed bonds was ISK 140,721 million (31.12.2013: ISK 23,770 million) at the end of the year. Market value of those bonds was ISK 137,175 million (31.12.2013: ISK 24,472 million).

The Group repurchased own debts during the year for the amount of ISK 20 billion (2013: nil) with minor effects on the Statement of Comprehensive Income.

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

## 30. Subordinated liabilities

| | Issued | Maturity | Maturity type | Terms of interest | 2014 | 2013 |
|---|---|---|---|---|---|---|
| Tier II capital in various currencies .... | 2010 | 2020 | At maturity | Floating, LIBOR + 4.00%* | 31,639 | 31,918 |
| **Subordinated liabilities** ........................................ | | | | | 31,639 | 31,918 |

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

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## 31. Pledged assets

| *Pledged assets against liabilities* | 2014 | 2013 |
|---|---|---|
| Assets, pledged as collateral against borrowings | 233,191 | 258,762 |
| Assets, pledged as collateral against loans from credit institutions and short positions | 17,973 | 18,440 |
| **Pledged assets against liabilities** | 251,164 | 277,202 |

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 233 billion at the end of the year (31.12.2013: ISK 259 billion). Those assets were mainly pool of mortgage loans to individuals, loans to real estate companies, wholesale and retal and industry and energy companies. The book value of those borrowings was ISK 184 billion at the end of the year (31.12.2013: ISK 189 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.

## 32. 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) | 2014 | Number (million) | 2013 |
|---|---|---|---|---|
| Issued share capital | 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* | 2014 | 2013 |
|---|---|---|
| Statutory reserve | 1,637 | 1,637 |
| Foreign currency translation reserve | (5) | - |
| **Other reserves** | 1,632 | 1,637 |

## OFF BALANCE SHEET INFORMATION

### 33. Obligations

| *Guarantees, unused overdraft and loan commitments the Group has granted its customers* | 2014 | 2013 |
|---|---|---|
| Guarantees | 9,542 | 9,922 |
| Unused overdrafts | 38,890 | 37,371 |
| Loan commitments | 56,363 | 48,585 |

*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. Even though the law has not been amended Icelandic bank‘s have made quarterly payments to a separate division within the fund since 2010. Despite this change in execution and 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.

### 34. Operating lease commitments

*Group as a lessee*

The Group has concluded lease agreements regarding some of the real estate it uses for its operations. These lease agreements are for a period of up to 19 years. The majority of the contracts include renewal options for various periods of time.

| | 2014 | 2013 |
|---|---|---|
| Less than one year | 292 | 272 |
| Over 1 year and up to 5 years | 829 | 960 |
| Over 5 years | 606 | 800 |
| **Future minimum lease payments under non-cancellable leases** | 1,727 | 2,032 |

*Group as a lessor*

The Group has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 8 years, with majority being non-cancellable agreements.

| | 2014 | 2013 |
|---|---|---|
| Less than one year | 93 | 2,353 |
| Over 1 year and up to 5 years | 125 | 5,086 |
| Over 5 years | 16 | 1,480 |
| **Future minimum lease payments under non-cancellable leases** | 234 | 8,919 |

The Bank sold its subsidiary Landfestar ehf. in 2014 as described in Note 3. Landfestar ehf. had large amount of lease agreements which are included in 2013 figures.

### 35. Assets under management and under custody

| | 2014 | 2013 |
|---|---|---|
| Assets under management | 923,599 | 895,457 |
| Assets under custody | 1,337,561 | 1,490,888 |

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## 36. 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. When the Group is of the opininon that it is to the detriment of the Group´s case to disclose potential amounts relating to legal claims, it elects not to do so. At the end of the year, the Group had several unresolved legal claims.

i) Contingent liabilities

*Investigation and legal proceedings regarding alleged breaches of competition law*

The Bank and Valitor hf. reached a settlement with the Icelandic Competition Authority (ICA) in December 2014 concerning an investigation into the structure of the payment card system. The central issue in the settlement concerned changes to the way in which interchange fees, which card companies pay to the banks, are decided and the awarding of customer loyalty points. The Bank has already implemented the agreed changes. As part of the settlement the Bank paid a fine of ISK 450 million and Valitor hf. ISK 220 m.kr. Further, under the settlement changes were made to the ownership of Valitor hf., with acquisition by the Bank of Landsbankinn´s stake in Valitor Holding hf. In June 2013 Kortaþjónustan hf. filed a suit, against the Bank and Valitor hf., as well as Landsbankinn hf., Íslandsbanki hf. and Borgun hf., claiming damages for the alleged loss suffered by Kortaþjónustan hf. in relation to above mentioned case. The case is being contested before the District Court of Reykjavík.

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

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

In 2012 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 was dropped in September 2014, and a new claim filed based on the findings of court appointed evaluators on Kortaþjónustan's alleged damage. Either the case will be defended against in court or settled between the parties. In both instances Valitor will argue that the damages estimated are too high. Settlement negotiations are on-going.

*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. 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.

### 36. Legal matters, continued

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 cases regarding the interpretation of certain provisions of EC Directives. In the cases the disagreement was is whether the CPI-indexation of a consumer loan and its presentation was in accordance with certain provisions of Icelandic law on contracts and consumer loans. An Advisory Opinion in the first case was published 28 August 2014 where the EFTA Court concluded, in short, that Directive 93/13/EEC does not generally prohibit contractual terms on the indexation of loans in contracts between lenders and consumers and that it was for the national court to assess whether the terms of such loans were fair. An Advisory Opinion in the second case was published 24 November 2014 where the EFTA Court concluded i.a. that it is not compatible with Directive 87/102/EEC to calculate the total cost of the credit and the annual percentage rate of charge on the basis of 0% inflation if the known rate of inflation at the time of the credit agreement is not 0%. Furthermore the EFTA Court concluded that it was for the national court to assess, having regard to all the circumstances of the case, the legal consequences of and the remedies for such incorrect information. Following the Advisory Opinions the cases were continued at the District Court of Reykjavík. Judgments in both cases were pronounced in the District Court on 6 February 2015. The conclusion on the first matter was that the indexation on the loan agreement was not considered an unfair contractual term. With respect to the second matter, the District Court concluded that the lender could not, in the calculations of the total cost of the credit and the percentage rate of charge, assume that inflation was 0%. Therefore the lender had not fulfilled its obligations to inform the borrower. However, the District Court concluded that this did not mean that the provisions of the loan agreement on such costs could be unconditionally ignored. In this respect the District Court pointed out that it should have been clear to borrowers, when taking out the loans, that price changes may occur during the loan period and that the loans would change in line with the CPI. The cases will likely be appeled to the Supreme Court. It is difficult to predict the likely outcome in the Supreme Court. If the Court finds in favour of the borrowers it is possible that the section of the loan agreements in general concerning the indexation of loans will be considered non-binding. It is also possible that the borrowers will be entitled to reimbursement of some or all the payments relating to CPI increases on their loans.. The Group considers the possibility of this happening remote and has therefore made no provision due to this.

iii) Legal matters concluded

*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 estimates to finish paying the adjusted part of the loan in the beginning of the year 2016, provided that funding is obtained from the Parliament. 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. Negotiations between the concerned parties have been successfully concluded.

*Legal proceedings regarding the Bank‘s variable interest rate*

Two borrowers issued summons against the Group where they claimed that a clause in their mortgage loan (in foreign currency), where it was stated that the bond should bear a variable interest rate, which the Bank was authorised to change, was illegal and unbinding. The borrowers made i.a. the claim that it would be recognised by the court that said clause on interest rates was illegal. With a judgment of the District Court of Reykjavík on 20 December 2013 the Group was acquitted. The judgment was appealed to the Supreme Court of Iceland and the Bank was acquitted with a judgement on 6 November 2014.

*Tryggingamiðstöðin hf.’s complaint to the ICA*

In 2010 Tryggingamiðstöðin hf. sent a complaint concerning the Bank´s alleged tying of banking services and insurance to the ICA. In 2014 the ICA announced that it had dismissed the complaint.

### 37. The uncertainty regarding the book value of foreign currency loans

In recent years there has been considerable uncertainty over the legality of foreign currency loans to individuals and companies and the recalculation of those loans which are clearly currency-linked loans in Icelandic krona. Firstly, there has been uncertainty over which loans are considered legal foreign currency loans and which loans are considered currency-linked loans in Icelandic krona, and secondly over how loans in the latter category should be recalculated. The Bank has been required to recalculate numerous loans which are considered currency-linked loans in Icelandic krona on the basis of the Interest and Indexation Act No. 38/2001 and after examining the judgments passed by the Supreme Court which were considered to set a precedent for the Bank's loans.

The uncertainty of legality of FX loans has continued in 2014 and the Group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans.

Although there is more clarity in the matters of FX loans there still remains uncertainty regarding foreign currency linked loans in three respects. Firstly, there is uncertainty over the legality of certain loans which are linked to foreign currencies. Secondly, there is disagreement over the recalculation and settlement of the loans, i.e. what interest rates should be used when recalculating the periods when the borrower did not actually pay any interest, for example during so-called "freeze-periods." Thirdly, there is uncertainty over which interest rate should apply to currency-linked loans in the future, i.e. whether they should bear the Central Bank's non-indexed rate or the contractual interest rate for each loan.

Nevertheless, the Group considers its portfolio of foreign currency linked loans fully provisioned for the most likely outcome.

### 38. Events after Balance Sheet date

In January Arion Bank bought back bonds for NOK 59 million at nominal value of its NOK 500 million issue from 2013. The effects on the Statement of Comprehensive Income are immaterial.

