Arion Bank

# Condensed Consolidated **Interim Financial Statements** 1 January - 30 June 2020

# Contents

# Arion Bank in brief

## 6M 2020

**2.9%**
Return on equity

**54.7%**
Cost-to-income

**28.1%**
Capital adequacy ratio

**Rating from S&P**

Long term: BBB

Short term: A-2

Outlook: Stable

FINANCE
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## Arion Bank

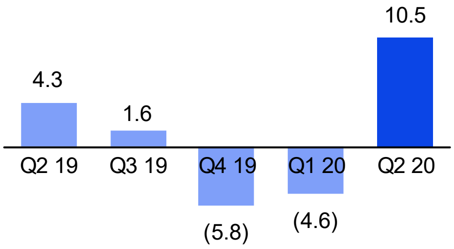
- Arion Bank is a leading universal relationship bank in Iceland which provides a full range of financial services.
- After a long period of strong economic growth the economy is trending into temporary negative recession due to Covid-19. Developments in Iceland and especially globally will heavily impact the Icelandic economy due to the importance of tourism. However, both fiscal and monitory policy have ammunition to support the economy.
- Arion Bank intends to maintain its leading position in digital banking, which has proven effective during the pandemic.
- The balance sheet is extraordinarily strong which is prudent at this time due to Covid-19 but not efficient, under normal circumstances.
- The Bank is very well positioned to meet the funding requirements of its customers in both ISK and FX and to provide customers with solutions through the challenging times that lie ahead.

## Key figures
(ISK million)

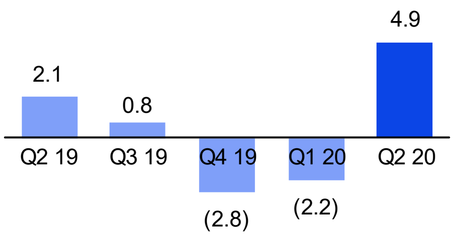
| | 6M 2020 | 6M 2019 |
|---|---|---|
| Net earnings | 2,742 | 3,114 |
| ROE | 2.9% | 3.2% |
| ROE continuing operations | 3.9% | 5.1% |
| Net interest margin | 2.9% | 2.8% |
| Cost to income ratio | 54.7% | 56.3% |
| Operating income / REA | 6.4% | 6.1% |

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Total assets | 1,182,249 | 1,081,855 |
| Loans to customers | 779,902 | 773,955 |
| Deposits | 555,855 | 492,916 |
| Borrowings | 314,952 | 304,745 |
| Stage 3 gross | 3.4% | 2.7% |
| Leverage ratio | 14.9% | 14.1% |
| Number of employees | 783 | 801 |
| EUR/ISK | 155.40 | 135.83 |

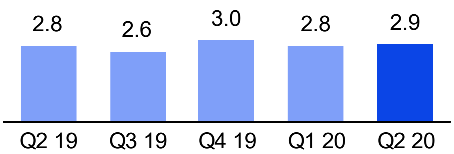
**Return on equity (%)**



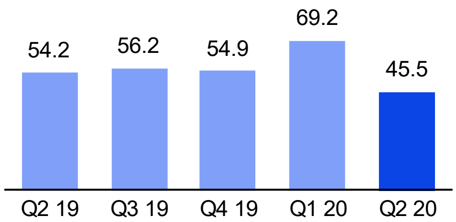

**Net earnings (ISK billion)**



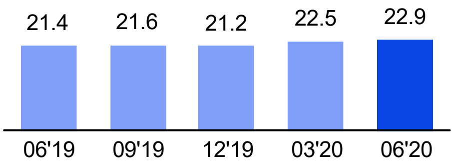

**Net interest margin (%)**



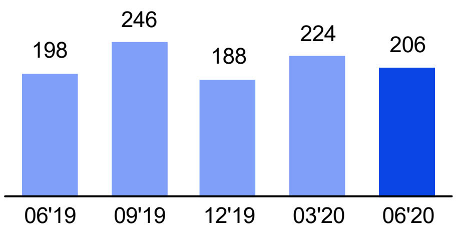

**Cost-to-income ratio (%)**




**CET 1 ratio (%)**




**LCR ratio (%)**



# Endorsement and statement
## by the Board of Directors and the CEO

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period from 1 January to 30 June 2020 include the Condensed Consolidated Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

### Operations during the period

Arion Bank reported net earnings of ISK 4,958 million from continuing operations in the second quarter and ISK 3,676 million from continuing operations during the first six months of the year. Net earnings amounted to ISK 4,913 million for the quarter and ISK 2,742 million for the first six months. Return on equity was 10.5% for the quarter and 2.9% for first six months of 2020. The cost-to-income ratio was 45.5% for the quarter and 54.7% for the first six months of 2020.

Net interest income increased by 0.6% compared with the second quarter in 2019, whilst interest bearing assets decreased by 1.4%. Net interest margin in the quarter was strong at 2.9%. Net commission income increased by 9% compared with the same period in 2019, mainly due to increased activities in the loan book and loan service agreements. Net financial income was significantly higher than for the second quarter of 2019 and amounted to ISK 2,691 million. Operating expenses are trending down and decreased by 3% compared with the second quarter in 2019, mainly due to the reduced number of FTEs. Impairments amounted to ISK 918 million during the quarter, substantially down from the first quarter. Given the ongoing economic uncertainty due to Covid 19, further impairments cannot be excluded as the reality of the situation becomes clearer. The bank levy decreased by 64% from the same quarter last year, as the levy was reduced from 0.376% to 0.145%, as part of the government's response to the Covid-19 pandemic.

The Group's balance sheet increased by 9% during the first half of 2020. The increase was mainly in liquid assets, funded by deposit growth and proceeds from the Bank's issuance of AT1. However, the risk-weighted exposure amount (REA) decreased by ISK 3 billion from year-end 2019.

Total equity amounted to ISK 188,827 million at the end of the period. Total equity increased due to the reported net earnings but decreased by ISK 4.4 billion due to share buy-backs under a buy-back program during the first quarter. The Group's capital ratio, as calculated under the Financial Undertakings Act No. 161/2002, was 28.1% and the CET1 ratio was 22.9%. The Bank's capital ratios comfortably exceed the requirements set by law and the Financial Supervisory Authority of the Central Bank. The Bank's liquidity position was also very strong at period end.

In May 2020 Valitor Group sold the operations of Valitor in Denmark, Valitor A/S. The operation of Valitor A/S contributed a net loss for the years 2018 and 2019. The financial effects of the sale of the entity did not have material effects on these Consolidated Interim Financial Statements.

In April 2020, Standard & Poor's downgraded Arion Bank's long-term credit rating from BBB+ to BBB, but revised the outlook from negative to stable. The Bank's short-term credit rating remains A-2.

### Outlook

The Covid-19 pandemic has had a widespread effect on Arion Bank and is expected to continue to do so over the coming quarters. It has delayed the planned distribution of capital, as the Central Bank of Iceland has recommended that financial institutions reconsider their proposals on capital distributions in light of the economic uncertainty. Arion Bank is, however, committed to its strategy of focusing on the profitability of its REA and reducing the cost-to-income ratio. The Bank has been supporting its customers and working with the authorities to develop government guaranteed loan facilities targeted at corporates that are going through temporary difficulties. The first loans under the program have already been granted.

Core revenues have been trending in the right direction and the second quarter performance demonstrates that the Bank can improve on the revenue side even during difficult times. Operating expenses are decreasing and the emphasis will continue to be on reducing them further. The Bank was able to operate effectively and service its customers, with 85% of its employees working from home during the height of the Covid-19 crisis. This experience has made the Bank take advantage of various opportunities to streamline its operations and product offering. Impairments continue to be difficult to predict given the uncertainty that still exists. Whilst the Bank has taken drastic steps as regards impairments during the first half of the year, it is impossible to state at this time that further impairments will not be needed as the reality of the economic crisis becomes clearer.

Sales processes of HFS assets will continue but Covid-19 related factors have already delayed the results somewhat.

Arion Bank expects the current turmoil to last at least until the end of this year. The Bank does not, however, rule out the possibility that the current economic environment, coupled with the Bank's very strong capital and liquidity position, might open up opportunities for the efficient use of these resources for either internal or external growth.

The Bank is committed to its medium-term targets and plans to resume its capital distribution as soon as practicable.

# Endorsement and statement
## by the Board of Directors and the CEO

### Economic environment and outlook

According to preliminary figures GDP decreased by 1.2% YoY in the first quarter of 2020, a much stronger result than many analysts had expected. Despite the almost 30% drop in tourist arrivals and the resulting substantial negative impact of external trade on GDP, private consumption increased, softening the economic contraction. However, the restrictions imposed by governments around the world due to the coronavirus outbreak only came into force at the end of March, meaning that economic figures for the second quarter will bear the brunt of the effects of the coronavirus. Few advanced economies are as dependent on tourism as Iceland, making the economy vulnerable to the coronavirus crisis. The consensus among domestic analysts currently stands at 8.6% economic contraction in 2020, followed by 4.8% economic growth in 2021. Even though Iceland has taken tentative steps towards opening its borders, prolonged travel restrictions on a global scale seem likely as new coronavirus cases continue to increase worldwide. The crisis has had, and will have, a deep impact on the labor market, and unemployment is expected to peak at 12% in the autumn of 2020. Inflation has remained relatively stable despite a depreciation of the ISK but is expected to inch upwards due to the exchange rate pass-through. The Central Bank has a target of 2.5% and inflation is expected to stay well within tolerance levels. Even though the outlook is bleak there are several indications that the economy will prove more resilient than first thought; both the government and the Central Bank have introduced numerous measures in order to soften the economic blow. Payment card turnover indicates that private consumption might bounce back quicker than expected and an ever-growing number of tourists are visiting the country.

### Funding and liquidity

The Group's liquidity position is strong, with a liquidity coverage ratio of 206%, see Note 44, well above the regulatory minimum of 100%. The Bank's foreseeable refinancing risk is low as it does not have any material redemption of long-term funding until December 2021. The comfortable liquidity position and limited foreseeable refinancing needs mean that the Bank does not need to access the international wholesale funding markets in 2020.

Arion Bank continued to issue covered bonds which are secured under the Covered Bond Act No. 11/2008. During the first six months of 2020 the Bank issued covered bonds amounting to ISK 5,060 million.

### Capital and REA

The Group‘s capital adequacy ratio at 30 June 2020 was 28.1% and the CET1 ratio 22.9%. The Group‘s own funds increased by ISK 28.1 billion from year-end 2019, primarily due to the successful issuance of a USD 100 million Additional Tier 1 capital instrument in February 2020, and as a result of the Board of Directors' decision to propose that no dividends are paid in connection with operations in 2019 in light of the Covid-19 pandemic. This effectively reintroduces the foreseeable ISK 10 billion dividend at year-end 2019 as loss absorbing capital.

On 4 May 2020 the Icelandic Ministry of Finance ratified Regulation (EU) 2017/2395 into Icelandic law. The regulation introduces transitional arrangements for IFRS 9 to allow the regulatory capital impact of expected credit loss to be phased in over time. These arrangements have been available to European banks since 2017. Institutions that elect to make use of these transitional arrangements can in 2020 add back CET1 equivalent to up to 70% of provisions incurred from the application of IFRS9. The Bank has opted to make use of the transitional arrangements, thus reflected in the Group's capital ratios as of 30 June 2020. The transitional arrangements increase the capital ratio by 0.2 percentage points.

