Arion Bank

Press release, 24 February 2015

ARION BANK'S 2014 FINANCIAL RESULTS

Arion Bank reported net earnings of ISK 28.7 billion for the year 2014, compared with ISK 12.7 billion for the year 2013. Return on equity was 18.6%, compared with 9.2% in 2013. Total assets amounted to ISK 933.7 billion, compared with ISK 938.9 billion at the end of 2013.

The Bank's capital ratio at the end of 2014 was 26.3%, compared with 23.6% at the end of 2013 and CET 1 was 21.8% compared with 19.2% in the previous year.

The Consolidated Financial Statements of Arion Bank have been audited by the Bank's auditor, Ernst & Young ehf.

Highlights of the annual financial statement

- Net earnings of ISK 28.6 billion, compared with ISK 12.7 billion in 2013.
- The capital ratio was 26.3% at the end of the year, compared with 23.6% at the end of 2013.
- Return on equity was 18.6%, compared with 9.2% in 2013.
- Net interest income of ISK 24.2 billion, compared with ISK 23.8 billion in 2013.
- Net commission income of ISK 13.3 billion, compared with ISK 11.2 billion in 2013.
- Operating income increased between years and amounted to ISK 54.0 billion, compared with ISK 44.3 billion in 2013.
- Net valuation change during the year is positive, amounting to ISK 2.1 billion, compared with a negative figure of ISK 0.7 billion in the previous year.
- Income tax and the bank levy amounted to ISK 7.3 billion, compared with ISK 6.0 billion in 2013.
- Earnings from discontinued operations of ISK 6.8 billion, compared with ISK 0.4 billion in 2013.
- The cost-to-income ratio was 50.1%, compared with 57.3% in 2013.
- Total equity amounted to ISK 162.2 billion, compared with ISK 144.9 billion at the end of 2013. The Bank paid a dividend of ISK 7.8 billion to its shareholders in 2014.

Highlights of the fourth quarter

- Net earnings in the fourth quarter amounted to ISK 6.0 billion, compared with ISK 2.5 billion in the fourth quarter of 2013.
- Return on equity in the fourth quarter was 14.8%, compared with 7.1% for the same period in 2013.

Höskuldur H. Ólafsson, CEO of Arion Bank:

"The results for 2014 were positive. Regular operations were strong and the results of all business segments exceeded expectations. Irregular items had a positive impact on the financial results, in particular the sale of the Bank's holding in HB Grandi and the successful listing of the company on NASDAQ Iceland. Valuation changes also had a positive effect.

Arion Bank has been successful in increasing the diversification of its funding and is now by far the largest issuer of covered bonds in Iceland.

It has been our expectation for a number of years that the Bank's net interest margin would decrease, narrowing in fact by 0.6 percentage points from 3.4% to 2.8% over a period of two years. We have therefore focused our efforts on increasing the contribution of commission income in all the Bank's business segments. This we have achieved, commission income rising by almost 19% over the year, mainly commission income in investment banking and in international payment cards.

Arion Bank increased its holding in Valitor to 99% by acquiring a 38% stake from Landsbanki. We have high expectations for Valitor. The company has been at the forefront of developing the payment card system in Iceland and occupies a key position in the operations, strategy and future vision of Arion Bank. Valitor has recently been establishing itself internationally and it has an exciting future ahead of it.

Irregular items will have less of an impact in the near term as the Bank's operations are stable and debt recovery work, a legacy of the financial crisis, decreases from one year to the next. One of our main priorities will be to continue to enhance our services to our customers and in doing so consolidate our regular operations and profitability. The focus will remain on commission income and further rationalization through the continued development of our service channels and digital banking services for our customers. Here I have in mind the Arion banking app, which has proven highly popular amongst our customers, and our new branch strategy as demonstrated in our new flagship branch in Reykjavik."

Conference call in English

Arion Bank will be hosting a conference call in English, Wednesday 25 February at 9:15 GMT (10:15 CET), where Stefán Pétursson, CFO, will present the 2014 results. Those who would like to participate in the conference call can send an e-mail to ir@arionbanki.is and will then receive instructions with dial in details.