In January and February 2015 Arion Bank completed two offerings of 6-month bills worth ISK 1,460 million in total, at 5.25% flat rates. The bills have been admitted to trading on NASDAQ Iceland.

## RELATED PARTY

### 39. 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 year. 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.

| 2014<br>*Balances with related parties* | Assets | Liabilities | Net balance |
|---|---|---|---|
| Shareholders with control over the Group | 577 | (53,970) | (53,393) |
| Board of Directors and key Management personnel | 260 | (67) | 193 |
| Associates and other related parties | 20,060 | (22,861) | (2,801) |
| **Balances with related parties** | 20,897 | (76,898) | (56,001) |

| *Transactions with related parties* | Interest income | Interest expense | Other income | Other expense |
|---|---|---|---|---|
| Shareholders with control over the Group | - | (1,184) | 10 | - |
| Shareholders with influence over the Group | - | - | 26 | (30) |
| Board of Directors and key Management personnel | 13 | (1) | 3 | - |
| Associates and other related parties | 2,807 | (804) | 282 | (377) |
| **Transactions with related parties** | 2,820 | (1,989) | 321 | (407) |

| 2013<br>*Balances with related parties* | Assets | Liabilities | Net balance |
|---|---|---|---|
| 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) |

| *Transactions with related parties* | Interest income | Interest expense | Other income | Other expense |
|---|---|---|---|---|
| Shareholders with control over the Group | - | (1,206) | 76 | - |
| Shareholders with influence over the Group | 33 | - | 2 | (11) |
| Board of Directors and key Management personnel | 7 | (3) | 27 | - |
| Associates and other related parties | 4,237 | (704) | 1,233 | (196) |
| **Transactions with related parties** | 4,277 | (1,912) | 1,337 | (207) |

Through the ownership of ISFI the Group has a related party relationship with Landsbankinn hf. Landsbankinn hf. provides banking services to the Bank's subsidiary Valitor hf. and has a traditional bank to bank relationship with Arion Bank hf. The Group holds assets amounting to ISK 28,881 million (31.12.2013: ISK 12,185 million) by Landsbankinn hf. and liabilities amounting to ISK 7,332 million at the end of the year (31.12.2013: ISK 7,234 million). Total interest income was ISK 73 million in 2014 (2013: ISK 53 million) and interest expense ISK 172 million (2013: ISK 219 million). Other income was ISK 301 million during the year (2013: ISK 54 million) and other expense was ISK 347 million (2013: ISK 347 million). Those amounts are not included in the table above.

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## 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.

The Board of Directors is ultimately responsible for the Group’s risk management framework and ensuring that satisfactory risk policies and governance for controlling the Group’s risk exposure are in place. The Board allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board sets risk appetite, which is translated into exposure limits and targets monitored by the Bank’s Risk Management division.

The Chief Executive Officer (CEO) is responsible for sustaining an effective risk management framework, processes and control as well as maintaining a high level of risk awareness among the employees, making risk everyone’s business.

The Bank operates several committees to manage risk. The Board Audit and Risk Committee (BARC) is responsible for supervising the Bank’s risk management framework, risk appetite and the internal capital adequacy assessment process (ICAAP). The Asset and Liability Committee (ALCO), is responsible for managing the asset-liability mismatch, liquidity risk, market risk, and interest rate risk and capital management. The Underwriting and Investment Committee (UIC) decides on underwriting and principal investments. The Bank operates four credit committees: The Board Credit Committee (BCC) which decides on all major credit risk exposures, the Arion Credit Committee (ACC) which operates within limits specified as a fraction of the Bank’s capital, and the Corporate Credit Committee (CCC) and Retail Branch Committees (RBC) which operate within tighter credit granting limits.

The Bank’s Internal Audit conducts independent reviews of the Bank’s and several subsidiaries’ operations, risk management framework, processes and measurements. Internal Audit discusses its results with management and reports its findings and recommendations to the BARC.

The Bank’s Risk Management division is headed by the Chief Risk Officer. It is independent and centralised and reports directly to the CEO. The division is divided into five units: Credit Analysis, which supports and monitors the credit granting process; Credit Control, which monitors credit exposures on a customer-by-customer basis; Economic Capital, which is responsible for the Bank‘s ICAAP; Portfolio Risk, which monitors liquidity risk and risks in the Bank‘s assets and liabilities at the portfolio level; and Operational Risk which monitors risks associated with the daily operation of the Bank. The Bank's Security Officer is a part of the Risk Management division.

The most significant risks the Group is exposed to are credit risk, including concentration risk, liquidity risk, currency risk, interest rate risk and legal risk. These risk factors are to the largest extent encountered within the Bank. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities.

The total sum of large exposures net of eligible collateral at the end of the year 2014 was 24% of the capital base, down from 45% in the previous year.

The Group is exposed to currency risk due to a net currency position on the balance sheet. The Group’s operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities.

Liquidity risk is a large risk factor in the Group’s operation due to maturity mismatch between assets and liabilities. The maturity of loans exceeds the maturity of deposits, of which 63% is on-demand or with less than 30 day term.

The Group faces legal risk related to legal matters including previous court judgments on foreign currency loans, see Note 36 and 37.

Further information on risk management and capital adequacy is provided in the annual Financial Statements for 2014 and in the Pillar 3 Risk Disclosures for 2014. The Pillar 3 Risk Disclosures 2014 will be published in March 2015 and be available on the Bank’s website, www.arionbanki.is. The Pillar 3 Risk Disclosures will not be subject to external audit.

## 40. 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.

Managing and analysing the Group's loan portfolio is of utmost importance. Great emphasis is placed on the quality of the credit portfolio, by maintaining a strict credit process, critically inspecting loan applications, actively monitoring the credit portfolio and identifying and reacting to possible problem loans at an early stage as well as restructuring of impaired credits.

The Group grants credit based on well informed lending decisions and seeks business with strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in the pricing.

Credit risk is managed and controlled by setting limits on the amount of risk the Group is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits. The Group seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to group of connected clients.

## 40. Credit risk, continued

*Maximum exposure to credit risk and credit concentration by industry sectors*

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the year before the effect of mitigation due to collateral agreements or other credit enhancements. The Group uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard.

2014

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

| | Individuals | Real estate activities and construction | Fishing industry | Information and communication technology | Wholesale and retail trade | Financial and insurance activities | Industry, energy and manufacturing | Transportation | Services | Public sector | Agriculture and forestry | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash & balances with Central Bank .......... | - | - | - | - | - | 21,063 | - | - | - | - | - | 21,063 |
| Loans to credit institutions ...................... | - | - | - | - | - | 108,792 | - | - | - | - | - | 108,792 |
| Loans to customers ................................ | 321,311 | 81,228 | 76,340 | 23,314 | 55,034 | 27,693 | 25,284 | 5,529 | 18,382 | 7,746 | 5,647 | 647,508 |
| Financial instruments .............................. | 25 | 53 | 22 | 4 | - | 5,113 | 1,086 | 5 | 1,166 | 63,230 | - | 70,704 |
| Other assets with credit risk .................... | 399 | 440 | 34 | 22 | 24 | 1,854 | 9 | 15 | 626 | 87 | 4 | 3,514 |
| **Total on-balance sheet maximum exposure to credit risk .........................** | 321,735 | 81,721 | 76,396 | 23,340 | 55,058 | 164,515 | 26,379 | 5,549 | 20,174 | 71,063 | 5,651 | 851,581 |

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

| | Individuals | Real estate activities and construction | Fishing industry | Information and communication technology | Wholesale and retail trade | Financial and insurance activities | Industry, energy and manufacturing | Transportation | Services | Public sector | Agriculture and forestry | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Financial guarantees ............................... | 390 | 2,300 | 784 | 573 | 1,128 | 1,201 | 1,322 | 709 | 1,101 | 27 | 7 | 9,542 |
| Unused overdrafts ................................... | 22,621 | 2,007 | 578 | 561 | 4,554 | 1,491 | 1,952 | 264 | 2,038 | 2,384 | 440 | 38,890 |
| Loan commitments ................................. | 392 | 7,281 | 9,010 | 3,587 | 9,040 | 1,797 | 6,183 | 10,679 | 970 | 7,392 | 32 | 56,363 |
| **Total off-balance sheet maximum exposure to credit risk ........................** | 23,403 | 11,588 | 10,372 | 4,721 | 14,722 | 4,489 | 9,457 | 11,652 | 4,109 | 9,803 | 479 | 104,795 |
| **Maximum exposure to credit risk ...........** | 345,138 | 93,309 | 86,768 | 28,061 | 69,780 | 169,004 | 35,836 | 17,201 | 24,283 | 80,866 | 6,130 | 956,376 |

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## 40. Credit risk, continued

2013

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

| | Individuals | Real estate activities and construction | Fishing industry | Information and com-munication technology | Wholesale and retail trade | Financial and insurance activities | Industry, energy and manu-facturing | Transpor-tation | Services | Public sector | Agriculture and forestry | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash & balances with Central Bank ........... | - | - | - | - | - | 37,999 | - | - | - | - | - | 37,999 |
| Loans to credit institutions ........................ | - | - | - | - | - | 102,307 | - | - | - | - | - | 102,307 |
| Loans to customers .................................. | 310,491 | 83,002 | 60,906 | 24,025 | 55,061 | 27,535 | 22,661 | 18,966 | 19,793 | 8,682 | 4,652 | 635,774 |
| Financial instruments ............................... | 3 | 26 | 1 | 7 | 42 | 2,960 | 1,336 | 6 | 514 | 58,836 | - | 63,731 |
| Other assets with credit risk ..................... | 295 | 312 | 78 | 15 | 835 | 3,636 | 23 | 1 | 506 | 45 | - | 5,746 |
| **Total on-balance sheet maximum exposure to credit risk ..........................** | 310,789 | 83,340 | 60,985 | 24,047 | 55,938 | 174,437 | 24,020 | 18,973 | 20,813 | 67,563 | 4,652 | 845,557 |