The Group‘s risk-weighted exposure amount (REA) decreased by ISK 3.4 billion in the first half of 2020. The introduction of the SME supporting factor into the Icelandic capital adequacy regime came into effect on 1 January 2020, reducing REA by ISK 13 billion, providing capital relief for exposures to SMEs below EUR 1.5 million. Increased proprietary trading equity positions increased REA by ISK 4.6 billion.

As part of the economic measures introduced by the Icelandic authorities, the 2% countercyclical capital buffer has been vacated entirely, which reduces the Group‘s total capital requirement from 20.3% to 18.4%. The Group‘s CET1 capital requirement is reduced from 15.5% to 13.6%. At 30 June 2020 the Group had ISK 67 billion of CET1 capital in excess of regulatory requirements and ISK 43 billion in excess of the Group‘s target CET1 ratio of 17%.

### Group ownership

At the end of June 2020 Taconic Capital was the largest shareholder of Arion Bank, with a holding of 24.67%, and Sculptor Capital Management was the second largest with a holding of 9.92%. Arion Bank held 0.69% of its own shares at the end of June 2020. The AGM on 17 March 2020 approved the cancellation of 84 million of the Bank's own shares, totalling ISK 84 million at nominal value. The reduction took place in May 2020. For further information on the shareholders of Arion Bank, see Note 36.

### Governance

At the AGM on 17 March 2020, seven members were elected to serve on the Board of Directors until the next AGM, four men and three women. Furthermore, three Alternate Directors (two men and one woman) were elected, and they attend meetings of the Board of Directors in the event that a Director resigns or is unable to attend.

On 26 March 2020 the Bank announced that Herdís Dröfn Fjeldsted, vice-chairman of the Board of Directors, would temporarily step aside as a board member while acting as the CEO of Valitor, a subsidiary of Arion Bank. In her absence one of the Alternate Directors will take a seat on the Board of Directors.

# Endorsement and statement
## by the Board of Directors and the CEO

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

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 30 June 2020 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

It is our opinion that the Condensed Consolidated Interim Financial Statements give a true and fair view of the financial performance and cash flow of the Group for the period ended 30 June 2020 and its financial position as at 30 June 2020.

Furthermore, in our opinion the Condensed Consolidated Interim 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 Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 30 June 2020 and confirm them by means of their signatures.

Reykjavík, 29 July 2020

**Board of Directors**

Brynjólfur Bjarnason, Chairman

Gunnar Sturluson

Liv Fiksdahl

Paul Richard Horner

Renier Lemmens

Sigurbjörg Ásta Jónsdóttir

Steinunn Kristín Thórdardóttir

**Chief Executive Officer**

Benedikt Gíslason

# Review Report
## on the Condensed Consolidated Interim Financial Statements

To the Board of Directors and shareholders of Arion Bank.

We have reviewed the accompanying Condensed Consolidated Interim Statement of Financial Position of Arion Bank hf. (the "Group") as of 30 June 2020 and the related Consolidated Interim Income Statement, Consolidated Interim Statement of Comprehensive Income, Consolidated Interim Statement of Changes in Equity and Consolidated Interim Statement of Cash Flows for the six months then ended and a summary of significant accounting policies and other explanatory notes.

### The Board of Directors and Management's Responsibility for the Consolidated Financial Statements

The Board of Directors and management are responsible for the preparation and fair presentation of this Interim Consolidated Financial Statements in accordance with International Financial Reporting Standards for Interim Financial Reporting, IAS 34, as adopted by the European Union.

### Auditor's Responsibility

Our responsibility is to express a conclusion on these Condensed Consolidated Interim Financial Statements based on our review.

### Scope of Review

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

### Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying Condensed Consolidated Interim Financial Statements do not give a true and fair view of the financial position of the Group as at 30 June 2020, and of its financial performance and its cash flows for the six month period then ended in accordance with International Financial Reporting Standards for Interim Financial Reporting, IAS 34, as adopted by the European Union.

### 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 Act on Annual Accounts 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 Act on Annual Accounts that is not disclosed elsewhere in the Consolidated Interim Financial Statements.

Kópavogur, 29 July 2020

**Deloitte ehf.**

Páll Grétar Steingrímsson

State Authorized Public Accountant

# Consolidated Interim Income Statement

| | Notes | 2020 1.1.-30.6. | 2019 1.1.-30.6. | 2020 1.4.-30.6. | 2019 1.4.-30.6. |
|---|---|---|---|---|---|
| Interest income | | 25,879 | 31,147 | 13,835 | 16,463 |
| Interest expense | | (10,769) | (15,905) | (5,978) | (8,655) |
| **Net interest income** | 7 | **15,110** | **15,242** | **7,857** | **7,808** |
| Fee and commission income | | 6,578 | 5,460 | 3,097 | 2,830 |
| Fee and commission expense | | (814) | (764) | (409) | (352) |
| **Net fee and commission income** | 8 | **5,764** | **4,696** | **2,688** | **2,478** |
| Net insurance income | 9 | 1,262 | 1,076 | 761 | 823 |
| Net financial income | 10 | 691 | 1,789 | 2,691 | 1,023 |
| Share of (loss) profit of associates | 26 | (29) | 720 | (5) | (7) |
| Other operating income | 11 | 241 | 405 | 71 | 95 |
| **Other net operating income** | | **2,165** | **3,990** | **3,518** | **1,934** |
| **Operating income** | | **23,039** | **23,928** | **14,063** | **12,220** |
| Salaries and related expenses | 12 | (6,707) | (7,435) | (3,577) | (3,805) |
| Other operating expenses | 13 | (5,895) | (6,045) | (2,818) | (2,813) |
| **Operating expenses** | | **(12,602)** | **(13,480)** | **(6,395)** | **(6,618)** |
| Bank levy | 14 | (655) | (1,818) | (324) | (912) |
| Net impairment | 15 | (3,778) | (2,069) | (918) | (988) |
| **Earnings before income tax** | | **6,004** | **6,561** | **6,426** | **3,702** |
| Income tax expense | 16 | (2,328) | (1,513) | (1,468) | (891) |
| **Net earnings from continuing operations** | | **3,676** | **5,048** | **4,958** | **2,811** |
| Discontinued operations held for sale, net of income tax | 17 | (934) | (1,934) | (45) | (715) |
| **Net earnings** | | **2,742** | **3,114** | **4,913** | **2,096** |

## Attributable to

| | | | | | |
|---|---|---|---|---|---|
| Shareholders of Arion Bank hf. | | 2,751 | 3,114 | 4,918 | 2,096 |
| Non-controlling interest | | (9) | - | (5) | - |
| **Net earnings** | | **2,742** | **3,114** | **4,913** | **2,096** |

## Earnings per share

| | | | | | |
|---|---|---|---|---|---|
| Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK) | 18 | 1.59 | 1.72 | 2.86 | 1.16 |

*The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements*

Amounts are in ISK millions

# Consolidated Interim Statement of Comprehensive Income

| | Notes | 2020<br>1.1.-30.6. | 2019<br>1.1.-30.6. | 2020<br>1.4.-30.6. | 2019<br>1.4.-30.6. |
|---|---|---|---|---|---|
| **Net earnings** | | **2,742** | **3,114** | **4,913** | **2,096** |
| Net gain on financial assets carried at fair value through OCI, net of tax | | 617 | 309 | 197 | 210 |
| Realized net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement | 10 | (152) | (83) | (156) | (52) |
| **Changes to reserve for financial instruments at fair value through OCI** | | **465** | **226** | **41** | **158** |
| Exchange difference on translating foreign subsidiaries | | 181 | 162 | (2) | (18) |
| **Other comprehensive income that is or may be reclassified subsequently to the Income Statement** | | **646** | **388** | **39** | **140** |
| **Total comprehensive income** | | **3,388** | **3,502** | **4,952** | **2,236** |

## Attributable to

| | | | | |
|---|---|---|---|---|
| Shareholders of Arion Bank | 3,397 | 3,502 | 4,957 | 2,236 |
| Non-controlling interest | (9) | - | (5) | - |
| **Total comprehensive income** | **3,388** | **3,502** | **4,952** | **2,236** |

*The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements*

Amounts are in ISK millions

# Consolidated Interim Statement of Financial Position

| Assets | Notes | 30.6.2020 | 31.12.2019 |
|---|---|---|---|
| Cash and balances with Central Bank | 19 | 103,432 | 95,717 |
| Loans to credit institutions | 20 | 33,597 | 17,947 |
| Loans to customers | 21 | 779,902 | 773,955 |
| Financial instruments | 22-24 | 197,141 | 117,406 |
| Investment property | 24 | 7,051 | 7,119 |
| Investments in associates | 26 | 861 | 852 |
| Intangible assets | 27 | 9,077 | 8,367 |
| Tax assets | 28 | 2 | 2 |
| Assets and disposal groups held for sale | 29 | 30,732 | 43,626 |
| Other assets | 30 | 20,454 | 16,864 |
| **Total Assets** | | **1,182,249** | **1,081,855** |

| Liabilities | | | |
|---|---|---|---|
| Due to credit institutions and Central Bank | 23 | 7,661 | 5,984 |
| Deposits | 23 | 555,855 | 492,916 |
| Financial liabilities at fair value | 23 | 3,118 | 2,570 |
| Tax liabilities | 28 | 3,882 | 4,404 |
| Liabilities associated with disposal groups held for sale | 29 | 26,982 | 28,631 |
| Other liabilities | 31 | 44,478 | 32,697 |
| Borrowings | 23,32 | 314,952 | 304,745 |
| Subordinated liabilities | 23,33 | 36,494 | 20,083 |
| **Total Liabilities** | | **993,422** | **892,030** |

| Equity | | | |
|---|---|---|---|
| Share capital and share premium | 35 | 51,330 | 55,715 |
| Other reserves | | 11,375 | 9,493 |
| Retained earnings | | 125,951 | 124,436 |
| **Total Shareholders' Equity** | | **188,656** | **189,644** |
| Non-controlling interest | | 171 | 181 |
| **Total Equity** | | **188,827** | **189,825** |
| **Total Liabilities and Equity** | | **1,182,249** | **1,081,855** |

*The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements*

**Amounts are in ISK millions**

# Consolidated Interim Statement of Changes in Equity

| | Share capital | Share premium | Restricted reserves: Gain in subs. & assoc., unrealized | Gain in securities, unrealized | Capitalized develop-ment cost | Financial assets at fair value thr. OCI, unrealized | Statutory reserve | Foreign currency trans-lation reserve | Retained earnings | **Total share-holders' equity** | Non-cont-rolling interest | **Total equity** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Equity 1 January 2020** | 1,773 | 53,942 | 6,127 | 692 | 459 | 135 | 1,637 | 443 | 124,436 | **189,644** | 181 | **189,825** |
| Net earnings / loss | | | | | | | | | 2,751 | **2,751** | (9) | **2,742** |
| Net fair value gain | | | | | | 617 | | | | **617** | | **617** |
| Realized net gain transferred to the Income Statement | | | | | | (152) | | | | **(152)** | | **(152)** |
| Translation difference | | | | | | | | 181 | | **181** | | **181** |
| **Total comprehensive income** | - | - | - | - | - | 465 | - | 181 | 2,751 | **3,397** | (9) | **3,388** |
| Purchase of treasury stock * | (55) | (4,325) | | | | | | | | **(4,380)** | | **(4,380)** |
| Changes in treasury stock ** | - | (5) | | | | | | | | **(5)** | | **(5)** |
| Changes in reserves | | | 810 | 125 | 301 | | | | (1,236) | **1** | | **1** |
| **Equity 30 June 2020** | 1,718 | 49,612 | 6,937 | 817 | 760 | 600 | 1,637 | 624 | 125,951 | **188,656** | 171 | **188,827** |

* Refers to the purchase of own shares after the Board of Directors authorized the Bank to initiate a share buy-back program in Iceland and Sweden (the Program) to purchase own shares, which is in line with the authorization granted by the AGM on 20 March 2019. The purpose of the Program was to reduce the Bank's share capital (in line with the Bank's dividend policy). When the Program was initiated on 31 October 2019, the Bank was authorized to purchase up to 59 million own shares in total under the Program, corresponding to 3.25% of the issued share capital, or for up to ISK 4.5 billion at market value. In January 2020 the FSA approved the buy-back of an additional 41 million own shares or for up to ISK 3.5 billion at market value, bringing the total amount of the share Program to 100 million shares or ISK 8.0 billion at market value. The Program continued until the AGM in March 2020. At the AGM in March 2020 a motion was passed to reduce the company's share capital by ISK 84 million at nominal value, by cancelling the company's own shares. The reduction took place in May 2020.