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

Income statement – highlights

Income statement				
In ISK million	**2014**	**2013**	**Diff**	**Diff%**
Net interest income	24,220	23,800	420	2%
Net commission income	13,309	11,223	2,086	19%
Net financial income	6,478	3,441	3,037	88%
Net foreign exchange gain (loss)	812	(1,766)	2,578	-
Other income	9,171	7,650	1,521	20%
Operating income	**53,990**	**44,348**	**9,642**	**22%**
Salaries and related expense	(13,979)	(13,537)	(442)	3%
Other operating expenses	(13,063)	(11,858)	(1,205)	10%
Net change in valuation	2,135	(680)	2,815	-
Net earnings before taxes	**29,083**	**18,273**	**10,810**	**59%**
Income tax	(4,679)	(3,143)	(1,536)	49%
Bank levy	(2,643)	(2,872)	229	(8%)
Net earnings from continuing operation	**21,761**	**12,258**	**9,503**	**78%**
Net gain (loss) from disc. operations	6,833	399	6,434	-
Net earnings	**28,594**	**12,657**	**15,937**	**126%**

Operating income

Operating income increased considerably between years, up ISK 9,642 million. Operating income amounted to ISK 53,990 million in 2014. The increase is primarily due to a ISK 3,037 million increase in net financial income, ISK 2,578 million shift in net gain on foreign exchange and ISK 2,086 million increase in net commission income.

Net interest income amounted to ISK 24,220 million, an increase of 2% from 2013. The net interest margin as a percentage of average interest-bearing assets was 2.8% in 2014, compared with 2.9% in 2103. Despite lower inflation, affecting index linked loans, the net interest margin has changed little which is mainly explained by lower funding cost due to effective liquidity management.

Net commission income increased by 19% between years to ISK 13,309 million in 2014. The increase is largely due to higher commission income from cards and higher income generated by Investment Banking.

Net financial income increased sharply between years to ISK 6,478 million in 2014, compared with ISK 3,441 million in 2013. The main difference is the valuation change due to the shareholding in HB Grandi hf. which was listed on NASDAQ Iceland in April 2014. In general, the return on equities was good during 2014 whilst return on bonds was rather low. Dividend income was ISK 829 million higher in 2014 than in 2013.

Net exchange rate gain amounted to ISK 812 million, compared with a loss of ISK 1,766 million in 2013. The Bank's net foreign exchange imbalance was ISK 18.9 billion at the end of the year, meaning that volatility in the exchange rate has a some impact on operating income. The net foreign exchange imbalance was ISK 31.6 billion at the end of 2013 and the Bank has made a targeted effort to reduce its net foreign exchange position. The foreign exchange balance of the parent company is well within the 15% limit stipulated by the Central Bank of Iceland.

Other operating income amounted to ISK 9,171 million which is a considerable increase from 2013. The main types of income included in other operating income are share of profit and valuation changes of associates, lease income, valuation changes and profits from the sale of commercial property owned by Landfestar ehf. (subsidiary sold in June 2014) and Landey ehf., and income from insurance premiums at OKKAR Life Insurance hf. The increase over last year, ISK 1,512 million, is primarily a result of valuation changes and profit of associates. Lease income from commercial property decreased considerably due to the sale of the Bank's shareholding in Landfestar ehf. and the fact that Landfestar ehf. has consequently ceased to be a subsidiary.

Operating expenses

Operating expenses amounted to ISK 27,042 million. The cost-to-income ratio decreased to 50.1% from 57.3% in 2013. The cost-to-assets ratio was 2.9%, compared with 2.8% in 2013.

Salaries and related expenses amounted to ISK 13,979 million, an increase of 3% between years. The increase is partly explained by contractual salary increases of 2.8%, the cost of the incentive scheme and a one-off expense related to terminations of employment. There were on average 1,128 full-time equivalent positions at the Group in 2014, compared with 1,159 in 2013.

Other operating expenses amounted to ISK 13,063 million, an increase of 10% between years. The increase can mainly be explained by relatively high one-off costs due to the impairment of assets and a fine imposed by the Icelandic Competition Authority as part of a settlement, relating to the operations of banks and credit card companies in Iceland that have existed for decades.

Net valuation change

Net valuation change amounted to ISK 2,135 million and is broadly divided into three types. Firstly, net valuation increases on loans to corporates of ISK 2,300 million. Secondly, net loan impairment on retail loans amounted to ISK 851 million. Thirdly, the net valuation increase of other assets of ISK 686 million.

Taxes

Income tax amounted to ISK 4,679 million, compared with ISK 3,143 million in 2013. Income tax, as reported in the financial statements, comprises 20% income tax on earnings and a special 6% financial tax which is levied on the earnings of financial institutions in excess of ISK 1 billion. The effective income tax rate was 16.1% in 2014, compared with 17.2% in 2013.

The bank levy amounted to ISK 2,643 million, compared with ISK 2,872 million in 2013.

Income tax and bank levy amounted in total to ISK 7.3 billion in 2014, compared with ISK 6.0 billion in 2013.