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

| | Individuals | Real estate activities and construction | Fishing industry | Information and com-munication technology | Wholesale and retail trade | Financial and insurance activities | Industry, energy and manu-facturing | Transpor-tation | Services | Public sector | Agriculture and forestry | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Financial guarantees ................................. | 387 | 1,781 | 534 | 769 | 1,328 | 1,183 | 2,539 | 500 | 833 | 60 | 8 | 9,922 |
| Unused overdrafts ................................... | 22,282 | 1,433 | 395 | 591 | 4,095 | 1,951 | 1,653 | 298 | 2,005 | 2,298 | 371 | 37,371 |
| Loan commitments ................................. | 205 | 6,651 | 2,895 | 2,617 | 12,517 | 5,536 | 16,529 | 837 | 778 | 20 | - | 48,585 |
| **Total off-balance sheet maximum exposure to credit risk ..........................** | 22,874 | 9,865 | 3,824 | 3,977 | 17,940 | 8,670 | 20,721 | 1,635 | 3,616 | 2,378 | 379 | 95,878 |
| **Maximum exposure to credit risk ............** | 333,663 | 93,205 | 64,809 | 28,024 | 73,878 | 183,107 | 44,741 | 20,608 | 24,429 | 69,941 | 5,031 | 941,435 |

*Amounts are in ISK millions*

## 40. Credit risk, continued

*Loans to customers specified by sectors*

| | 2014 | 2013 |
|---|---|---|
| Individuals | 49.6% | 48.8% |
| Real estate activities and construction | 12.5% | 13.1% |
| Fishing industry | 11.8% | 9.6% |
| Information and communication technology | 3.6% | 3.8% |
| Wholesale and retail trade | 8.5% | 8.7% |
| Financial and insurance activities | 4.3% | 4.3% |
| Industry, energy and manufacturing | 3.9% | 3.5% |
| Transportation | 0.9% | 3.0% |
| Services | 2.8% | 3.1% |
| Public sector | 1.2% | 1.4% |
| Agriculture and forestry | 0.9% | 0.7% |
| | 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 on residential properties.
- Corporate loans: Real estate, fishing vessels and other fixed and current assets, including 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.

The value of collateral is based on estimated market value. The valuation of real estate is built on market price, official valuation of the Icelandic Property Registry, or the opinion of internal or external specialists. The valuation of fishing vessels takes into account related fishing quota.

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.

The collateral value in the table below is capped by the exposure amount.

*Collateral held by the Bank against different types of financial assets*

| 2014 | Cash and securities | Real estate | Fishing vessels | Other collateral | Total |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | - | - | - | - | - |
| Loans to credit institutions | - | - | - | - | - |
| Loans to customers | | | | | |
| Individuals | 589 | 282,889 | 43 | 1,093 | 284,614 |
| Real estate activities and construction | 754 | 67,907 | 11 | 3,034 | 71,706 |
| Fishing industry | 100 | 7,980 | 57,462 | 3,190 | 68,732 |
| Information and communication technology | 33 | 2,077 | - | 18,603 | 20,713 |
| Wholesale and retail trade | 367 | 16,826 | 5 | 30,632 | 47,830 |
| Financial and insurance activities | 12,108 | 2,584 | - | 2,886 | 17,578 |
| Industry, energy and manufacturing | 6,007 | 10,391 | 47 | 4,325 | 20,770 |
| Transportation | 86 | 601 | 153 | 3,019 | 3,859 |
| Services | 384 | 3,377 | 96 | 1,348 | 5,205 |
| Public sector | 22 | 3,718 | - | 152 | 3,892 |
| Agriculture and forestry | 5 | 2,553 | - | 124 | 2,682 |
| Financial instruments | 3,330 | - | - | - | 3,330 |
| **Collateral held against different types of financial assets** | 23,785 | 400,903 | 57,817 | 68,406 | 550,911 |

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## 40. Credit risk, continued

| 2013 | Cash and securities | Real estates | Fishing vessels | Other collateral | Total |
|---|---|---|---|---|---|
| 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 sector | 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 |

Information on collateral held at subsidiaries is not available.

*Credit quality by class of financial assets*

| 2014 | Neither past due nor impaired | Past due but not impaired | Individually impaired | Total |
|---|---|---|---|---|
| Cash and balances with Central Bank | 21,063 | - | - | 21,063 |
| Loans to credit institutions | 108,792 | - | - | 108,792 |
| Loans to customers | | | | |
| Loans to corporates | 308,588 | 15,114 | 2,495 | 326,197 |
| Loans to individuals | 277,859 | 32,847 | 10,605 | 321,311 |
| Financial instruments | 70,704 | - | - | 70,704 |
| Other assets with credit risk | 3,514 | - | - | 3,514 |
| **Credit quality by class of financial assets** | 790,520 | 47,961 | 13,100 | 851,581 |

| 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 by class of financial assets** | 783,148 | 44,396 | 18,013 | 845,557 |

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### 40. 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 models are updated annually and recalibrated with current data with the aim of improving their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement.

The table below shows loans to customers that are neither past due nor impaired, broken down by the Bank's classification scale, where 5 denotes the highest risk.

| | Risk classification | | | | | | |
|---|---|---|---|---|---|---|---|
| 2014 | 1 | 2 | 3 | 4 | 5 | Not rated | Total |
| Individuals | 57,039 | 139,569 | 51,547 | 17,397 | 6,818 | 5,489 | 277,859 |
| Real estate activities and construction | 2,898 | 13,931 | 49,417 | 5,679 | 98 | 4,767 | 76,790 |
| Fishing industry | 25,757 | 26,757 | 13,681 | 2,182 | 1,599 | 1,596 | 71,572 |
| Information and communication technology | 371 | 19,469 | 3,205 | 219 | - | - | 23,264 |
| Wholesale and retail trade | 7,248 | 20,332 | 21,292 | 2,843 | 160 | 381 | 52,256 |
| Financial and insurance activities | 679 | 1,907 | 14,707 | 90 | - | 8,032 | 25,415 |
| Industry, energy and manufacturing | 7,804 | 8,017 | 6,996 | 517 | 363 | 621 | 24,318 |
| Transportation | 268 | 3,575 | 958 | 593 | 3 | 62 | 5,459 |
| Services | 820 | 9,848 | 3,577 | 533 | 13 | 2,571 | 17,362 |
| Public sector | 209 | 3,427 | 1,817 | 340 | 35 | 1,422 | 7,250 |
| Agriculture and forestry | 225 | 1,283 | 1,754 | 386 | 388 | 866 | 4,902 |
| **Neither past due nor impaired loans** | 103,318 | 248,115 | 168,951 | 30,779 | 9,477 | 25,807 | 586,447 |
| 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 not applicable.

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### 40. Credit risk, continued

*Past due but not impaired loans by class of loans*

| 2014 | Up to 3 days | 4 to 30 days | 31 to 60 days | 61 to 90 days | More than 90 days | Total |
|---|---|---|---|---|---|---|
| Loans to corporates | 6,553 | 2,434 | 2,267 | 565 | 3,295 | 15,114 |
| Loans to individuals | 3,436 | 10,589 | 5,974 | 847 | 12,001 | 32,847 |
| **Past due but not impaired loans** | 9,989 | 13,023 | 8,241 | 1,412 | 15,296 | 47,961 |

| 2013 | | | | | | |
|---|---|---|---|---|---|---|
| Loans to corporates | 4,550 | 1,550 | 923 | 111 | 2,655 | 9,789 |
| Loans to individuals | 3,719 | 7,505 | 3,751 | 543 | 19,089 | 34,607 |
| **Past due but not impaired loans** | 8,269 | 9,055 | 4,673 | 655 | 21,744 | 44,396 |

Loans past due up to three days are mainly overdrafts that were not renewed in time. The majority of the past due but not impaired loans are considered fully secured with collateral or have been acquired at discount. Loans aquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

*Collateral repossessed*

During the year the Group took possession of assets due to foreclosures. The total amount of real estates the Group took possession of in 2014 and still holds at year end amount to ISK 1,607 million (31.12.2013: ISK 1,692 million) and other assets ISK 10 million (31.12.2013: ISK 5 million). The assets are held for sale, see Note 27.

| *Impaired loans to customers specified by sector* | 2014 Impair-ment amount | 2014 Gross carrying amount | 2013 Impair-ment amount | 2013 Gross carrying amount |
|---|---|---|---|---|
| Individuals | 11,016 | 21,621 | 11,711 | 19,110 |
| Real estate activities and construction | 1,396 | 1,981 | 1,763 | 3,868 |
| Fishing industry | 1,115 | 2,366 | 1,229 | 3,769 |
| Information and communication technology | 251 | 251 | 164 | 190 |
| Wholesale and retail trade | 751 | 831 | 4,034 | 5,985 |
| Financial and insurance activities | 6,739 | 6,756 | 4,513 | 6,080 |
| Industry, energy and manufacturing | 296 | 474 | 463 | 1,029 |
| Transportation | 18 | 18 | 71 | 365 |
| Services | 375 | 641 | 818 | 1,918 |
| Public sector | 27 | 35 | 8 | 35 |
| Agriculture and forestry | 230 | 340 | 352 | 790 |
| | 22,214 | 35,314 | 25,126 | 43,139 |

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### 40. 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 according to FME rules No 625/2013.