** In 2018 approximately 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees stock grant program, an employee who resigned within the vesting period of two years, returned the shares to the Bank. The vesting period ended in June 2020.

*The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements*

Amounts are in ISK millions

# Consolidated Interim Statement of Changes in Equity

| | | | Restricted reserves | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Share capital | Share premium | Gain in subs. & assoc., unrealized | Gain in securities, unrealized | Capitalized develop-ment cost | Financial assets at fair value thr. OCI unrealized | Statutory reserve | Foreign currency trans-lation reserve | Retained earnings | **Total share-holders' equity** | Non-cont-rolling interest | **Total equity** |
| **Equity 1 January 2019** | 1,814 | 57,196 | 12,373 | 417 | - | 87 | 1,637 | 308 | 126,897 | **200,729** | 130 | **200,859** |
| Net earnings | | | | | | | | | 3,114 | **3,114** | | **3,114** |
| Net fair value gain | | | | | | 309 | | | | **309** | | **309** |
| Realized net gain transferred to the Income Statement | | | | | | (83) | | | | **(83)** | | **(83)** |
| Translation difference | | | | | | | | 162 | | **162** | | **162** |
| **Total comprehensive income** | - | - | - | - | - | 226 | - | 162 | 3,114 | **3,502** | - | **3,502** |
| Dividend paid | | | | | | | | | (9,069) | **(9,069)** | | **(9,069)** |
| Changes in treasury stock * | | (3) | | | | | | | | **(3)** | | **(3)** |
| Changes in reserves | | | (1,490) | 378 | | | | | 1,112 | **-** | | **-** |
| **Equity 30 June 2019** | 1,814 | 57,193 | 10,883 | 795 | - | 313 | 1,637 | 470 | 122,054 | **195,159** | 130 | **195,289** |

* In 2018 approximately 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees stock grant program, an employee who resigns within the vesting period of two years, returns the shares to the Bank.

*The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements*

**Amounts are in ISK millions**

# Consolidated Interim Statement of Cash flows

| | 2020 | 2019 |
|---|---|---|
| **Operating activities** | 1.1.-30.6. | 1.1.-30.6. |
| Net earnings | 2,742 | 3,114 |
| Non-cash items included in net earnings | (3,984) | (7,674) |
| *Changes in operating assets and liabilities:* | | |
| Loans to credit institutions, excluding bank accounts | (2,560) | (12,222) |
| Loans to customers | 10,914 | 23,781 |
| Financial instruments and financial liabilities at fair value | (69,755) | (24,528) |
| Deposits | 51,395 | 28,279 |
| Borrowings | (6,259) | 2,977 |
| Other changes in operating assets and liabilities | 16,613 | (1,130) |
| Interest received | 27,472 | 26,530 |
| Interest paid | (10,632) | (9,685) |
| Dividend received | 45 | 119 |
| Income tax paid | (2,850) | (2,127) |
| **Net cash from operating activities** | **13,141** | **27,434** |
| **Investing activities** | | |
| Proceeds from sale of associates | - | 740 |
| Acquisition of associates | (38) | (18) |
| Acquisition of intangible assets | (1,102) | (1,547) |
| Proceeds from sale of property and equipment | 88 | 357 |
| Acquisition of property and equipment | (326) | (144) |
| **Net cash used in investing activities** | **(1,378)** | **(612)** |
| **Financing activities** | | |
| Issued subordinated liabilities | 13,171 | 4,050 |
| Purchase of treasury stock | (4,381) | - |
| Dividend paid to shareholders of Arion Bank | - | (9,069) |
| **Net cash from (used) in financing activities** | **8,790** | **(5,019)** |
| Net increase in cash and cash equivalents | 20,553 | 21,803 |
| Cash and cash equivalents at beginning of the year | 102,186 | 110,589 |
| Effect of exchange rate changes on cash and cash equivalents | 4,204 | 3,472 |
| **Cash and cash equivalents** | **126,943** | **135,864** |
| **Cash and cash equivalents** | | |
| Cash and balances with Central Bank | 103,432 | 107,649 |
| Bank accounts | 29,111 | 38,695 |
| Mandatory reserve deposit with Central Bank | (5,600) | (10,480) |
| **Cash and cash equivalents** | **126,943** | **135,864** |

*The accompanying Notes are an integral part of these Condensed Consolidated Interim Financial Statements*

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements
## Contents

# Notes to the Condensed Consolidated Interim Financial Statements

## General information

Arion Bank hf., the Parent Company, was established on 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion Bank hf. is located at Borgartún 19, Reykjavík. The Condensed Consolidated Interim Financial Statements for the period ended 30 June 2020 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

### 1. Basis of preparation

The Condensed Consolidated Interim Financial Statements were approved and authorized for publication by the Board of Directors of Arion Bank on 29 July 2020.

In preparing the Condensed Consolidated Interim Financial Statements, the Bank has applied the concept of materiality to the presentation and level of disclosure. Only essential and mandatory information is disclosed which is relevant to an understanding by the reader of the Condensed Consolidated Interim Financial Statements.

*Statement of compliance*

The Condensed Consolidated Interim Financial Statements have been prepared in accordance with International Financial Reporting Standard, IAS 34 Interim Financial Reporting, as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions. The Condensed Consolidated Interim Financial Statements do not include all the information and disclosures required in the Annual Financial Statements, and should be read in conjunction with Arion Bank's Annual Consolidated Financial Statements for the year ended 31 December 2019. The Annual Consolidated Financial Statements are available on Arion Bank's website www.arionbanki.is.

The same accounting policies, presentation and methods of computation are followed in these Condensed Consolidated Interim Financial Statements as were applied in the Consolidated Financial Statements for the year ended 31 December 2019.

*Basis of measurement*

The Condensed Consolidated Interim Financial Statements have been prepared on a historical cost basis except for the following:

- bonds and debt instruments, shares and equity instruments, short positions in listed bonds and equities and derivatives. For details on the accounting policy, see Note 56 in the Annual Financial Statements 2019;

- investment properties are measured at fair value; and

- non-current assets and disposal groups held for sale are stated at the lower of their carrying amounts and fair value, less cost to sell.

*Functional and presentation currency*

The Condensed Consolidated Interim Financial Statements are presented in Icelandic krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the period the exchange rate of the ISK against USD was 138.23 and 155.40 for EUR (31.12.2019: USD 121.04 and EUR 135.83).

### 2. 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 Condensed Consolidated Interim Financial Statements are prepared on a going concern basis.

### 3. Significant accounting estimates and judgments in applying accounting policies

The preparation of the Condensed Consolidated Interim Financial Statements requires management to make judgments, estimates and assumptions that affect the reported amount of revenues, expenses, assets and liabilities, and the accompanying disclosures, as well as the disclosure of contingent liabilities. Uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of assets or liabilities affected in future periods.

*Estimates and assumptions*

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are described below. The Group based its assumptions and estimates on parameters available when the Condensed Consolidated Interim Financial Statement were prepared. Existing circumstances and assumptions about future developments, however, may change due to market changes or circumstances arising that are beyond the control of the Group. Such changes are reflected in the assumptions when they occur.

## 3. Significant accounting estimates and judgements in applying accounting policies, continued

*Impairment of financial assets*

The book value of financial assets which fall under the impairment requirements of IFRS 9 are presented net of expected credit losses in the statement of financial position. On a monthly basis expected credit losses are recalculated for each asset, the calculations being derived from PD, LGD and EAD models. In addition to the model outcomes, the assessment of expected credit losses is based on three key factors: management's assumptions regarding the development of macroeconomic factors over the next three years, how those factors affect each model and how to estimate a significant increase in credit risk. The assumptions for macroeconomic development are incorporated into each model for three scenarios: a base case, an optimistic case and a pessimistic case. Management estimates the probability weight for each scenario used for calculations of the probability weighted expected credit losses. The amount of expected credit losses to be recognized is dependent on the Bank's definition of significant increase in credit risk, which controls the impairment stage each asset is allocated to. Management has estimated factors to measure significant increase in credit risk from origination, by comparison of changes in PD values, annualized lifetime PD values, days past due and watch list. For further information see Note 56 in the Annual Financial Statements 2019.

*Macroeconomic outlook*

Due to the unprecedented circumstances caused by the Covid-19 pandemic, Arion Bank has made changes to its macroeconomic outlook used for IFRS 9 provision calculations. Arion Bank has followed the guidelines of the European supervisors and the Central Bank of Iceland and used moderation in the application of impairment calculations in light of the level of economic uncertainty. In doing so, the Bank has estimated the effects of the governmental stimulus programs, general and specific payment moratoria and other actions on expected default rates. The unemployment rate is the key macro factor that drives the forward-looking expectation of defaults. It is assumed that there will be a sharp increase in unemployment which will recover, and the speed of the recovery varies between scenarios, as quarantine restrictions and travel bans are eased.

Unemployment levels and scenarios have been updated from the ones used for Q1 2020 and are more in line with current economic projections. Expected unemployment levels have risen from the ones used for the Q1 2020 impairment calculations. Furthermore, the likelihood of the pessimistic scenario has been increased from year-end 2019. Among the steps taken to address the uncertainty and information that is available but not addressed by the models are (1) shortening of the forecasting period, (2) application of expert judgment in cases where economic forecasts are outside the range of the Bank’s macro models, (3) assessment of mitigating effects on default rates in the near-term, and (4) adjustment of collateral haircuts to more accurately reflect the realized economic development due to Covid-19. The scenarios and the weights assigned to them will be reexamined in the coming quarter as uncertainty over the local and global impact of Covid-19 is reduced.

Arion Bank has concluded that credit risk relating to the tourism sector has significantly increased and has taken this into consideration as of Q1 2020 in the provision calculations, which means that all such exposures are in Stage 2. The extent of the related impact on other industries and supporting businesses is unclear. Companies that receive the court-determined status of temporary financial restructuring as per Act No. 57/2020 are transferred to Stage 3. The Bank continues to monitor developments closely and will adjust its provisions accordingly.

*Assets and disposal groups held for sale*

Legal entities acquired exclusively with a view to resale, and discontinued operations held for sale are measured at the lower of carrying amount and fair value, less cost to sell. For the most part, fair value at the date of classification of these legal entities and discontinued operations was calculated using valuation models based on discontinued future cash flows that incorporated significant non-market observable inputs and assumptions. The use of reasonably possible alternative inputs and assumptions to these models, in particular changes to the discount rate employed (representing the required rate of return on equity), could have an impact on the value of these disposal groups.

Real estates acquired exclusively with a view to resale are measured at the lower of carrying amount and fair value, less cost to sell. Fair value at the date of classification is based on independent property values or management valuation. As the fair value measurement of real estates is based on valuation techniques, there is some uncertainty about the actual fair value of assets.