Earnings from discontinued operations

Earnings from discontinued operations amounted to ISK 6,833 million in 2014. In April the Bank sold 18.8% shareholding in HB Grandi hf. (previously held 31%) and the majority of these earnings originate from this sale. Following this transaction and the company's stock market listing the Bank's remaining shareholding was classed as a financial asset and it changes in value in accordance with the listed share price. These valuation changes are categorized under net financial income in the Statement of Comprehensive Income.

Fourth quarter of 2014

Return on equity was 14.8% in the fourth quarter, compared with 7.1% in the fourth quarter of 2013.

Income statement				
In ISK million	**Q4 2014**	**Q4 2013**	**Diff**	**Diff%**
Net interest income	5,911	5,487	424	8%
Net commission income	3,190	2,939	251	9%
Net financial income	1,181	1,452	(271)	(19%)
Net foreign exchange gain (loss)	248	(731)	979	-
Other income	5,208	3,615	1,593	44%
Operating income	**15,738**	**12,762**	**2,976**	**23%**
Salaries and related expense	(3,953)	(4,098)	145	(4%)
Other operating expenses	(4,465)	(3,114)	(1,351)	43%
Net change in valuation	(742)	(561)	(181)	32%
Net earnings before taxes	**6,578**	**4,989**	**1,589**	**32%**
Income tax	(222)	(292)	70	(24%)
Bank levy	(636)	(2,572)	1,936	(75%)
Net earnings from continuing operation	**5,720**	**2,125**	**3,595**	**169%**
Net gain (loss) from disc. operations	241	402	(161)	(40%)
Net earnings	**5,961**	**2,527**	**3,434**	**136%**

Operating income in the fourth quarter increased between years, up 23%, with the largest rise being in other income, mainly as a result of the increase in the share of profit and valuation changes of associates, which was ISK 1,969 million higher in the fourth quarter of 2014 than in the same period in 2013. Net foreign exchange gain was also higher in the fourth quarter by ISK 979 million compared with the same period in 2013.

Operating expenses were overall higher in the fourth quarter of 2014 than the same period of 2013. The increase is partly explained by fines imposed by the Icelandic Competition Authority and impairment of assets at year end.

Balance sheet – highlights

Assets			
In ISK million	**31.12.2014**	**31.12.2013**	**Diff%**
Cash & balances with CB	21,063	37,999	(45%)
Loans to credit institutions	108,792	102,307	6%
Loans to customers	647,508	635,774	2%
Financial assets	101,828	86,541	18%
Investment property	6,842	28,523	(76%)
Investments in associates	21,966	17,929	23%
Intangible assets	9,596	5,383	78%
Non-current assets & disposal Groups HFS	3,958	10,046	(61%)
Other assets	12,182	14,348	(15%)
Total assets	**933,736**	**938,850**	**(1%)**

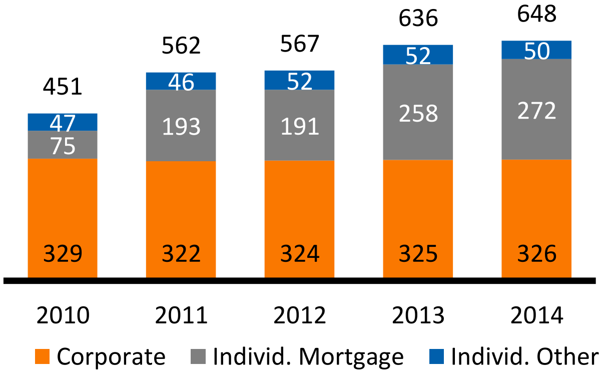
Arion Bank's *total assets* amounted to ISK 933,736 million at the end of the year. Changes to individual asset classes during the year are mainly due to changes in the Bank's liquidity management, partly related to the adoption of the Liquidity Coverage Ratio, LCR. This results in lower deposits at the Central Bank of Iceland, higher loans at credit institutions and increased securities holdings. There was new lending during the year, both to individuals and corporates in seafood, real estate and general industry. Investment property decreased relatively during the year due to the sale of the subsidiary Landfestar ehf. Non-current assets and disposal groups HFS decreased mainly due to the sale of shareholding in HB Grandi hf.