The legal maximum for individual large exposures is 25% of the capital base, net of eligible collateral, 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 year was ISK 25 billion (31.12.2013: ISK 29 billion) before taking account of eligible collateral. The Group has two large exposures at the end of the year (31.12.2013: three exposures) net of eligible collateral.

| | 2014 | | 2013 | |
|---|---|---|---|---|
| no. | Gross | Net | Gross | Net |
| 1 | 14% | 14% | 16% | 16% |
| 2 | 11% | 10% | - | - |
| <10% | <10% | <10% | 12% | 12% |
| <10% | <5% | <5% | 17% | 17% |
| <10% | <5% | <5% | 10% | <10% |
| <10% | <1% | <1% | 10% | <10% |
| **Sum of large exposure gross and net > 10%** | 25% | 24% | 65% | 45% |

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

The sum of exposures exceeding 10% of capital base is 25% of the Group's capital base before collateral mitigation or 24% net of eligible collateral, which is well below the 400% legal maximum.

### 41. Market risk

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

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

The Group keeps firm track of market risk and separates its exposures for trading book and banking book. Market risk in the trading book arises from proprietary trading activities. Market risk in the banking book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. Market risk in the trading book and in the banking book is managed separately by Treasury.

Market risk allowance is set by the Board in the Bank’s risk appetite and the CEO decides on the limit framework for each trading desk and sets individual limits. The Asset and Liability Committee is responsible for managing the Bank’s overall market risk. Risk Management is responsible for measuring and monitoring market risk exposure, and reporting the exposure, usage and limit breaches.

The Group's strategy towards market risk is to limit the risk exposure due to imbalances in the Group's balance sheet but accept limited risk in its trading book.

*Interest rate risk*

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair value of financial instruments. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities. This mismatch is characterised by a large gap between the interest fixing period of assets and liabilities, with a large amount of liabilities being demand deposits while the interest rates of assets are generally fixed for a long period, resulting in a yield curve risk for the Group. The Group also faces interest basis risk between interest bearing assets and interest bearing liabilities due to different types of floating rate indices in different currencies, of which the largest one is EUR.

The Group's strategy for managing its interest rate risk is to strive for an interest rate balance between assets and liabilities by offering deposit incentives and by targeted lending practices.

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### 41. Market risk, continued

*Interest rate risk in the banking book*

The following table shows the Group's interest bearing assets and liabilities by interest fixing periods. The figures for loans to customers and borrowings are shown on a fair value basis, see Note 22, and are therefore different from the amounts shown in the financial statements. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category.

The Group's interest bearing assets and liabilities by interest rate adjustement periods

| 2014<br>Assets | Up to 3 months | 3-12 months | 1-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|
| Balances with Central Bank | 15,808 | - | - | - | - | 15,808 |
| Loans to credit institutions | 108,792 | - | - | - | - | 108,792 |
| Loans to customers | 358,943 | 56,338 | 78,887 | 2,845 | 160,248 | 657,261 |
| Financial instruments | 39,963 | 1,552 | 12,609 | 4,672 | 1,046 | 59,842 |
| **Assets** | 523,506 | 57,890 | 91,496 | 7,517 | 161,294 | 841,703 |
| Liabilities | | | | | | |
| Due to credit institutions and Central Bank | 22,876 | - | - | - | - | 22,876 |
| Deposits | 449,638 | 2,124 | 3,270 | - | 101 | 455,133 |
| Borrowings | 62,821 | 18,307 | 7,313 | 1,124 | 107,550 | 197,115 |
| Subordinated loans | 31,639 | - | - | - | - | 31,639 |
| **Liabilities** | 566,974 | 20,431 | 10,583 | 1,124 | 107,651 | 706,763 |
| Derivatives and other off-balance sheet items (net position) | 56 | (2,760) | 2,778 | - | - | 74 |
| **Net interest gap** | (43,412) | 34,699 | 83,691 | 6,393 | 53,643 | 135,014 |

| 2013<br>Assets | Up to 3 months | 3-12 months | 1-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|
| Balances with Central Bank | 33,900 | - | - | - | - | 33,900 |
| Loans to credit institutions | 102,307 | - | - | - | - | 102,307 |
| Loans to customers | 334,622 | 66,274 | 75,931 | 3,261 | 163,906 | 643,994 |
| Financial instruments | 38,474 | 26 | 11 | 555 | 653 | 39,719 |
| **Assets** | 509,303 | 66,300 | 75,942 | 3,816 | 164,559 | 819,920 |
| Liabilities | | | | | | |
| Due to credit institutions and Central Bank | 28,000 | - | - | - | - | 28,000 |
| Deposits | 455,343 | 13,618 | 2,905 | - | - | 471,866 |
| Borrowings | 61,062 | 5,072 | 4,584 | 4,421 | 121,842 | 196,981 |
| Subordinated loans | 31,918 | - | - | - | - | 31,918 |
| **Liabilities** | 576,323 | 18,690 | 7,489 | 4,421 | 121,842 | 728,765 |
| Derivatives and other off-balance sheet items (net position) | 272 | (3,649) | 3,724 | - | - | 347 |
| **Net interest gap** | (66,748) | 43,961 | 72,177 | (605) | 42,717 | 91,502 |

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## 41. Market risk, continued

*Sensitivity analysis of interest rate risk in the banking 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. Sensitivity is quantified as the net change in value of interest bearing assets and liabilities when assuming a simultaneous parallel shift upwards and downwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income and is not an estimate of risk.

| | 2014 | | 2013 | |
|---|---|---|---|---|
| Currency | -100 bps | +100 bps | -100 bps | +100 bps |
| ISK, CPI indexed linked | 5,278 | (4,525) | 2,804 | (2,370) |
| ISK, Non Indexed linked | 995 | (955) | 657 | (638) |
| EUR | 321 | (296) | (63) | 61 |
| Other | 405 | (380) | 38 | (34) |

*Interest rate risk in the trading book*

The following table shows the total basis point value (BPV) of the Group's long and short bond positions in the trading book at market value (MV). BVP denotes the change in the price of a bond given a basis point (0.01%) change in the yield of the bond.

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| Trading financial instruments, long positions | MV | Duration | BPV | MV | Duration | BPV |
| ISK, CPI Indexed linked | 1,924 | 6.3 | (1.2) | 3,417 | 4.4 | (1.5) |
| ISK, Non Indexed linked | 3,353 | (2.1) | 0.7 | 5,810 | 2.4 | (1.4) |
| FX | 22,844 | 0.1 | (0.2) | 12,965 | 0.0 | 0.0 |
| **Total** | 28,121 | 0.3 | (0.7) | 22,192 | 1.3 | (2.9) |
| Trading financial instruments, short positions | | | | | | |
| ISK, CPI Indexed linked | 1,003 | 6.1 | (0.6) | 709 | 2.2 | (0.2) |
| ISK, Non Indexed linked | 7,139 | 0.4 | (0.3) | 5,407 | (0.5) | 0.3 |
| FX | 22,243 | 0.1 | (0.2) | 14,080 | 0.0 | (0.1) |
| **Total** | 30,385 | 0.4 | (1.1) | 20,196 | (0.0) | 0.0 |

*Sensitivity analysis of interest rate risk in the trading book*

The following table shows the sensitivity of the Group's net long and short positions in the trading book by currencies. Sensitivity is quantified as the net change in value of the bonds when assuming a simultaneous parallel shift upwards and downwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income and is not an estimate of risk. The calculations are based on duration and convexity in this table.

| | 2014 | | 2013 | |
|---|---|---|---|---|
| Currency | -100 bps | +100 bps | -100 bps | +100 bps |
| ISK, CPI indexed linked | 62 | (58) | 143 | (126) |
| ISK, Non Indexed linked | (104) | 93 | 169 | (156) |
| EUR | 13 | (12) | (2) | 1 |
| Other | (13) | 13 | (0) | 1 |

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## 41. Market risk, continued

*Indexation risk*

The Group is exposed to indexation risk when there is a mismatch between index-linked assets and liabilities. The total amount of indexed assets is ISK 289.2 billion (31.12.2013: ISK 291.6 billion) and the total amount of indexed liabilities is ISK 204.0 billion (31.12.2013: ISK 223.7 billion). The increase in the Group's indexation balance is mostly due to the prepayment of structured covered bonds. However, new indexed covered bonds were issued late in the year 2014.

Transaction maturity profile of indexed assets and liabilities

| 2014<br>Assets, CPI indexed linked | Up to 1 year | 1 to 5 years | Over 5 years | Total |
|---|---|---|---|---|
| Loans to customers | 9,566 | 74,705 | 200,030 | 284,301 |
| Financial instruments | 2,090 | - | - | 2,090 |
| Off-balance sheet position | 825 | 1,952 | - | 2,777 |
| **Assets, CPI indexed linked** | 12,481 | 76,657 | 200,030 | 289,168 |
| Liabilities, CPI indexed linked | | | | |
| Deposits | 66,489 | 19,615 | 2,415 | 88,519 |
| Borrowings | 2,019 | 13,703 | 99,277 | 114,999 |
| Off-balance sheet position | 524 | - | - | 524 |
| **Liabilities, CPI indexed linked** | 69,032 | 33,318 | 101,692 | 204,042 |
| Net on-balance sheet position | (56,852) | 41,387 | 98,338 | 82,873 |
| Net off-balance sheet position | 301 | 1,952 | - | 2,253 |
| **CPI Balance** | (56,551) | 43,339 | 98,338 | 85,126 |

| 2013<br>Assets, CPI indexed linked | Up to 1 year | 1 to 5 years | Over 5 years | Total |
|---|---|---|---|---|
| Loans to customers | 13,894 | 78,509 | 192,001 | 284,404 |
| Financial instruments | 2,305 | - | - | 2,305 |
| Off-balance sheet position | 2,523 | 2,870 | - | 5,393 |
| **Assets, CPI indexed linked** | 18,722 | 81,379 | 192,001 | 292,102 |
| Liabilities, CPI indexed linked | | | | |
| Deposits | 67,044 | 21,585 | 2,707 | 91,336 |
| Borrowings | 2,830 | 12,625 | 116,914 | 132,369 |
| Off-balance sheet position | 9 | 512 | | 521 |
| **Liabilities, CPI indexed linked** | 69,883 | 34,722 | 119,621 | 224,226 |
| Net on-balance sheet position | (53,675) | 44,299 | 72,380 | 63,004 |
| Net off-balance sheet position | 2,514 | 2,358 | - | 4,872 |
| **CPI Balance** | (51,161) | 46,657 | 72,380 | 67,876 |

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**41. Market risk, continued**

*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.