*Impairment of intangible assets*

The carrying amounts of goodwill, infrastructure and customer relationship and related agreements are reviewed annually to determine whether there is any indication of impairment. If any such indication exists the asset's recoverable amount is estimated. An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in the Consolidated Income Statement. 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.

*Revaluation of investment properties*

The Group carries its investment properties at fair value, with changes in fair value being recognized in the statement of profit or loss. For investment properties, either a valuation methodology based on present value calculations is used, as there is a lack of comparable market data because of the nature of the properties, or the investment properties are valued by reference to transactions involving properties of a similar nature, location and condition.

# Notes to the Condensed Consolidated Interim Financial Statements

## 4. The Group

*Shares in the main subsidiaries in which Arion Bank holds a direct interest*

| | | | Equity interest | |
|---|---|---|---|---|
| | Operating activity | Currency | 30.6.2020 | 31.12.2019 |
| SRL slhf., Borgartún 19, Reykjavík, Iceland | Real estate | ISK | 100.0% | 100.0% |
| Eignabjarg ehf., Borgartún 19, Reykjavík, Iceland | Holding company | ISK | 100.0% | 100.0% |
| Leiguskjól ehf., Lágmúli 6, Reykjavík, Iceland | Rental guarantee | ISK | 51.0% | 51.0% |
| Stefnir hf., Borgartún 19, Reykjavík, Iceland | Asset management | ISK | 100.0% | 100.0% |
| Valitor Holding hf., Dalshraun 3, Hafnarfjördur, Iceland | Payment solutions | ISK | 100.0% | 100.0% |
| VISA Ísland ehf., Borgartún 19, Reykjavík, Iceland | Holding company | ISK | 100.0% | 100.0% |
| Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland | Insurance | ISK | 100.0% | 100.0% |

The subsidiaries Eignabjarg ehf. (holding company of Stakksberg ehf. and Sólbjarg ehf.) and Valitor Holding hf. are classified as held for sale in accordance with IFRS 5.

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## Operating segment reporting

Segment information is presented in respect of the Group's operating segments and is 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.

### 5. Operating segments

*Markets*

Markets comprises Asset Management and Capital Markets. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. Asset Management also administers pension funds. Asset management comprises Institutional Asset Management, Private Banking and Pension Fund Administration. The operation of Stefnir hf. is presented under the segment. Stefnir hf. is an independently operating financial company owned by Arion Bank and manages a broad range of mutual funds, investment funds and institutional investor funds. Capital Markets is a securities brokerage and provides clients with a diverse range of fixed income services and risk management products.

*Corporate & Investment Banking*

Corporate & Investment Banking services large and medium-sized corporate clients and investors, both in Iceland and abroad. The division is divided into Corporate Banking and Corporate Finance.

Corporate Banking's experienced account managers specialize in key economic sectors such as retail and services, seafood, energy and real estate. The division provides a full range of lending products such as guarantees, deposit accounts, payment solutions and a variety of value-added digital solutions to meet the needs of the Bank's larger corporate clients. The Corporate Banking portfolio includes several larger international transactions, partly in syndicates with other Icelandic banks and international banks.

Arion Bank's Corporate Finance works closely with Corporate Banking, providing customers with various financial advisory and capital raising services, including M&A and LBO services. Furthermore, Corporate Finance offers financial structuring advice, as well as various services on public offerings of securities.

*Retail Banking*

Retail Banking provides a comprehensive range of products and services, including mortgage loans, savings and current accounts, vehicle and equipment financing, factoring, payment cards, pension services, insurance and funds, to both individuals and SMEs. Retail Banking has a strong focus on digital banking solutions, using the online bank and the Arion Bank app as key channels. Retail Banking operates out of several branches across Iceland with over 100,000 customers.

*Treasury*

Treasury is responsible for the Bank's liquidity, currency and interest rate management. Treasury is a market maker in Iceland in domestic securities and FX. Treasury is responsible for funds' transfer pricing and hedging and pricing of financial products. FX brokerage is part of the Treasury unit. Treasury also handles all debt issuance both in the domestic and foreign markets and maintaining the Banks credit ratings.

*Vördur*

The subsidiary Vördur is the fourth largest insurance company in Iceland, providing non-life and life insurance.

*Subsidiaries*

Subsidiaries include the subsidiaries SRL slhf., which holds the main part of investment property of the Group and the holding companies VISA Ísland ehf. and other smaller entities of the Group. The subsidiaries Valitor Holding, Stakksberg and Sólbjarg (both subsidiaries of Eignabjarg) are classified as disposal groups held for sale in accordance with IFRS 5.

*Supporting units*

Supporting units include the Bank's headquarters which carry out support functions such as the CEO office, Risk Management, Finance (excluding Treasury) and IT. The information presented relating to the supporting units does not represent an operating segment. A significant proportion of expenses from support functions is allocated to operating segments in a separate line in the operating segment overview.

*Other information*

At the beginning of 2020 the proportion of deposits from corporate customers divided between Corporate & Investment Banking and Retail Banking changed. Deposits amounting to approx. ISK 50 billion were transferred from Retail Banking to Corporate & Investment Banking. At the same time direct income and expense from those deposits were transferred between divisions. As a result of these changes the figures are not fully comparable with those from 2019, mainly reflected in Net interest income.

## 5. Operating segments, continued

| 1.1.-30.6.2020 | Markets and Stefnir | Corporate & Investment Banking | Retail Banking | Treasury | Vördur | Other sub-sidiaries | Supporting units and elimi-nations | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income (expense) ............. | 409 | 5,070 | 7,830 | 2,028 | 92 | (262) | (57) | 15,110 |
| Net fee and commission income (exp.) . | 1,980 | 1,558 | 2,237 | 237 | (91) | (356) | 199 | 5,764 |
| Net insurance income .......................... | - | - | - | - | 1,318 | - | (56) | 1,262 |
| Net financial (loss) income ................... | (3) | - | - | (58) | 884 | (144) | 12 | 691 |
| Share of profit (loss) of associates | 1 | (49) | - | - | - | - | 19 | (29) |
| Other operating income (loss) .............. | 4 | (10) | 124 | - | 3 | 298 | (178) | 241 |
| **Operating income / loss ....................** | 2,391 | 6,569 | 10,191 | 2,207 | 2,206 | (464) | (61) | 23,039 |
| Operating expenses ............................. | (1,005) | (750) | (2,899) | (333) | (1,281) | (104) | (6,230) | (12,602) |
| Allocated expenses .............................. | (965) | (1,349) | (3,099) | (436) | (9) | (3) | 5,861 | - |
| Bank levy ............................................. | (18) | (202) | (296) | (139) | - | - | - | (655) |
| Net impairment .................................... | (4) | (2,707) | (1,979) | 17 | - | 895 | - | (3,778) |
| **Earnings / loss before income tax .....** | 399 | 1,561 | 1,918 | 1,316 | 916 | 324 | (430) | 6,004 |
| Net seg. rev. from ext. customers ......... | 1,361 | 10,238 | 16,406 | (7,029) | 2,066 | 175 | (178) | 23,039 |
| Net seg. rev. from other segments ........ | 1,030 | (3,669) | (6,215) | 9,236 | 140 | (639) | 117 | - |
| **Operating income / loss ....................** | 2,391 | 6,569 | 10,191 | 2,207 | 2,206 | (464) | (61) | 23,039 |
| Depreciation and amortization ............. | 1 | 1 | 93 | - | 102 | 1 | 518 | 716 |
| **Total assets ........................................** | 75,592 | 316,633 | 485,327 | 471,858 | 29,418 | 56,527 | (253,106) | 1,182,249 |
| **Total liabilities ....................................** | 68,211 | 249,021 | 436,718 | 441,285 | 18,595 | 32,698 | (253,106) | 993,422 |
| **Allocated equity .................................** | 7,381 | 67,612 | 48,609 | 30,573 | 10,823 | 23,829 | - | 188,827 |

| 1.1.-30.6.2019 | Markets and Stefnir | Corporate & Investment Banking | Retail Banking | Treasury | Vördur | Other sub-sidiaries | Supporting units and elimi-nations | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income .............................. | 553 | 4,494 | 9,005 | 1,454 | 103 | (261) | (106) | 15,242 |
| Net fee and commission income (exp.) . | 2,210 | 1,007 | 2,291 | (201) | (31) | (515) | (65) | 4,696 |
| Net insurance income .......................... | - | - | - | - | 1,105 | - | (29) | 1,076 |
| Net financial income (loss) ................... | 200 | (194) | (26) | 224 | 1,064 | 544 | (23) | 1,789 |
| Share of profit of associates and net impairment .................................. | - | - | - | - | - | - | 720 | 720 |
| Other operating income (loss) .............. | 11 | (11) | 156 | 6 | 11 | 31 | 201 | 405 |
| **Operating income ..............................** | 2,974 | 5,296 | 11,426 | 1,483 | 2,252 | (201) | 698 | 23,928 |
| Operating expenses ............................. | (1,022) | (862) | (3,563) | (154) | (1,133) | (31) | (6,715) | (13,480) |
| Allocated expenses .............................. | (911) | (1,935) | (3,138) | (567) | (8) | (2) | 6,561 | - |
| Bank levy ............................................. | (92) | (425) | (640) | (661) | - | - | - | (1,818) |
| Net impairment .................................... | (8) | (2,248) | 232 | 14 | - | (59) | - | (2,069) |
| **Earnings / loss before income tax .....** | 941 | (174) | 4,317 | 115 | 1,111 | (293) | 544 | 6,561 |
| Net seg. rev. from ext. customers ......... | 1,373 | 10,104 | 18,260 | (9,936) | 2,104 | 1,538 | 486 | 23,929 |
| Net seg. rev. from other segments ........ | 1,601 | (4,808) | (6,834) | 11,419 | 148 | (515) | (1,012) | (1) |
| **Operating income ..............................** | 2,974 | 5,296 | 11,426 | 1,483 | 2,252 | 1,023 | (526) | 23,928 |
| Depreciation and amortization ............. | 2 | 2 | 83 | - | - | 105 | 504 | 696 |
| **Total assets ........................................** | 78,441 | 327,950 | 554,871 | 573,660 | 26,222 | 67,056 | (394,781) | 1,233,419 |
| **Total liabilities ....................................** | 71,767 | 254,184 | 495,724 | 555,797 | 16,869 | 40,738 | (396,949) | 1,038,130 |
| **Allocated equity .................................** | 6,674 | 73,766 | 59,147 | 17,863 | 9,353 | 26,318 | 2,168 | 195,289 |

Comparative amounts for the first half of 2019 have been restated based on the organizational structure changes made at the end of September 2019.

Income taxes and discontinued operations held for sale are excluded from the profit and loss segment information.