Loans to customers

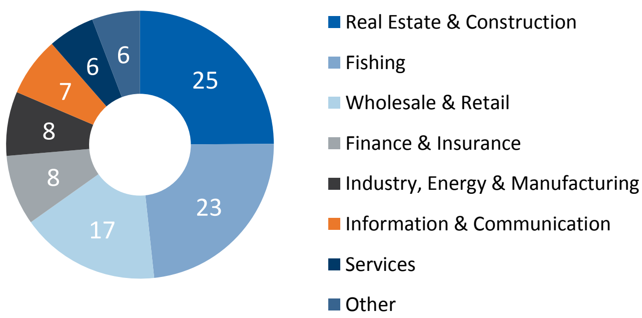
Loans to customers amounted to ISK 647,508 million at the end of the year. Since 2010 the Group's loan book has increased substantially, with two events being especially significant. Firstly, the Bank's acquisition of Arion Bank Mortgage Institutional Investor Fund at the end of 2011; and secondly when the Bank took over retail loans from SPRON of a value of more than ISK 50 billion at the end of 2013. Mortgage loans represent a large proportion of loans to individuals and a substantial percentage of these are low-risk loans with very strong collateral.

The loan portfolio is well diversified. Loans are now evenly split between individuals and corporates. The distribution of the corporate loan book reflects the relative size of sectors in the Icelandic economy. The graph shows loans to corporates specified by sector at year end 2014.

Loans to customers (In ISK bn.)



Corporate loan book (in %)



Securities

Securities holdings amounted to ISK 101,827 million at the end of the year, compared with ISK 86,541 million at the end of 2013.

Securities			
In ISK million	**31.12.2014**	**31.12.2013**	**Diff%**
Bonds	66,465	62,171	7%
Shares and instruments w. variable income	25,233	17,449	45%
Derivatives	1,026	1,070	(4%)
Securities used for hedging	9,104	5,851	56%
Securities total	**101,828**	**86,541**	**18%**

The increase is particularly attributable to changes in the Bank's liquidity management and the growth in the Bank's equities holdings due to Eik fasteignafélag hf. and the listing and re-categorization of the holding in HB Grandi hf.

Intangible assets

Intangible assets amounted to ISK 9,596 million at the end of the year, compared with ISK 5,383 million at the end of 2013. The increase is mainly due to the acquisition by Valitor Holding hf. of a Danish group, AltaPay A/S. The aim of the acquisition is to support Valitor's growing e-commerce business in the Nordics.

Liabilities and equity

Liabilities and Equity			
In ISK million	**31.12.2014**	**31.12.2013**	**Diff%**
Due to credit institutions & CB	22,876	28,000	(18%)
Deposits from customers	454,973	471,866	(4%)
Financial liabilities at fair value	9,143	8,960	2%
Other liabilities	52,314	48,591	8%
Borrowings	200,580	204,568	(2%)
Subordinated loans	31,639	31,918	(1%)
Equity	162,211	144,947	12%
Total liabilities and equity	**933,736**	**938,850**	**(1%)**

Total liabilities amounted to ISK 771,524 million at the end of the year, compared with ISK 793,903 million at the end of 2013.

Deposits

Total deposits amounted to ISK 477,849 million at year end, decreasing between years, mainly due to large business transactions in the Icelandic market at the close of 2014.

Borrowings

Borrowings amounted to ISK 200,580 million at the end of 2014. The decrease is mainly due to an early redemption of the Bank's own long-term covered bonds of ISK 20 billion in July and the issuance of new covered bonds of ISK 10 billion, which mature in 2015. Borrowings also decreased as a result of the sale of the real estate company Landfestar ehf. which has issued listed bonds of almost ISK 3 billion.

In early 2014 the Bank was assigned a rating by the international ratings agency Standard & Poor's, the first Icelandic bank to obtain a rating for more than five years. The Bank's rating of BB+ was affirmed by the rating agency in October and the outlook was changed from stable to positive. This rating and the positive outlook will increase Arion Bank's opportunities in the capital markets both in Iceland and internationally in the coming years.

Key performance indicators

Key performance indicators	2014	2013
Return on equity (ROE)	18.6%	9.2%
Return on total assets (ROA)	3.0%	1.4%
Net interest margin (int. bearing assets)	2.8%	2.9%
Net interest margin (total assets)	2.6%	2.6%
Cost-to-income ratio	50.1%	57.3%
Cost-to-Total assets ratio	2.9%	2.8%
Effecticve tax rate	16.1%	17.2%
CET1-ratio	26.3%	23.6%
Tier 1 ratio	21.8%	19.2%
Leverage ratio	15.4%	14.5%
Problem loans	4.4%	6.3%
RWA/Total assets	74.5%	76.8%
Loans to deposit rato	142.3%	134.7%
The Group's average number of employees	1,128	1,159
The Group's employees at the end of the period	1,139	1,145
The Parent's average number of employees	890	923
The Parent's employees at the end of the period	865	911

Financial calendar

The Bank's financial statements are scheduled for publication on the dates stated below.

Annual general meeting 2015	19 March 2015
First quarter 2015	12 May 2015
Second quarter 2015	26 August 2015
Third quarter 2015	11 November 2015

This calendar may be subject to change.