*Breakdown of assets and liabilities by currency at the end of the year*

| 2014 Assets | ISK | EUR | USD | GBP | DKK | NOK | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 19,472 | 5 | 904 | 178 | 107 | 46 | 351 | 21,063 |
| Loans to credit institutions ................ | 35,076 | 16,570 | 13,141 | 13,646 | 2,946 | 11,084 | 16,329 | 108,792 |
| Loans to customers ........................... | 538,828 | 40,526 | 27,606 | 6,605 | 14,734 | 5,376 | 13,833 | 647,508 |
| Financial instruments ........................ | 73,851 | 14,963 | 7,776 | 3,436 | 47 | 1,736 | 19 | 101,828 |
| Investment property ......................... | 6,842 | - | - | - | - | - | - | 6,842 |
| Investments in associates .................. | 16,052 | - | - | 5,914 | - | - | - | 21,966 |
| Intangible assets ................................ | 5,469 | - | - | - | 4,127 | - | - | 9,596 |
| Tax assets .......................................... | 655 | - | - | - | - | - | - | 655 |
| Other assets ...................................... | 14,665 | 485 | 128 | 123 | 26 | 52 | 7 | 15,486 |
| **Assets ............................................** | 710,910 | 72,549 | 49,555 | 29,902 | 21,987 | 18,294 | 30,539 | 933,736 |
| | | | | | | | | |
| Liabilities and equity | | | | | | | | |
| Due to credit inst. and Central Bank .. | 16,752 | 2,103 | 958 | 5 | 1 | - | 3,057 | 22,876 |
| Deposits ............................................ | 374,063 | 25,949 | 16,247 | 11,348 | 9,306 | 8,075 | 9,985 | 454,973 |
| Financial liabilities at fair value ......... | 8,971 | 43 | 127 | - | 1 | - | 1 | 9,143 |
| Tax liabilities ..................................... | 4,642 | - | - | - | 481 | - | - | 5,123 |
| Other liabilities .................................. | 37,336 | 2,217 | 3,470 | 975 | 2,199 | 174 | 819 | 47,190 |
| Borrowings ........................................ | 135,285 | 1,714 | 22,475 | 8,812 | - | 8,478 | 23,816 | 200,580 |
| Subordinated liabilities ...................... | - | 25,133 | 2,550 | 3,956 | - | - | - | 31,639 |
| Shareholders' equity ......................... | 160,711 | - | - | - | - | - | - | 160,711 |
| Non-controlling interest .................... | 1,501 | - | - | - | - | - | - | 1,501 |
| **Liabilities and equity .......................** | 739,261 | 57,159 | 45,827 | 25,096 | 11,988 | 16,727 | 37,678 | 933,736 |
| | | | | | | | | |
| Net on-balance sheet position .......... | (28,351) | 15,390 | 3,728 | 4,806 | 9,999 | 1,567 | (7,139) | |
| Net off-balance sheet position .......... | 9,454 | (9,065) | (397) | 56 | (8,963) | - | 8,915 | |
| | | | | | | | | |
| **Net position ...................................** | (18,897) | 6,325 | 3,331 | 4,862 | 1,036 | 1,567 | 1,776 | |

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### 41. Market risk, continued

2013

| Assets | ISK | EUR | USD | GBP | DKK | NOK | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 30,745 | 4,971 | 731 | 376 | 108 | 48 | 1,020 | 37,999 |
| Loans to credit institutions | 25,156 | 17,490 | 10,064 | 15,071 | 1,118 | 17,463 | 15,945 | 102,307 |
| Loans to customers | 514,206 | 50,739 | 27,080 | 7,241 | 10,041 | 842 | 25,625 | 635,774 |
| Financial instruments | 65,025 | 13,754 | 4,860 | 73 | - | 2,819 | 10 | 86,541 |
| Investment property | 28,523 | - | - | - | - | - | - | 28,523 |
| Investments in associates | 12,253 | - | - | 5,676 | - | - | - | 17,929 |
| Intangible assets | 5,383 | - | - | - | - | - | - | 5,383 |
| Tax assets | 818 | - | - | - | - | - | - | 818 |
| Other assets | 22,903 | 486 | 104 | 46 | - | 5 | 32 | 23,576 |
| **Assets** | 705,012 | 87,440 | 42,839 | 28,483 | 11,267 | 21,177 | 42,632 | 938,850 |
| | | | | | | | | |
| Liabilities and equity | | | | | | | | |
| Due to credit inst. and Central Bank | 23,189 | 1,832 | 622 | 4 | - | - | 2,353 | 28,000 |
| Deposits | 390,397 | 27,457 | 13,751 | 10,940 | 9,024 | 9,299 | 10,998 | 471,866 |
| Financial liabilities at fair value | 8,921 | 32 | 2 | - | - | 1 | 4 | 8,960 |
| Tax liabilities | 4,924 | - | - | - | - | - | - | 4,924 |
| Other liabilities | 38,508 | 1,120 | 2,114 | 59 | 1,018 | 112 | 736 | 43,667 |
| Borrowings | 140,012 | 2,202 | 18,669 | 6,728 | - | 9,356 | 27,601 | 204,568 |
| Subordinated liabilities | - | 25,818 | 2,303 | 3,797 | - | - | - | 31,918 |
| Shareholders' equity | 140,089 | - | - | - | - | - | - | 140,089 |
| Non-controlling interest | 4,858 | - | - | - | - | - | - | 4,858 |
| **Liabilities and equity** | 750,898 | 58,461 | 37,461 | 21,528 | 10,042 | 18,768 | 41,692 | 938,850 |
| | | | | | | | | |
| Net on-balance sheet position | (45,886) | 28,979 | 5,378 | 6,955 | 1,225 | 2,409 | 940 | |
| Net off-balance sheet position | 14,256 | (17,076) | 924 | 1,069 | (498) | (1,077) | 2,402 | |
| | | | | | | | | |
| **Net position** | (31,630) | 11,903 | 6,302 | 8,024 | 727 | 1,332 | 3,342 | |

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## 41. Market risk, continued

*Sensitivity analysis on currency risk*

The table below indicates the currencies to which the Group had significant exposure at 31 December 2014. The analysis calculates the effect of a reasonably possible movement of the currency rate against the ISK, with all other variables held constant, on the income statement (due to the fair value of currency sensitive non-trading monetary assets and liabilities). A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase. An equivalent decrease in each of the below currencies against the ISK would have resulted in an equivalent but opposite impact (+10% denotes a depreciation of the ISK).

| | 2014 | | 2013 | |
|---|---|---|---|---|
| Currency | -10% | +10% | -10% | +10% |
| EUR | (633) | 633 | (1,190) | 1,190 |
| USD | (333) | 333 | (630) | 630 |
| GBP | (486) | 486 | (124) | 124 |
| DKK | (104) | 104 | (802) | 802 |
| NOK | (157) | 157 | (150) | 150 |
| Other | (178) | 178 | (266) | 266 |

*Equity risk*

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. The non-trading equity price risk exposure is mainly due to restructuring of the Group's assets i.e. restructuring of troubled companies which the Group has taken over. For information on assets seized and held for sale and equity exposures, see Notes 27 and 21 respectively.

*Sensitivity analysis on equity risk*

The analysis below calculates the effect of a reasonable possible movement in equity prices on the income statement. A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase.

| | 2014 | | 2013 | |
|---|---|---|---|---|
| Equity | -10% | +10% | -10% | +10% |
| Trading book - listed | (154) | 154 | (120) | 120 |
| Banking book - listed | (708) | 708 | (307) | 307 |
| Banking book - unlisted | (1,551) | 1,551 | (1,094) | 1,094 |

*Derivatives*

Customers can enter into derivatives contracts with the Bank. The types of derivatives currently offered by the Group are FX swaps and forwards, interest rate swaps, cross-currency swaps, as well as options and forwards on equities, Treasury notes and bonds with Government guarantee. Limits on exposures and collateral are determined in accordance with the Group's risk appetite. The Group also uses derivatives to reduce market risk on its balance sheet. The Group's exposure to derivative instruments is not considered a material risk.

*Prepayment risk*

Prepayment risk is the risk that the Group will incur a financial loss because its customers and counterparties repay or request repayment earlier or later than expected, such as fixed rate mortgages when interest rates fall. The Group is not materially exposed to prepayment risk at the end of the year 2014.

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### 42. 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.

The Group's primary source of funding is deposits from individuals, businesses and financial institutions. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 63% is on-demand or with less than 30 day term.

Liquidity risk is one of the Group's most significant risk factors and a great deal of emphasis is placed on managing it. The Asset and Liability Committee is responsible for managing liquidity risk within the risk appetite the Board sets. The Bank's Treasury manages liquidity positions on a day-to day basis. Risk Management measures, monitors and reports the Bank's liquidity risk.