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## Quarterly statements

### 6. Operations by quarters, unaudited

| 2020 | Q1 | Q2 | Total |
|---|---|---|---|
| Net interest income | 7,253 | 7,857 | 15,110 |
| Net fee and commission income | 3,076 | 2,688 | 5,764 |
| Net insurance income | 501 | 761 | 1,262 |
| Net financial income | (2,000) | 2,691 | 691 |
| Share of profit (loss) of associates and net impairment | (24) | (5) | (29) |
| Other operating income | 170 | 71 | 241 |
| **Operating income** | 8,976 | 14,063 | 23,039 |
| Salaries and related expense | (3,130) | (3,577) | (6,707) |
| Other operating expense | (3,077) | (2,818) | (5,895) |
| **Operating expenses** | (6,207) | (6,395) | (12,602) |
| Bank levy | (331) | (324) | (655) |
| Net impairment | (2,860) | (918) | (3,778) |
| **Earnings before income tax** | (422) | 6,426 | 6,004 |
| Income tax expense | (860) | (1,468) | (2,328) |
| **Net earnings from continuing operations** | (1,282) | 4,958 | 3,676 |
| Discontinued operations, net of tax | (889) | (45) | (934) |
| **Net earnings** | (2,171) | 4,913 | 2,742 |

| 2019 | | | |
|---|---|---|---|
| Net interest income | 7,434 | 7,808 | 15,242 |
| Net fee and commission income | 2,218 | 2,478 | 4,696 |
| Net insurance income | 253 | 823 | 1,076 |
| Net financial income | 766 | 1,023 | 1,789 |
| Share of profit (loss) of associates and net impairment | 727 | (7) | 720 |
| Other operating income | 310 | 95 | 405 |
| **Operating income** | 11,708 | 12,220 | 23,928 |
| Salaries and related expense | (3,630) | (3,805) | (7,435) |
| Other operating expense | (3,232) | (2,813) | (6,045) |
| **Operating expenses** | (6,862) | (6,618) | (13,480) |
| Bank levy | (906) | (912) | (1,818) |
| Net impairment | (1,081) | (988) | (2,069) |
| **Earnings before income tax** | 2,859 | 3,702 | 6,561 |
| Income tax expense | (622) | (891) | (1,513) |
| **Net earnings from continuing operations** | 2,237 | 2,811 | 5,048 |
| Discontinued operations, net of tax | (1,219) | (715) | (1,934) |
| **Net earnings** | 1,018 | 2,096 | 3,114 |

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

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## Notes to the Consolidated Interim Income Statement

### 7. Net interest income

| 1.1.-30.6.2020 | Amortized cost | Fair value thr. P/L | Fair value thr. OCI | Total |
|---|---|---|---|---|
| *Interest income* | | | | |
| Cash and balances with Central Bank | 1,077 | - | - | 1,077 |
| Loans | 23,616 | - | - | 23,616 |
| Securities | - | 574 | 514 | 1,088 |
| Other | 98 | - | - | 98 |
| **Interest income** | 24,791 | 574 | 514 | 25,879 |
| *Interest expense* | | | | |
| Deposits | (3,980) | - | - | (3,980) |
| Borrowings | (5,911) | - | - | (5,911) |
| Subordinated liabilities | (814) | - | - | (814) |
| Other | (64) | - | - | (64) |
| **Interest expense** | (10,769) | - | - | (10,769) |
| **Net interest income** | 14,022 | 574 | 514 | 15,110 |

| 1.1.-30.6.2019 | | | | |
|---|---|---|---|---|
| *Interest income* | | | | |
| Cash and balances with Central Bank | 2,030 | - | - | 2,030 |
| Loans | 28,480 | 23 | - | 28,503 |
| Securities | - | 200 | 308 | 508 |
| Other | 106 | - | - | 106 |
| **Interest income** | 30,616 | 223 | 308 | 31,147 |
| *Interest expense* | | | | |
| Deposits | (6,860) | - | - | (6,860) |
| Borrowings | (8,872) | - | - | (8,872) |
| Subordinated liabilities | (106) | - | - | (106) |
| Other | (67) | - | - | (67) |
| **Interest expense** | (15,905) | - | - | (15,905) |
| **Net interest income** | 14,711 | 223 | 308 | 15,242 |

Amounts are in ISK millions

## 7. Net interest income, continued

| 1.4.-30.6.2020 | Amortized cost | Fair value thr. P/L | Fair value thr. OCI | Total |
|---|---|---|---|---|
| *Interest income* | | | | |
| Cash and balances with Central Bank | 303 | - | - | 303 |
| Loans | 12,926 | - | - | 12,926 |
| Securities | - | 214 | 324 | 538 |
| Other | 68 | - | - | 68 |
| **Interest income** | 13,297 | 214 | 324 | 13,835 |
| *Interest expense* | | | | |
| Deposits | (1,969) | - | - | (1,969) |
| Borrowings | (3,468) | - | - | (3,468) |
| Subordinated liabilities | (501) | - | - | (501) |
| Other | (40) | - | - | (40) |
| **Interest expense** | (5,978) | - | - | (5,978) |
| **Net interest income** | 7,319 | 214 | 324 | 7,857 |

| 1.4.-30.6.2019 | | | | |
|---|---|---|---|---|
| *Interest income* | | | | |
| Cash and balances with Central Bank | 1,061 | - | - | 1,061 |
| Loans | 15,075 | - | - | 15,075 |
| Securities | - | 92 | 179 | 271 |
| Other | 56 | - | - | 56 |
| **Interest income** | 16,192 | 92 | 179 | 16,463 |
| *Interest expense* | | | | |
| Deposits | (3,608) | - | - | (3,608) |
| Borrowings | (4,945) | - | - | (4,945) |
| Subordinated liabilities | (59) | - | - | (59) |
| Other | (43) | - | - | (43) |
| **Interest expense** | (8,655) | - | - | (8,655) |
| **Net interest income** | 7,537 | 92 | 179 | 7,808 |

*Interest spread*

| | 2020 | 2019 | 2020 | 2019 |
|---|---|---|---|---|
| Interest spread (the ratio of net interest income to the average carrying amount | 1.1.-30.6. | 1.1.-30.6. | 1.4.-30.6. | 1.4.-30.6. |
| of interest bearing assets) | 2.9% | 2.8% | 2.9% | 2.8% |

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## 8. Net fee and commission income

| | 1.1.-30.6.2020 | | | 1.1.-30.6.2019 | | |
|---|---|---|---|---|---|---|
| | Income | Expense | Net income | Income | Expense | Net income |
| Asset management | 2,018 | (218) | 1,800 | 1,901 | (255) | 1,646 |
| Capital markets and corporate finance | 659 | (14) | 645 | 818 | (25) | 793 |
| Lending and financial guarantees | 2,068 | - | 2,068 | 907 | - | 907 |
| Collection and payment services | 634 | (54) | 580 | 769 | (49) | 720 |
| Cards and payment solution | 869 | (161) | 708 | 733 | (108) | 625 |
| Other | 330 | (367) | (37) | 333 | (327) | 6 |
| **Net fee and commission income** | 6,578 | (814) | 5,764 | 5,460 | (764) | 4,696 |

| | 1.4.-30.6.2020 | | | 1.4.-30.6.2019 | | |
|---|---|---|---|---|---|---|
| Asset management | 1,003 | (103) | 900 | 1,008 | (120) | 888 |
| Capital markets and corporate finance | 246 | (5) | 241 | 464 | (11) | 453 |
| Lending and financial guarantees | 1,040 | - | 1,040 | 438 | - | 438 |
| Collection and payment services | 302 | (26) | 276 | 397 | (22) | 375 |
| Cards and payment solution | 333 | (68) | 265 | 354 | (30) | 324 |
| Other | 173 | (207) | (34) | 169 | (168) | 1 |
| **Net fee and commission income** | 3,097 | (409) | 2,688 | 2,830 | (352) | 2,478 |

Asset management fees are earned by the Group for trust and fiduciary activities where the Group holds or invests assets on behalf of the customers.

Fee and commission income from capital markets and corporate finance includes miscellaneous corporate finance services plus commission from capital markets relating to sales of shares, bonds, FX and derivatives.

Fee and commission income from lending and financial guarantees is mainly related to lending activities, extension fees, advisory services and documentation, notification and payment fees plus fees from the issuing of guarantees on behalf of customers.

Fee and commission income on collection and payment services is generated billing services, such as issuing invoices and payment collection notices, wire transfer services and other payment services.

Commission from cards and payment solutions is mainly from the Bank's issuance of credit and debit cards and other card related commission, e.g. yearly fee on cards and transaction fees.

Other fee and commission income is mainly fees relating to FX transactions at branches and in ATMs, custody and market making on the Icelandic stock exchange.

## 9. Net insurance income

| | 2020 | 2019 | 2020 | 2019 |
|---|---|---|---|---|
| *Earned premiums, net of reinsurers' share* | 1.1.-30.6. | 1.1.-30.6. | 1.4.-30.6. | 1.4.-30.6. |
| Premiums written | 7,007 | 6,813 | 3,004 | 3,012 |
| Premiums written, reinsurers' shares | (206) | (186) | (98) | (92) |
| Change in provision for unearned premiums | (1,329) | (1,215) | (282) | (149) |
| **Earned premiums, net of reinsurers' share** | 5,472 | 5,412 | 2,624 | 2,771 |
| *Claims incurred, net of reinsurers' share* | | | | |
| Claims paid | (4,081) | (3,627) | (2,076) | (1,778) |
| Claims paid, reinsurers' share | 56 | 115 | 41 | 84 |
| Change in provision for claims | (216) | (772) | 183 | (242) |
| Changes in provision for claims, reinsurers' share | 31 | (52) | (11) | (12) |
| **Claims incurred, net of reinsurers' share** | (4,210) | (4,336) | (1,863) | (1,948) |
| **Net insurance income** | 1,262 | 1,076 | 761 | 823 |

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## 10. Net financial income

| | 2020<br>1.1.-30.6. | 2019<br>1.1.-30.6. | 2020<br>1.4.-30.6. | 2019<br>1.4.-30.6. |
|---|---|---|---|---|
| Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss | 656 | 2,589 | 2,298 | 1,541 |
| Gain (loss) on prepayments of borrowings | 79 | (188) | 79 | (188) |
| Net (loss) gain on fair value hedge of interest rate swap | (123) | (155) | 43 | (140) |
| Realized gain on financial assets carried at fair value through OCI | 205 | 112 | 211 | 70 |
| Net foreign exchange (loss) gain | (126) | (569) | 60 | (260) |
| **Net financial income** | 691 | 1,789 | 2,691 | 1,023 |

*Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss*

| | | | | |
|---|---|---|---|---|
| Equity instruments | (658) | 1,795 | 1,717 | 889 |
| Debt instruments | 1,060 | 699 | 588 | 454 |
| Derivatives | 254 | 141 | (7) | 180 |
| Loans | - | (46) | - | 18 |
| **Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss** | 656 | 2,589 | 2,298 | 1,541 |

*Net (loss) gain on fair value hedge of interest rate swap*

| | | | | |
|---|---|---|---|---|
| Fair value change of interest rate swaps designated as hedging instruments | 593 | 1,087 | 53 | 690 |
| Fair value change on bonds issued by the Group attributable to interest rate risk | (716) | (1,242) | (10) | (830) |
| **Net (loss) gain on fair value hedge of interest rate swap** | (123) | (155) | 43 | (140) |

## 11. Other operating income

| | | | | |
|---|---|---|---|---|
| Net gain on assets held for sale | 116 | 125 | - | 12 |
| Other income | 125 | 280 | 71 | 83 |
| **Other operating income** | 241 | 405 | 71 | 95 |

*Net gain on assets held for sale*

| | | | | |
|---|---|---|---|---|
| Income from real estates and other assets | 154 | 191 | 21 | 54 |
| Expense related to real estates and other assets | (38) | (66) | (21) | (42) |
| **Net gain on assets held for sale** | 116 | 125 | - | 12 |

Real estates and other assets classified as assets held for sale are generally the result of foreclosures on companies and individuals.

## 12. Personnel and salaries

| *Number of employees* | 2020<br>1.1.-30.6. | 2019<br>1.1.-30.6. | 2020<br>1.4.-30.6. | 2019<br>1.4.-30.6. |
|---|---|---|---|---|
| Average number of full-time equivalent positions during the period | 800 | 903 | 792 | 897 |
| Full-time equivalent positions at the end of the period | 783 | 880 | 783 | 880 |

*Number of employees at the parent company*

| | | | | |
|---|---|---|---|---|
| Average number of full-time equivalent positions during the period | 673 | 795 | 665 | 788 |
| Full-time equivalent positions at the end of the period | 655 | 770 | 655 | 770 |

*Salaries and related expenses*

| | | | | |
|---|---|---|---|---|
| Salaries | 5,438 | 5,930 | 2,896 | 3,049 |
| Defined contribution pension plans | 805 | 850 | 429 | 436 |
| Salary-related expenses | 765 | 854 | 402 | 440 |
| Capitalization of salaries due to implementation of core systems | (301) | (199) | (150) | (120) |
| **Salaries and related expenses** | 6,707 | 7,435 | 3,577 | 3,805 |

*Salaries and related expenses for the parent company*

| | | | | |
|---|---|---|---|---|
| Salaries | 4,494 | 5,164 | 2,389 | 2,657 |
| Defined contribution pension plans | 666 | 740 | 355 | 380 |
| Salary-related expenses | 647 | 749 | 344 | 387 |
| Capitalization of salaries due to implementation of core systems | (301) | (199) | (150) | (120) |
| **Salaries and related expenses for the parent company** | 5,506 | 6,454 | 2,938 | 3,304 |

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## 12. Personnel and salaries, continued

In June 2018 Arion Bank adopted a share-based remuneration programme, when a limited stock grant was offered to all employees of the parent company, excluding internal control units, in connection with the IPO and listing of the Bank. Remuneration was paid in the form of deferred shares with a vesting period of two years. The Bank recognizes expenses related to the programme as salaries and related expenses, a total of ISK 651 million, over the vesting period, or approximately ISK 27 million per month from June 2018 to May 2020.

During the period the Group made a provision of ISK 35 million (H1 2019: ISK 6 million) for performance plan payments, including salary-related expenses, for which the Bank made no provision (H1 2019: nil). Forty percent of the payment is deferred for three years in accordance with FSA rules on remuneration policies for financial undertakings. At the end of the period the Group's accrual for performance plan payments amounted to ISK 198 million (31.12.2019: ISK 371 million), of which the Bank's accrual amounts to ISK 100 million (31.12.2019: ISK 239 million).

## 13. Other operating expenses

| | 2020<br>1.1.-30.6. | 2019<br>1.1.-30.6. | 2020<br>1.4.-30.6. | 2019<br>1.4.-30.6. |
|---|---|---|---|---|
| IT expenses | 2,488 | 2,140 | 1,323 | 984 |
| Professional services | 503 | 558 | 201 | 265 |
| Housing expenses | 508 | 545 | 235 | 270 |
| Other administration expenses | 1,307 | 1,711 | 519 | 781 |
| Depositors' and Investors' Guarantee Fund | 373 | 395 | 182 | 163 |
| Depreciation of property and equipment | 259 | 268 | 129 | 126 |
| Depreciation of right of use asset | 65 | 64 | 31 | 32 |
| Amortization of intangible assets | 392 | 364 | 198 | 192 |
| **Other operating expenses** | 5,895 | 6,045 | 2,818 | 2,813 |

## 14. Bank levy

The Bank levy is 0.145% (2019: 0.376%) on total debts excluding tax liabilities, in excess of ISK 50 billion. The tax is assessed on Financial Undertakings but non-financial subsidiaries are exempt from this tax.

## 15. Net impairment

| | 2020<br>1.1.-30.6. | 2019<br>1.1.-30.6. | 2020<br>1.4.-30.6. | 2019<br>1.4.-30.6. |
|---|---|---|---|---|
| *Net impairment on financial instruments* | | | | |
| Net change in impairment of loans to credit institutions | (91) | 14 | (55) | 18 |
| Net change in impairment of loans to corporates | (2,039) | (2,156) | (301) | (2,342) |
| Net change in impairment of loans to individuals | (834) | 385 | (69) | 412 |
| Write offs on loans and receivables to corporates | (477) | (674) | (211) | (279) |
| Write offs on loans and receivables to individuals | (307) | (676) | (183) | (313) |
| Payments on loans and receivables previously written off from corporates | 2 | 19 | - | 19 |
| Payments on loans and receivables previously written off from individuals | 42 | 77 | 22 | 44 |
| Net change in impairment of financial instruments at FVOCI | (1) | - | 2 | 1 |
| Net change in impairment of loan commitments, guarantees and unused credit facilities | (395) | 312 | (261) | 1,166 |
| **Net impairment on financial instruments** | (4,100) | (2,699) | (1,056) | (1,274) |
| *Other value changes of loans* | | | | |
| Increase in book value of loans to corporates | 58 | 60 | 36 | 14 |
| Increase in book value of loans to individuals | 264 | 570 | 102 | 272 |
| **Other value changes of loans** | 322 | 630 | 138 | 286 |
| **Net impairment** | (3,778) | (2,069) | (918) | (988) |

Increase in book value of loans to individuals and corporates is mainly due to release of discount from loans acquired with discount during the years 2008 to 2013, both due to impairments and other discount rate than reflected in the interest rates of the loans. The discount release was primarily related to loans that were paid up or sold during the period.

Amounts are in ISK millions

## 16. Income tax expense

| | 2020 1.1.-30.6. | 2019 1.1.-30.6. | 2020 1.4.-30.6. | 2019 1.4.-30.6. |
|---|---|---|---|---|
| Current tax expense | 3,094 | 1,448 | 2,250 | 784 |
| Deferred tax expense | (766) | 65 | (782) | 107 |
| **Income tax expense** | 2,328 | 1,513 | 1,468 | 891 |

*Reconciliation of effective tax rate*

| | 2020 1.1.-30.6. | | 2019 1.1.-30.6. | |
|---|---|---|---|---|
| Earnings before tax | | 6,004 | | 6,561 |
| Income tax using the Icelandic corporate tax rate | 20.1% | 1,201 | 20.0% | 1,312 |
| Additional 6% tax on Financial Undertakings | 10.2% | 613 | 4.3% | 285 |
| Non-deductible expenses | 0.0% | 2 | 0.0% | 2 |
| Tax exempt revenues (loss) | 4.2% | 254 | (7.9%) | (521) |
| Non-deductible taxes (bank levy) | 2.2% | 131 | 5.6% | 364 |
| Tax incentives not recognized in the Income Statement | 1.8% | 108 | 0.9% | 60 |
| Other changes | 0.3% | 19 | 0.2% | 11 |
| **Effective tax rate** | 38.8% | 2,328 | 23.1% | 1,513 |

Financial undertakings pay 6% additional tax on taxable profit exceeding ISK 1 billion.

Tax exempt revenues / loss consist mainly of profit / loss from equity positions.

Bank levy of 0.145% on liabilities exceeding ISK 50 billion is non-deductible (2019: 0.376%).

## 17. Discontinued operations held for sale, net of income tax

| | 2020 1.1.-30.6. | 2019 1.1.-30.6. | 2020 1.4.-30.6. | 2019 1.4.-30.6. |
|---|---|---|---|---|
| Net loss from discontinued operations held for sale | (934) | (2,378) | (45) | (872) |
| Income tax expense | - | 444 | - | 157 |
| **Discontinued operations held for sale, net of income tax** | (934) | (1,934) | (45) | (715) |
| | | | | |
| Valitor Holding hf. | (870) | (1,934) | 30 | (715) |
| Stakksberg ehf. | 344 | - | (69) | - |
| Sólbjarg ehf. | (408) | - | (6) | - |
| **Discontinued operations held for sale, net of income tax** | (934) | (1,934) | (45) | (715) |

The operating loss of Valitor was ISK 1,300 million for the first six months of 2020 whereas Valitor's negative contribution to the Group, after taking into account the Group's eliminations, was ISK 870 million. Operating income of Valitor was ISK 3,147 million for the first six months of 2020, or ISK 3,578 million, after taking into account the Group's eliminations. In the same period in 2019 the operation of Valitor was greatly affected by the ISK 1,200 million Valitor paid to Sunshine Press Production and Datacell in damages. When Arion Bank acquired a 38.62% shareholding in Valitor in 2014, the Bank signed an agreement with the seller (Landsbankinn) which stipulated that the seller would bear a part of the liability which Valitor might potentially be subject to in relation to the compensatory damages. Hence, Landsbankinn was liable to pay part of the damages. The total effect of the damages was ISK 595 million, net of tax. The operating loss of Valitor for the first six months of 2019 was ISK 2,754 million, whereas Valitor's negative contribution to the Group, after taking into account the Group's eliminations, was ISK 1,934 million.

Operating effects of Stakksberg and Sólbjarg are due to fair value and currency changes of underlying assets.

For further information about Valitor Holding hf., Stakksberg ehf. and Sólbjarg ehf. see Note 29.

## 18. Earnings per share

| | Continued operations | | Discontinued operations | | Net Earnings | |
|---|---|---|---|---|---|---|
| | 2020 1.1.-30.6. | 2019 1.1.-30.6. | 2020 1.1.-30.6. | 2019 1.1.-30.6. | 2020 1.1.-30.6. | 2019 1.1.-30.6. |
| Net earnings attributable to the shareholders of Arion Bank | 3,685 | 5,048 | (934) | (1,934) | 2,751 | 3,114 |
| Weighted average number of outstanding shares | 1,727 | 1,814 | 1,727 | 1,814 | 1,727 | 1,814 |
| **Basic earnings per share** | 2.13 | 2.78 | (0.54) | (1.07) | 1.59 | 1.72 |
| | | | | | | |
| | 1.4.-30.6. | 1.4.-30.6. | 1.4.-30.6. | 1.4.-30.6. | 1.4.-30.6. | 1.4.-30.6. |
| Net earnings attributable to the shareholders of Arion Bank | 4,963 | 2,811 | (45) | (715) | 4,918 | 2,096 |
| Weighted average number of outstanding shares | 1,718 | 1,814 | 1,718 | 1,814 | 1,718 | 1,814 |
| **Basic earnings per share** | 2.89 | 1.55 | (0.03) | (0.39) | 2.86 | 1.16 |

There were no instruments at the end of the period that could potentially dilute basic earnings per share (2019: none).

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## Notes to the Consolidated Interim Statement of Financial Position

### 19. Cash and balances with Central Bank

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Cash on hand | 3,917 | 4,206 |
| Cash with Central Bank | 93,915 | 81,543 |
| Mandatory reserve deposit with Central Bank | 5,600 | 9,968 |
| **Cash and balances with Central Bank** | 103,432 | 95,717 |

The mandatory reserve deposit with the Central Bank is not available for the Group to use in its daily operations. Minimum reserve requirements of the Central Bank falls into two categories: a fixed reserve requirement and an average maintenance requirement. The fixed reserve requirement is 1%. In March 2020 the Central Bank decided to lower the average reserve requirement from 1% to 0%.