The Icelandic economy has been subject to capital controls since late 2008. The Group's strategy is to always maintain sufficient liquidity by maintaining a high ratio of liquid assets and available funding to near term liabilities and possible payment outflows. The lifting of the capital controls remains uncertain.

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

| 2014<br>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 | 21,063 | 12,285 | - | 8,778 | - | - | - |
| Loans to credit institutions | 108,792 | 52,119 | 56,673 | - | - | - | - |
| Loans to customers | 647,508 | 11,678 | 50,642 | 89,332 | 230,055 | 265,801 | - |
| Financial instruments | 101,828 | 7,562 | 742 | 2,203 | 52,527 | 7,670 | 31,124 |
| *Derivatives - assets leg* | 28,234 | - | 6,654 | 15,659 | 5,921 | - | - |
| *Derivatives - liabilities leg* | (27,209) | - | (5,912) | (15,524) | (5,773) | - | - |
| Investment property | 6,842 | - | - | - | - | - | 6,842 |
| Investments in associates | 21,966 | - | - | - | - | - | 21,966 |
| Intangible assets | 9,596 | - | - | - | - | - | 9,596 |
| Tax assets | 655 | - | - | - | 655 | - | - |
| Other assets | 15,486 | 47 | 2,283 | 46 | 1,121 | 17 | 11,972 |
| **Assets** | 933,736 | 83,691 | 110,340 | 100,359 | 284,358 | 273,488 | 81,500 |
| Liabilities | | | | | | | |
| Due to credit institutions and Central Bank | 22,876 | 13,652 | 2,238 | 6,962 | 24 | - | - |
| Deposits | 454,973 | 263,899 | 96,009 | 46,412 | 45,102 | 3,551 | - |
| Financial liabilities at fair value | 9,143 | - | 8,663 | 227 | 253 | - | - |
| *Derivatives - assets leg* | (15,693) | - | (4,525) | (10,504) | (664) | - | - |
| *Derivatives - liabilities leg* | 16,598 | - | 4,950 | 10,731 | 917 | - | - |
| *Short position bonds and derivatives* | 5,478 | - | 5,478 | - | - | - | - |
| *Short position bonds used for hedging* | 2,760 | - | 2,760 | - | - | - | - |
| Tax liabilities | 5,123 | - | 1,125 | 3,374 | 624 | - | - |
| Other liabilities | 47,190 | 667 | 30,372 | 5,192 | 2,680 | 120 | 8,159 |
| Borrowings | 200,580 | - | 1,776 | 20,057 | 24,908 | 153,839 | - |
| Subordinated liabilities | 31,639 | - | - | - | - | 31,639 | - |
| **Liabilities** | 771,524 | 278,218 | 140,183 | 82,224 | 73,591 | 189,149 | 8,159 |
| Off-balance sheet items | | | | | | | |
| Guarantees | 9,542 | 2,373 | 1,234 | 2,389 | 1,753 | 1,793 | - |
| Unused overdraft | 38,890 | 658 | 10,163 | 17,738 | 10,273 | 58 | - |
| Loan commitments | 56,363 | 2,432 | 21,419 | 15,705 | 16,807 | - | - |
| **Off-balance sheet items** | 104,795 | 5,463 | 32,816 | 35,832 | 28,833 | 1,851 | - |
| **Net assets (liabilities)** | 57,417 | (199,990) | (62,659) | (17,697) | 181,934 | 82,488 | 73,341 |

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## 42. Liquidity risk, continued

| 2013<br>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** | 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** | 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 assets (liabilities)** | 49,069 | (185,733) | (89,857) | (15,655) | 189,534 | 65,225 | 85,556 |

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## 42. Liquidity risk, continued

*Liquidity coverage ratio*

The liquidity coverage ratio (LCR) is part of the standards introduced in the Basel III Accord and is to be implemented in 2015 on a global level. The LCR is the result of a stress test that is designed to ensure that banks have the necessary assets on hand to withstand short-term liquidity disruptions. More accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, 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 LCR. In 2014, the LCR requirement was 100% in foreign currency and 70% in total (ISK and foreign currency). In 2015 the limits are 100% and 80%, respectively. The latter benchmark increases by 10% every year until a 100% requirement is implemented in 2017.

| Liquidity coverage ratio | 2014 | 2013 |
|---|---|---|
| FX | 254% | 274% |
| Total | 174% | 123% |

*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.

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## 42. 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. The table contains deposits at the Bank and at banking subsdidiaries. Thus, amounts due to Central Bank and amounts due to credit institutions at non-banking subsidiaries are excluded.

*LCR categorization - amounts and LCR outflow weights*

| | Deposits maturing within 30 days | | | | | |
|---|---|---|---|---|---|---|
| 2014 | Less Stable | Weight (%) | Stable | Weight (%) | Term deposits* | Total deposits |
| Retail | 78,659 | 10% | 36,076 | 5% | 53,803 | 168,538 |
| SME | 36,060 | 10% | 3,895 | 5% | 6,011 | 45,966 |
| Operational relationship | - | 25% | - | 5% | 1,190 | 1,190 |
| Corporations | 36,961 | 40% | 830 | 20% | 5,873 | 43,664 |
| Sovereigns, central-banks and PSE | 12,196 | 40% | - | - | 2,870 | 15,066 |
| Financial entities being wound up | 19,796 | 100% | - | - | 67,105 | 86,901 |
| Pension funds | 36,824 | 100% | - | - | 19,765 | 56,589 |
| Domestic financial entities | 22,634 | 100% | - | - | 16,752 | 39,386 |
| Foreign financial entities | 4,532 | 100% | - | - | 522 | 5,054 |
| Other foreign parties | 3,425 | 100% | 3,026 | 25% | 2,082 | 8,533 |
| **Total** | 251,087 | | 43,827 | | 175,973 | 470,887 |

| 2013** | | | | | | |
|---|---|---|---|---|---|---|
| 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 2014 resulted in certain deposit pension funds being re-classified as retail deposits. Here, 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.

## 43. Operational risk

Operational risk is the risk of direct or indirect loss, or damage to the Bank's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Group's image and operational earnings.

Each business unit within the Group is primarily responsible for taking and managing their own operational risk. Operational risk function is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Group's operational risk.

The Group uses the Basel II basic indicator approach to the calculation of capital requirements for operational risk.

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## 44. Capital management

The capital base at 31 December 2014 amounts to ISK 183,388 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 26.3%, 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 | 2014 | 2013 |
|---|---|---|
| Share capital and share premium | 75,861 | 75,861 |
| Other reserves | 1,632 | 1,637 |
| Retained earnings | 83,218 | 62,591 |
| Non-controlling interests | 1,501 | 4,858 |
| **Total equity** | 162,212 | 144,947 |
| Intangible assets | (9,596) | (5,383) |
| Tax assets | (655) | (818) |
| Other statutory deductions | (111) | (119) |
| **Tier 1 capital** | 151,850 | 138,627 |
| Subordinated liabilities | 31,639 | 31,918 |
| Other statutory deductions | (101) | (106) |
| **Tier 2 capital** | 31,538 | 31,812 |
| **Total Capital base** | 183,388 | 170,439 |
| Risk weighted assets | | |
| Credit risk | 591,994 | 608,029 |
| Market risk FX | 18,915 | 31,703 |
| Market risk other | 2,890 | 4,993 |
| Operational risk | 82,211 | 76,097 |
| **Total risk weighted assets** | 696,010 | 720,822 |
| Tier 1 ratio | 21.8% | 19.2% |
| Capital adequacy ratio | 26.3% | 23.6% |

As part of the Basel III regulatory framework, the leverage ratio is seen as a complementary measure to the risk-based Capital adequacy ratio.

| | 2014 | 2013 |
|---|---|---|
| On-balance sheet exposures | 912,303 | 921,079 |
| Derivative exposures | 1,348 | 1,929 |
| Securities financing transaction exposures | 10,044 | 10,381 |
| Off-balance sheet exposures | 59,922 | 25,199 |
| **Total exposure** | 983,617 | 958,588 |
| **Tier 1 capital** | 151,850 | 138,627 |
| Leverage ratio | 15.4% | 14.5% |

*Arion Bank Consolidated Financial Statements 2014* 65 *Amounts are in ISK millions*

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## SIGNIFICANT ACCOUNTING POLICIES

The accounting policies adopted in the preparation of these 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 except for new and amended IFRS adopted by the European Union, that became effective as of 1 January 2014, see Note 70, and amendmends to Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions, to the extent that they are not inconsistent with the requirements of IFRS EU.

### 1. 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.

### 2. Principles underlying the consolidation

*Subsidiaries*

Subsidiaries are entities controlled by the Group. The Financial Statements of subsidiaries are included in the Financial Statements from the date that control commences until the date that control ceases. The Financial Statements of the subsidiaries are prepared for the same reporting period as the parent entity, using consistent accounting policies.

*Business combinations*

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if, and only if, the Group has:

- power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee);
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect its returns.

Generally, there is a presumption that a majority of voting rights result in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an investee, the Group considers all relevant facts and circumstances in assessing whether it has power over an investee, including (i) the contractual arrangement with the other vote holders of the investee, (ii) rights arising from other contractual arrangements and (iii) the Group's voting rights and potential voting rights. The Group re-assesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

The Group measures goodwill at the acquisition date as:

- the fair value of the consideration transferred; plus
- the recognised amount of any non-controlling interests in the acquiree; less
- if the business combination is achieved in stages, the fair value of the pre-existing equity interest in the acquiree; less
- the net recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed.

When the excess is negative, a bargain purchase gain is recognised immediately in profit or loss.

Transaction costs incurred are expensed and included in administration expense.

*Non-controlling interests*

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Group; such interests are presented separately in the Statement of Comprehensive Income and are included in equity in the Statement of Financial Position, separately from equity attributable to owners of the Group.