### 20. Loans to credit institutions

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Bank accounts | 29,111 | 16,437 |
| Other loans | 4,486 | 1,510 |
| **Loans to credit institutions** | 33,597 | 17,947 |

### 21. Loans to customers

| | Individuals | | Corporates | | Total | |
|---|---|---|---|---|---|---|
| 30.6.2020 | Gross carrying amount | Book value | Gross carrying amount | Book value | Gross carrying amount | Book value |
| Overdrafts | 13,917 | 12,889 | 15,915 | 15,013 | 29,832 | 27,902 |
| Credit cards | 11,809 | 11,467 | 1,102 | 1,024 | 12,911 | 12,491 |
| Mortgage loans | 333,249 | 332,790 | 23,941 | 23,522 | 357,190 | 356,312 |
| Other loans | 33,207 | 31,601 | 359,459 | 351,596 | 392,666 | 383,197 |
| **Loans to customers** | 392,182 | 388,747 | 400,417 | 391,155 | 792,599 | 779,902 |
| | | | | | | |
| 31.12.2019 | | | | | | |
| Overdrafts | 14,421 | 13,720 | 18,709 | 17,780 | 33,130 | 31,500 |
| Credit cards | 13,028 | 12,786 | 1,373 | 1,281 | 14,401 | 14,067 |
| Mortgage loans | 310,562 | 310,195 | 23,475 | 23,211 | 334,037 | 333,406 |
| Other loans | 33,105 | 31,868 | 368,453 | 363,114 | 401,558 | 394,982 |
| **Loans to customers** | 371,116 | 368,569 | 412,010 | 405,386 | 783,126 | 773,955 |

The total book value of pledged loans that were pledged against amounts borrowed was ISK 164 billion at the end of the period (31.12.2019: ISK 182 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk management disclosures.

### 22. Financial instruments

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Bonds and debt instruments | 140,576 | 65,874 |
| Shares and equity instruments with variable income | 19,809 | 21,600 |
| Derivatives | 8,911 | 6,617 |
| Securities used for economic hedging | 27,845 | 23,315 |
| **Financial instruments** | 197,141 | 117,406 |

Amounts are in ISK millions

## 23. Financial assets and financial liabilities

| 30.6.2020 | Amortized cost | Fair value through OCI | Manda-torily at fair value thr. P/L | Total |
|---|---|---|---|---|
| *Financial assets* | | | | |
| *Loans* | | | | |
| Cash and balances with Central Bank | 103,432 | - | - | 103,432 |
| Loans to credit institutions | 33,597 | - | - | 33,597 |
| Loans to customers | 779,902 | - | - | 779,902 |
| **Loans** | 916,931 | - | - | 916,931 |
| *Bonds and debt instruments* | | | | |
| Listed | - | 120,604 | 17,563 | 138,167 |
| Unlisted | - | 1,582 | 827 | 2,409 |
| **Bonds and debt instruments** | - | 122,186 | 18,390 | 140,576 |
| *Shares and equity instruments with variable income* | | | | |
| Listed | - | - | 10,039 | 10,039 |
| Unlisted | - | - | 6,517 | 6,517 |
| Bond funds with variable income, unlisted | - | - | 3,253 | 3,253 |
| **Shares and equity instruments with variable income** | - | - | 19,809 | 19,809 |
| *Derivatives* | | | | |
| OTC derivatives | - | - | 5,801 | 5,801 |
| Derivatives used for hedge accounting | - | - | 3,110 | 3,110 |
| **Derivatives** | - | - | 8,911 | 8,911 |
| *Securities used for economic hedging* | | | | |
| Bonds and debt instruments, listed | - | - | 18,028 | 18,028 |
| Shares and equity instruments with variable income, listed | - | - | 9,817 | 9,817 |
| **Securities used for economic hedging** | - | - | 27,845 | 27,845 |
| *Other financial assets* | | | | |
| Accounts receivable | 5,067 | - | - | 5,067 |
| Other financial assets | 7,155 | - | - | 7,155 |
| **Other financial assets** | 12,222 | - | - | 12,222 |
| **Financial assets** | 929,153 | 122,186 | 74,955 | 1,126,294 |
| *Financial liabilities* | | | | |
| Due to credit institutions and Central Bank | 7,661 | - | - | 7,661 |
| Deposits | 555,855 | - | - | 555,855 |
| Borrowings | 314,952 | - | - | 314,952 |
| Subordinated liabilities | 36,494 | - | - | 36,494 |
| Short position in bonds | - | - | 21 | 21 |
| Short position in bonds used for economic hedging | - | - | 127 | 127 |
| Derivatives | - | - | 2,970 | 2,970 |
| Other financial liabilities | 17,580 | - | - | 17,580 |
| **Financial liabilities** | 932,542 | - | 3,118 | 935,660 |

Amounts are in ISK millions

## 23. Financial assets and financial liabilities, continued

| 31.12.2019 | Amortized cost | Fair value through OCI | Manda-torily at fair value thr. P/L | Total |
|---|---|---|---|---|
| *Financial assets* | | | | |
| *Loans* | | | | |
| Cash and balances with Central Bank | 95,717 | - | - | 95,717 |
| Loans to credit institutions | 17,947 | - | - | 17,947 |
| Loans to customers | 773,955 | - | - | 773,955 |
| **Loans** | 887,619 | - | - | 887,619 |
| *Bonds and debt instruments* | | | | |
| Listed | - | 47,698 | 16,479 | 64,177 |
| Unlisted | - | 1,196 | 501 | 1,697 |
| **Bonds and debt instruments** | - | 48,894 | 16,980 | 65,874 |
| *Shares and equity instruments with variable income* | | | | |
| Listed | - | - | 9,632 | 9,632 |
| Unlisted | - | - | 7,417 | 7,417 |
| Bond funds with variable income, unlisted | - | - | 4,551 | 4,551 |
| **Shares and equity instruments with variable income** | - | - | 21,600 | 21,600 |
| *Derivatives* | | | | |
| OTC derivatives | - | - | 5,001 | 5,001 |
| Derivatives used for hedge accounting | - | - | 1,616 | 1,616 |
| **Derivatives** | - | - | 6,617 | 6,617 |
| *Securities used for economic hedging* | | | | |
| Bonds and debt instruments, listed | - | - | 10,852 | 10,852 |
| Shares and equity instruments with variable income, listed | - | - | 12,459 | 12,459 |
| Shares and equity instruments with variable income, unlisted | - | - | 4 | 4 |
| **Securities used for economic hedging** | - | - | 23,315 | 23,315 |
| *Other financial assets* | | | | |
| Accounts receivable | 3,617 | - | - | 3,617 |
| Other financial assets | 5,058 | - | - | 5,058 |
| **Other financial assets** | 8,675 | - | - | 8,675 |
| **Financial assets** | 896,294 | 48,894 | 68,512 | 1,013,700 |
| *Financial liabilities* | | | | |
| Due to credit institutions and Central Bank | 5,984 | - | - | 5,984 |
| Deposits | 492,916 | - | - | 492,916 |
| Borrowings | 304,745 | - | - | 304,745 |
| Subordinated liabilities | 20,083 | - | - | 20,083 |
| Short position in bonds | - | - | 385 | 385 |
| Short position in equity, used for economic hedging | - | - | 107 | 107 |
| Short position in equity | - | - | 24 | 24 |
| Derivatives | - | - | 2,054 | 2,054 |
| Other financial liabilities | 6,408 | - | - | 6,408 |
| **Financial liabilities** | 830,136 | - | 2,570 | 832,706 |

Amounts are in ISK millions

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

*Bonds and debt instruments measured at fair value, specified by issuer*

| 30.6.2020 | FVOCI | Mandatorily FVPL | Total |
|---|---|---|---|
| Financial and insurance activities | 433 | 6,858 | 7,291 |
| Public sector | 113,567 | 7,095 | 120,662 |
| Corporates | 8,186 | 4,437 | 12,623 |
| **Bonds and debt instruments at fair value** | 122,186 | 18,390 | 140,576 |
| 31.12.2019 | | | |
| Financial and insurance activities | 417 | 5,613 | 6,030 |
| Public sector | 41,417 | 7,259 | 48,676 |
| Corporates | 7,060 | 4,108 | 11,168 |
| **Bonds and debt instruments at fair value** | 48,894 | 16,980 | 65,874 |

The total amount of pledged bonds was ISK 6.6 billion at the end of the period (31.12.2019: ISK 6.0 billion). Pledged bonds comprised Icelandic Government Bonds and Financial Institutions 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.

### 24. 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 recognized at fair value on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorization (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting period.

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

30.6.2020

| *Assets at fair value* | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 130,892 | 9,389 | 295 | 140,576 |
| Shares and equity instruments with variable income | 4,843 | 13,222 | 1,744 | 19,809 |
| Derivatives | - | 5,801 | - | 5,801 |
| Derivatives used for hedge accounting | - | 3,110 | - | 3,110 |
| Securities used for economic hedging | 27,845 | - | - | 27,845 |
| Investment property | - | - | 7,051 | 7,051 |
| **Assets at fair value** | 163,580 | 31,522 | 9,090 | 204,192 |
| *Liabilities at fair value* | | | | |
| Short position in bonds | 21 | - | - | 21 |
| Short position in bonds used for economic hedging | 127 | - | - | 127 |
| Derivatives | - | 2,970 | - | 2,970 |
| **Liabilities at fair value** | 148 | 2,970 | - | 3,118 |

Amounts are in ISK millions

## 24. Fair value hierarchy, continued

31.12.2019

| *Assets at fair value* | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 57,196 | 8,650 | 28 | 65,874 |
| Shares and equity instruments with variable income | 5,169 | 14,876 | 1,555 | 21,600 |
| Derivatives | - | 5,001 | - | 5,001 |
| Derivatives used for hedge accounting | - | 1,616 | - | 1,616 |
| Securities used for economic hedging | 22,819 | 496 | - | 23,315 |
| Investment property | - | - | 7,120 | 7,120 |
| **Assets at fair value** | 85,184 | 30,639 | 8,703 | 124,526 |

| *Liabilities at fair value* | | | | |
|---|---|---|---|---|
| Short position in bonds | 385 | - | - | 385 |
| Short position in equity | 24 | - | - | 24 |
| Short position in equity, used for economic hedging | 107 | - | - | 107 |
| Derivatives | - | 2,054 | - | 2,054 |
| **Liabilities at fair value** | 516 | 2,054 | - | 2,570 |

Transfers from Level 2 to Level 1 amounted to ISK 85 million at the end of the period (31.12.2019: Transfers from Level 1 to Level 2 amounted to ISK 20 million).

*Fair value of assets and liabilities*

The fair value of asset 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 an 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*

The best evidence of the fair value of an 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 an asset in Note 23 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.

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

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from quoted 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 valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent market transactions between knowledgeable and willing parties, if available, reference to 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.

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.

Level 2 instruments include unlisted shares, unlisted funds with underlying bonds and equity holdings (share certificates), unlisted and less liquid listed bonds and all OTC derivatives.

Amounts are in ISK millions

## 24. Fair value hierarchy, continued

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

In some 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 organizations. 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.