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:

- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

Changes in the Group's interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

## 2. Principles underlying the consolidation, continued

*Loss of control*

On the loss of control, the Group derecognises the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss.

*Transactions eliminated on consolidation*

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Financial Statements.

If an investment in subsidiary is classified as held for sale the investment is accounted for, as non-current asset and disposal groups held for sale from the date of classification.

*Funds management*

The Group manages and administers assets held in unit trusts and investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Financial Statements except when the Group controls the entity.

When assessing whether to consolidate investment funds, the Group reviews all facts and circumstances to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal, and hence controls and consolidates a fund, when the Group acts as fund manager and cannot be removed without cause, has variable returns through significant holdings, and is able to influence the returns of the funds by exercising its power. The Group is defined as agent in all instances.

## 3. Associates

Associates are those entities over which the Group has significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Group holds 20% or more of the voting power, including potential voting rights, unless it can be clearly demonstrated that this is not the case. Investments in associates are initially recognised at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The considerations made in determining significant influence are similar to those necessary to determine control over subsidiaries.

The Group’s investments in its associate are accounted for using the equity method.

The Financial Statements include the Group's share of the total recognised income and expenses of associates from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its carrying value of associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

Upon loss of significant influence over the associate, the Group measures and recognises any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognised in profit or loss.

*Impairment on investments in associates*

After applying the equity method to account for investments in associates, the Group determines whether it is necessary to recognise any impairment loss with respect to its investments in associates. The Group first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Group then tests the entire carrying amount of the investment for impairment, by comparing its recoverable amount, which is the higher of value in use and fair value less costs to sell, with its carrying amount. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the Group. The excess of the carrying amount over the recoverable amount is recognised in the Statement of Comprehensive Income as an impairment loss. Impairment losses are subsequently reversed through the Statement of Comprehensive Income if the reasons for the impairment loss no longer apply.

### 4. Foreign currency

Items included in the Financial Statements of each of the Group's subsidiaries are measured using the functional currency of the respective entity.

*Foreign currency transactions*

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. All differences arising on settlement or translation of monetary items are taken to the Statement of Comprehensive Income. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

### 5. Interest

Interest income and expense are recognised in the Statement of Comprehensive Income using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and financial liability and is not revised subsequently.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the Statement of Comprehensive Income include:

- interest on financial assets and liabilities at amortised cost on an effective interest rate basis;
- interest on financial assets and liabilities held for trading; and
- interest on financial assets designated at fair value through profit or loss.

### 6. Fee and commission

The Group provides various services to its clients and earns income therefrom, such as income from Corporate banking, Retail banking, Capital Markets, Corporate Finance,  Asset Management and Private banking. Fees earned from services that are provided over a certain period of time are recognised as the services are provided. Fees earned from transaction type services are recognised when the service has been completed. Fees that are performance linked are recognised when the performance criteria are fulfilled.

Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

### 7. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and financial liabilities classified as held for trading, Net gain on financial assets and liabilities at fair value, Net foreign exchange gain.

i) Dividend income is recognised when the right to receive dividend is established. Usually this is the ex-dividend date for equity securities.

ii) Net gain on financial assets and liabilities at fair value comprises all realised and unrealised fair value changes in trading portfolio and assets and liabilities designated at fair value through profit or loss, except for interest (which is included in Interest income and Interest expense) and foreign exchange gain and losses (which are included in Net foreign exchange gains as described below).

iii) Net foreign exchange gain comprise all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous Financial Statements.

Net foreign exchange gain also include foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognised in profit or loss.

## 8. Income tax expense

Tax expense comprises current and deferred tax. Income tax for the year has been calculated and recognised in the Financial Statements.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is recognised in respect of temporary differences between the carrying amounts of assets and liabilities and the realization of foreign exchange gain or loss, for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantively enacted at the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

A deferred tax asset is recognised for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

## 9. Financial assets and financial liabilities

*Recognition*

The Group initially recognises loans, deposits, debt securities issued and subordinated liabilities on the date that they are originated. Regular way purchases and sales of financial assets are recognised on the trade date at which the Group commits to purchase or sell the asset. All other financial assets and liabilities are recognised on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction costs that are directly attributable to its acquisition or issue.

*Classification*

The Group classifies its financial assets in one of the following categories:

- amortised cost;
- at fair value through profit or loss and within the category as:
  - held for trading; or
  - designated at fair value through profit or loss.

The Group classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortised cost or held for trading.

*Designation at fair value through profit or loss*

The Group has designated financial assets and liabilities at fair value through profit or loss in either of the following circumstances:

- the assets or liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

*Derecognition*

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership.

Financial liabilities are derecognised when the obligation of the Group specified in the contract is discharged or cancelled or expires.

### 9. Financial assets and financial liabilities, continued

*Offsetting*

Financial assets and liabilities are set off and the net amount reported in the Statement of Financial Position when, and only when, the Group has a legal right to offset the recognised amounts and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains or losses arising from a group of similar transactions such as in the Group's trading activity.

Disclosures on offsetting are provided in Note 23.

*Amortised cost measurement*

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

All consumer price indexed assets and liabilities are revalued based on the index rate at the end of the year.

*Fair value measurement*

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Group measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses, and option pricing models. The Group uses widely recognised valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the Statement of Financial Position.

*Identification and measurement of impairment*

At each reporting date the Group assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired. Financial assets are impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the assets, and that the loss event has an impact on the future cash flows on the asset that can be estimated reliably.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, default or delinquency by a borrower, restructuring of a loan or advance by the Group on terms that the Group would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, the disappearance of an active market for a security, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group. In addition, for an investment in an equity security, a significant or prolonged decline in its fair value below its cost is objective evidence of impairment.

### 9. Financial assets and financial liabilities, continued

The Group considers evidence of impairment for loans at both a borrower-specific and a collective level. Borrowers for specific assessment are sampled based on a combination of the borrowers' exposure, days in default and an internal classification where customers are classified according to financial position, defaults and credit rating. In determining specific provisions for impairment on individually assessed borrowers, the following factors are considered:

- the Group's aggregate exposure to the customer;
- the amount and timing of expected receipts and recoveries;
- the likely distribution available on liquidation or bankruptcy;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of collateral (or other credit mitigates) and likelihood of successful repossession; and
- the likely deduction of any costs involved in recovery of amounts outstanding.

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow.

Collective provisions are taken for all loans other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default, but have been determined not to require specific impairment.

In assessing collective impairment, two deciding, quantitative components need to be addressed in order to perform the calculation i.e. probability of default (PD) and loss given default (LGD). The Group uses internally developed probability-of-default models, which are regularly benchmarked against actual outcomes to ensure the predictive power of the models. For loss given default the Group uses internally developed models as well.

Impairment losses are recognised in profit or loss and reflected in an allowance account against loans. When an event occurring after the impairment was recognised causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument´s original effective interest rate. The adjustment is recognised as increase in value of loans in profit or loss when recalculation results in an increase in carrying amount and impairment when decrease in carrying amount.

Loans are written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of collateral have been received.

### 10. Cash and cash equivalents

Cash and cash equivalents in the Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition. Cash and cash equivalents are carried at amortised cost in the Statement of Financial position.

### 11. Loans

Loans are financial instruments with fixed or determinable payments that are not quoted in an active market and that the Group does not intend to sell immediately or in the near term. Loans include loans provided by the Group to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

Loans are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method.

### 11. Loans, continued

When the Group is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, the arrangement is classified as a capital lease and a receivable equal to the net investment in the lease is recognised and presented within loans.

When the Group purchases a asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date reverse repo or stock borrowing, the arrangement is accounted for as a loan, and the underlying asset is not recognised in the Group's Financial Statements.

### 12. Financial instruments

*Trading assets and liabilities*

Trading assets and liabilities are financial instruments acquired principally for the purpose of generating profits from short term price fluctuations or from a dealer’s margin, and derivative financial instruments.

Securities used for hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts.

*Financial assets designated at fair value through profit or loss*

Assets classified designated at fair value through profit or loss consist of equity and debt instruments which are acquired by the Group with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial instruments and trading liabilities are initially and subsequently measured at fair value in the Statement of Financial position, with transaction costs recognised in profit or loss.  All changes in fair value are recognised as part of net financial income in profit or loss.

Interest and dividend income that arises from these assets are included in Interest income and Net financial income, respectively.

### 13. Derivatives

A derivative is a financial instrument or other contract, the value of which changes in response to a change in an underlying variable, such as share, commodity or bond prices, an index value or an exchange or interest rate, which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

Derivatives are recognised at fair value. Fair value changes are recognised in the Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and net financial gain or loss. Interest income is recognised on an accrual basis. Derivatives with positive fair values are recognised as Financial instruments and derivatives with negative fair values are recognised as Financial liabilities at fair value.

### 14. Intangible assets

*Goodwill*
Goodwill that arises on the acquisition of subsidiaries is presented with intangible assets.  Subsequent to initial recognition goodwill is measured at cost less accumulated impairment losses.

*Infrastucture and customer relationship*
Infrastructure and customer relationship and related agreements  are measured at cost less any accumulated impairment losses.

*Software*

Software acquired by the Group is measured at cost less accumulated amortisation and any accumulated impairment losses.

Subsequent expenditure on software is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Amortisation of software is recognised in the Statement of Comprehensive Income on a straight-line basis over the estimated useful life, from the date that it is available for use. The estimated useful life of software for the current and comparative periods is five years.

### 15. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both.

Investment property is initially measured at cost and subsequently at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the statement of comprehensive income.

### 16. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than non-current assets held for resale, investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The recoverable amount of intangible assets is assessed annually.

An impairment loss is recognised if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognised in profit or loss.

The recoverable amount of an asset is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss in respect of other assets, where impairment losses have been recognised in prior periods, are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

### 17. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortised cost using the effective interest method.

### 18. Borrowings

Some of the borrowings of the Group are classified as other financial liabilities and are initially recognised at fair value less attributable transaction costs. Subsequent to initial recognition, borrowings are measured at amortised cost with any difference between cost and redemption amount being recognised in the Statement of Comprehensive Income over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

### 19. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within Tier II, as shown in Note 44. The Group may only retire subordinated liabilities with the permission of the Icelandic Financial Supervisory Authority.

Subordinated liabilities are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at principal amount due plus accrued interest, which is recognised in the Statement of Comprehensive Income based on the contractual terms of the borrowing.

## 20. Other assets and other liabilities

*Property and equipment*

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses. When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

Subsequent expenditure is capitalised only when it is probable that the future economic benefits of the expenditure will flow to the Group. Ongoing repairs and maintenance are expensed as incurred.

The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives are as follows:

| | |
|---|---|
| Buildings | 33-50 years |
| Equipment | 3-8 years |

The depreciation methods, useful lives and residual values are reassessed annually.

*Non-current assets and disposal groups held for sale*

The Group classifies a non-current asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset or disposal group and the sale must be highly probable.

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognised at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement. Revaluation through the reversal of impairment in subsequent periods is limited so that the carrying amount of the held for sale, non-current assets or disposal group does not exceed the carrying amount that would have been determined had no impairment loss been recognised in prior years.

*Other assets and other liabilities*

Other assets and other liabilities are stated at cost less impairment.

## 21. Equity

*Dividends*

Dividends on shares are recognised in equity in the period in which they are approved by Arion Bank´s shareholders.

*Statutory reserve*

According to the Icelandic companies Act No. 2/1995 at least 10% of the profit of the Group which is not devoted to meeting losses from previous years and is not contributed to other legal reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital. When that limit has been reached the contribution must be at least 5% of the profit until the statutory reserve amounts to 25% of the share capital of the Bank.

*Foreign currency translation reserve*

The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the Financial Statements of foreign operations.

## 22. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to the shareholders of Arion Bank hf. by the weighted average number of ordinary shares outstanding during the year.

### 23. Financial guarantees

In the ordinary course of business, the Group gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognised in the Financial Statements at fair value, being the premium received. Subsequent to initial recognition, the Group's liability under each guarantee is measured at the higher of the amount initially recognised less, when appropriate, cumulative amortisation recognised in the Statement of Comprehensive Income, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is recorded in the Statement of Comprehensive Income. The premium received is recognised in the Statement of Comprehensive Income in Net fees and commission income on a straight line basis over the life of the guarantee.

### 24. Fiduciary activities

The Group provides asset custody, asset management, investment management and advisory services to its clients. These services require the Group to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Group's custody are not reported in its Statement of Financial Position.

### 25. Employee benefits

All entities with employees within the Group have defined contribution plans. The entities pay fixed contribution to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid. The contributions are recognised as an expense in the Statement of Comprehensive Income when they become due. The Group does not operate any pension fund which confers pension rights.

### 26. New standards and amendments to standards

*New and amended standards and interpretations*

The accounting policies adopted are consistent with those of the previous financial year, except for the following new and amended IFRS and intepretations effective as of 1 January 2014:

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. Adoption of the standard did not have impacts on the financial position or performance of the Group during the year.

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. The standard has led to some additional disclosures in the Financial Statements.

IAS 32 Offsetting Financial Assets and Financial Liabilities — Amendments to IAS 32. The amendments clarify the meaning of "currently has a legally enforceable right to set-off". The amendments did not have impact on the financial position or performance of the Group.

IFRIC 21 Levies. The intepretation clarifies that an entity recognises a liability for a levy when the activity that triggers payment, as identified by the relevant legislation, occurs. For a levy that is triggered upon reaching a minimum threshold, the interpretation clarifies that no liability should be anticipated before the specified minimum threshold is reached. Retrospective application is required for IFRIC 21. This interpretation did not have material impact on the financial position or performance of the Group.

### 26. New standards and amendments to standards, continued

*A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2014, and have not been applied in preparing these Financial Statements. Relevant to the Group's reporting are:*

IFRS 9 Financial Instruments. In July 2014, the IASB issued the final version of IFRS 9 Financial Instruments which reflects all phases of the financial instruments project and replaces IAS 39 Financial Instruments: Recognition and Measurement and all previous versions of IFRS 9. The standard introduces new requirements for classification and measurement, impairment, and hedge accounting. IFRS 9 is effective for annual periods beginning on or after 1 January 2018, with early application permitted. Retrospective application is required, but comparative information is not compulsory. Early application of previous versions of IFRS 9 (2009, 2010 and 2013) is permitted if the date of initial application is before 1 February 2015. The Group is currently assessing the impact of the new standard on its Financial Statements. This standard has not been adopted by the European Union.

IFRS 15 Revenue from Contracts with Customers. The standard was issued in May 2014 and establishes a new five-step model that will apply to revenue arising from contracts with customers. Under IFRS 15 revenue is recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. The principles in IFRS 15 provide a more structured approach to measuring and recognising revenue. The new revenue standard is applicable to all entities and will supersede all current revenue recognition requirements under IFRS. Either a full or modified retrospective application is required for annual periods beginning on or after 1 January 2017 with early adoption permitted. The Group is currently assessing the impact of IFRS 15.

# 5 YEAR OVERVIEW

## INCOME STATEMENT

| | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|
| Net interest income | 24,220 | 23,800 | 27,142 | 23,388 | 19,785 |
| Net fee and commission income | 13,309 | 11,223 | 10,748 | 10,685 | 6,866 |
| Net financial income | 6,477 | 3,441 | 583 | 511 | (3,098) |
| Net foreign exchange gain (loss) | 813 | (1,766) | 1,434 | 1,836 | 4,459 |
| Other operating income | 9,171 | 7,650 | 9,595 | 5,505 | 5,733 |
| **Operating income** | 53,990 | 44,348 | 49,502 | 41,925 | 33,745 |
| Salaries and related expense | (13,979) | (13,537) | (12,459) | (11,254) | (9,272) |
| Other operating expense | (13,063) | (11,858) | (12,209) | (10,762) | (9,020) |
| **Net earnings before impairment** | 26,948 | 18,953 | 24,834 | 19,909 | 15,453 |
| Net impairment | 2,135 | (680) | (4,690) | (8,649) | 1,878 |
| **Net earnings before taxes** | 29,083 | 18,273 | 20,144 | 11,260 | 17,331 |
| Income tax expense | (4,679) | (3,143) | (3,633) | (1,912) | (3,481) |
| Bank levy | (2,643) | (2,872) | (1,062) | (1,046) | (290) |
| **Net earnings from continuing operations** | 21,761 | 12,258 | 15,449 | 8,302 | 13,560 |
| Net gain (loss) from discontinued operations, net of tax | 6,833 | 399 | 1,607 | 2,792 | (1,003) |
| **Net earnings** | 28,594 | 12,657 | 17,056 | 11,094 | 12,557 |

## STATEMENT OF FINANCIAL POSITION

| | 31.12.2014 | 31.12.2013 | 31.12.2012 | 31.12.2011 | 31.12.2010 |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Cash and balances with Central Bank | 21,063 | 37,999 | 29,746 | 29,200 | 30,628 |
| Loans to credit institutions | 108,792 | 102,307 | 101,011 | 69,103 | 67,846 |
| Loans to customers | 647,508 | 635,774 | 566,610 | 561,550 | 451,219 |
| Financial instruments | 101,828 | 86,541 | 137,800 | 157,659 | 158,955 |
| Investment property | 6,842 | 28,523 | 28,919 | 27,100 | 27,642 |
| Investments in associates | 21,966 | 17,929 | 7,050 | 2,987 | 2,713 |
| Intangible assets | 9,596 | 5,383 | 4,941 | 4,765 | 4,352 |
| Tax assets | 655 | 818 | 463 | 724 | 295 |
| Other assets | 15,486 | 23,576 | 24,135 | 39,033 | 68,965 |
| **Total Assets** | 933,736 | 938,850 | 900,675 | 892,121 | 812,615 |
| **Liabilities and Equity** | | | | | |
| Due to credit institutions and Central Bank | 22,876 | 28,000 | 32,990 | 16,160 | 95,646 |
| Deposits | 454,973 | 471,866 | 448,683 | 489,995 | 457,881 |
| Financial liabilities at fair value | 9,143 | 8,960 | 13,465 | 4,907 | 999 |
| Tax liabilities | 5,123 | 4,924 | 3,237 | 3,421 | 4,454 |
| Other liabilities | 47,190 | 43,667 | 42,117 | 43,772 | 52,564 |
| Borrowings | 200,580 | 204,568 | 195,085 | 187,203 | 65,278 |
| Subordinated liabilities | 31,639 | 31,918 | 34,220 | 32,105 | 26,257 |
| **Total liabilities** | 771,524 | 793,903 | 769,797 | 777,563 | 703,079 |
| Shareholders´ equity | 160,711 | 140,089 | 127,072 | 110,448 | 105,917 |
| Non-controlling interest | 1,501 | 4,858 | 3,806 | 4,110 | 3,619 |
| **Total equity** | 162,212 | 144,947 | 130,878 | 114,558 | 109,536 |
| **Total Liabilities and Equity** | 933,736 | 938,850 | 900,675 | 892,121 | 812,615 |

*Arion Bank Consolidated Financial Statements 2014* 77 *Amounts are in ISK millions*

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