*Movements in Level 3 assets measured at fair value*

| | Investment | Financial assets | | |
|---|---|---|---|---|
| 30.6.2020 | property | Bonds | Shares | Total |
| Balance at the beginning of the year | 7,119 | 28 | 1,555 | 8,702 |
| Net fair value changes | - | 6 | (7) | (1) |
| Additions | 10 | 517 | 196 | 723 |
| Disposals | (78) | (256) | - | 723 |
| **Balance at the end of the period** | 7,051 | 295 | 1,744 | 10,147 |

| 31.12.2019 | | | | |
|---|---|---|---|---|
| Balance at the beginning of the year | 7,092 | 42 | 1,329 | 8,463 |
| Net fair value changes | - | 20 | 62 | 82 |
| Additions | 30 | 5 | 281 | 316 |
| Disposal | (3) | (27) | (117) | (147) |
| Transfers out of Level 3 | - | (12) | - | (12) |
| **Balance at the end of the period** | 7,119 | 28 | 1,555 | 8,702 |

*Line items where effects of Level 3 assets are recognized in the Consolidated Interim Income Statement*

| | Financial assets | | |
|---|---|---|---|
| 1.1.-30.6.2020 | Bonds | Shares | Total |
| Net financial income | 6 | (7) | (1) |
| **Effects recognized in the Income Statement** | 6 | (7) | (1) |

| 1.1.-30.6.2019 | | | |
|---|---|---|---|
| Net financial income | 19 | (55) | (36) |
| **Effects recognized in the Income Statement** | 19 | (55) | (36) |

Amounts are in ISK millions

## 24. Fair value hierarchy, continued

*Carrying values and fair values of financial assets and financial liabilities not carried at fair value*

| 30.6.2020<br>*Financial assets not carried at fair value* | Carrying value | Fair value | Unrealized gain (loss) |
|---|---|---|---|
| Cash and balances with Central Bank | 103,432 | 103,432 | - |
| Loans to credit institutions | 33,597 | 33,597 | - |
| Loans to customers | 779,902 | 785,057 | 5,155 |
| Other financial assets | 12,222 | 12,222 | - |
| **Financial assets not carried at fair value** | 929,153 | 934,308 | 5,155 |
| *Financial liabilities not carried at fair value* | | | |
| Due to credit institutions and Central Bank | 7,661 | 7,661 | - |
| Deposits | 555,855 | 555,855 | - |
| Borrowings | 314,952 | 331,150 | (16,198) |
| Subordinated liabilities | 36,494 | 33,356 | 3,138 |
| Other financial liabilities | 17,580 | 17,580 | - |
| **Financial liabilities not carried at fair value** | 932,542 | 945,602 | (13,060) |

| 31.12.2019<br>*Financial assets not carried at fair value* | | | |
|---|---|---|---|
| Cash and balances with Central Bank | 95,717 | 95,717 | - |
| Loans to credit institutions | 17,947 | 17,947 | - |
| Loans to customers | 773,955 | 777,320 | 3,327 |
| Other financial assets | 8,675 | 8,675 | - |
| **Financial assets not carried at fair value** | 896,294 | 899,659 | 3,327 |
| *Financial liabilities not carried at fair value* | | | |
| Due to credit institutions and Central Bank | 5,984 | 5,984 | - |
| Deposits | 492,916 | 492,916 | - |
| Borrowings | 304,745 | 316,589 | (8,608) |
| Subordinated liabilities | 20,083 | 20,177 | 78 |
| Other financial liabilities | 6,408 | 6,408 | - |
| **Financial liabilities not carried at fair value** | 830,136 | 842,074 | (8,530) |

Loans to customers largely bear variable interest rates. Those loans, including corporate loans, are presented at book value as they generally have a short duration and very limited interest rate risk. Loans with fixed interest rates, mainly long-term retail mortgages, are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account loan to value. 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

Amounts are in ISK millions

## 24. Fair value hierarchy, continued

*Derivatives*

| 30.6.2020 | Notional value | Fair value Assets | Fair value Liabilities |
|---|---|---|---|
| Forward exchange rate agreements | 103,151 | 1,426 | 347 |
| Fair value hedge of interest rate swap | 138,143 | 3,110 | - |
| Interest rate and exchange rate agreements | 72,347 | 2,547 | 1,778 |
| Bond swap agreements | 17,227 | 2 | 572 |
| Share swap agreements | 11,031 | 1,826 | 273 |
| Options - purchased agreements, unlisted | 1 | - | - |
| **Derivatives** | 341,900 | 8,911 | 2,970 |

| 31.12.2019 | Notional value | Fair value Assets | Fair value Liabilities |
|---|---|---|---|
| Forward exchange rate agreements | 90,121 | 1,196 | 407 |
| Fair value hedge of interest rate swap | 114,337 | 1,616 | - |
| Interest rate and exchange rate agreements | 65,823 | 2,312 | 1,168 |
| Bond swap agreements | 9,936 | 46 | 48 |
| Share swap agreements | 12,710 | 1,447 | 431 |
| **Derivatives** | 292,927 | 6,617 | 2,054 |

*Fair value hedge of interest rate swap*

The Group applies fair value hedge accounting only with respect to interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest, with identical cash flows to the borrowings. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate euro bonds, see Note 32, arising from changes in interest rates. On 1 January 2018 the Group adopted IFRS 9, but has elected to continue to apply the hedge accounting principles under IAS 39. For further information about the Group's hedge accounting policy, see Note 57 in the Annual Financial Statements 2019.

| 30.6.2020 | Notional | Maturity date | Fair value Assets | Fair value Liabilities | Gain (loss) on FV changes |
|---|---|---|---|---|---|
| Interest rates swaps - EUR | 124,320 | 1-5 years | 2,124 | - | (128) |
| Interest rates swaps - EUR | - | 0-3 months | - | - | (5) |
| Interest rates swaps - USD | 13,823 | >5 years | 989 | - | 726 |
| **31.12.2019** | | | | | |
| Interest rates swaps - EUR | 108,667 | 1-5 years | 1,608 | - | 457 |
| Interest rates swaps - EUR | 5,670 | 0-3 months | 8 | - | 302 |

*Hedged borrowings and subordinated liabilities*

| 30.6.2020 | Book value | Accumulated fair value Assets | Accumulated fair value Liabilities | Gain (loss) on FV changes |
|---|---|---|---|---|
| EUR 500 million - issued 2017/18 - 5 years | 77,974 | 338 | - | 153 |
| EUR 300 million - issued 2017 - 3 years | - | - | - | (38) |
| EUR 300 million - issued 2018 - 3 years | 44,391 | - | 921 | (56) |
| USD 100 million - issued 2020 - Perpetual | 14,705 | - | 757 | (775) |
| **Hedged borrowings and subordinated liabilities** | 137,070 | 338 | 1,678 | (716) |

| 31.12.2019 | Book value | Accumulated fair value Assets | Accumulated fair value Liabilities | Gain (loss) on FV changes |
|---|---|---|---|---|
| EUR 500 million - issued 2016/18 - 5 years | 67,713 | 157 | - | (410) |
| EUR 300 million - issued 2017 - 3 years | 5,635 | 33 | - | (199) |
| EUR 300 million - issued 2018 - 3 years | 41,601 | - | 756 | (295) |
| **Hedged borrowings** | 114,949 | 190 | 756 | (904) |

The effectiveness of each hedge is measured regularly with linear regression. The relationship between fair value changes of an interest rate swap on the one hand and a borrowing on the other hand is examined. In all cases the effectiveness is within limits, or between 95-113%.

Amounts are in ISK millions

## 25. 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 | | | | |
|---|---|---|---|---|---|---|---|---|
| 30.6.2020 | Gross assets before nettings | Nettings with gross liabilities | Assets recognized on Balance Sheet, net | Financial liabilities | Collateral received | Assets after consideration of netting potential | Assets not subject to enforceable netting arr-angements | Total assets recognized on Balance Sheet, net |
| Reverse repurchase agreements .......... | 6,712 | (387) | 6,325 | (5,566) | - | 759 | - | 6,325 |
| Derivatives .......................................... | 5,414 | - | 5,414 | (1,749) | - | 3,665 | 3,497 | 8,911 |
| **Total assets ........................................** | 12,126 | (387) | 11,739 | (7,315) | - | 4,424 | 3,497 | 15,236 |
| | | | | | | | | |
| 31.12.2019 | | | | | | | | |
| Reverse repurchase agreements .......... | 6,539 | (44) | 6,495 | (5,921) | - | 574 | - | 6,495 |
| Derivatives .......................................... | 4,601 | - | 4,601 | (713) | - | 3,888 | 2,016 | 6,617 |
| **Total assets ........................................** | 11,140 | (44) | 11,096 | (6,634) | - | 4,462 | 2,016 | 13,112 |

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

| | Liabilities subject to netting arrangements | | | Netting potential not recognized in the Balance Sheet | | | | |
|---|---|---|---|---|---|---|---|---|
| 30.6.2020 | Gross liabilities before nettings | Nettings with gross assets | Liabilities recognized on Balance Sheet, net | Financial assets | Collateral pledged | Liabilities after consideration of netting potential | Liabilities not subject to enforceable netting arr-angements | Total liabilities recognized on balance sheet |
| Repurchase agreements ...................... | 5,953 | (387) | 5,566 | (5,566) | - | - | - | 5,566 |
| Derivatives .......................................... | 2,013 | - | 2,013 | (1,749) | - | 264 | 957 | 2,970 |
| **Total liabilities ....................................** | 7,966 | (387) | 7,579 | (7,315) | - | 264 | 957 | 8,536 |
| | | | | | | | | |
| 31.12.2019 | | | | | | | | |
| Repurchase agreements ...................... | 5,965 | (44) | 5,921 | (5,921) | - | - | - | 5,921 |
| Derivatives .......................................... | 761 | - | 761 | (713) | - | 48 | 1,293 | 2,054 |
| **Total liabilities ....................................** | 6,726 | (44) | 6,682 | (6,634) | - | 48 | 1,293 | 7,975 |

Reverse repurchase agreements and repurchase agreements are recognized within the line items Financial instruments and Due to credit institutions and Central Bank respectively.

## 26. Investments in associates

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Carrying amount at the beginning of the year ........................................ | 852 | 818 |
| Acquisitions ........................................ | 38 | 18 |
| Disposals ........................................ | - | (740) |
| Share of profit (loss) of associates and profit from sale ........................................ | (29) | 756 |
| **Investment in associates ........................................** | 861 | 852 |

*The Group's interest in its principal associates*

| | | |
|---|---|---|
| Audkenni hf., Borgartún 31, Reykjavík, Iceland ........................................ | 25.4% | 25.4% |
| JCC ehf., Borgartún 19, Reykjavík, Iceland ........................................ | 33.3% | 33.3% |
| Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland ........................................ | 20.0% | 20.0% |
| 220 Fjördur ehf., Fjardargata 13-15, Hafnarfjördur, Iceland ........................................ | 37.4% | 37.4% |
| SER eignarhaldsfélag ehf., Borgartún 19, Reykjavík ........................................ | 35.3% | 35.3% |

Amounts are in ISK millions

## 27. Intangible assets

Intangible assets comprise the following categories: Goodwill, which arises on business combinations; Infrastructure, Customer relationships and related agreements which are identified during the acquisition of subsidiaries and related to the activities of the businesses being acquired; and Software, which is acquired (i.e. software licenses) and expenses of implementation.

Infrastructure, which is capitalized as an intangible asset, is related to the asset management operation and branding of the insurance operation. The business activity is based on years of developing expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually.

Customer relationships and related agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The lifetime of these agreements is based on the experience of the Group and the industry. As a result, these agreements are assessed as having an identified useful lifetime.

Acquired software and internally developed software is capitalized on the basis of the cost of acquiring and bringing the software into service. Expenditure on internally developed software is recognized as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and when it can reliably measure the costs to complete the development. The capitalized costs of internally developed software include external expenses directly attributable to developing the software and salary and salary related expenses of implementation of core systems. Capitalized costs of software are amortized over its useful life. Computer software licenses and internally developed software recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

| *Policies applied to the Group's intangible assets* | Goodwill and infrastructure | Customer relationship and related agreements | Software |
|---|---|---|---|
| Useful lives ........ | Undefined | Finite 6-15 years and undefined | Finite 3-10 years |
| Amortization method ........ | Impairment test | Straight-line basis over 6-15 years and impairment test | Straight-line basis over 3-10 years |
| Internally generated or acquired ........ | Acquired | Acquired | Acquired and internally generated |

| 30.6.2020 | Goodwill | Infra-structure | Customer relationship and related agreements | Software | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year ........ | 669 | 2,383 | 727 | 4,588 | 8,367 |
| Additions ........ | - | - | - | 801 | 801 |
| Additions, capitalized salaries ........ | - | - | - | 301 | 301 |
| Amortization ........ | - | - | (30) | (362) | (392) |
| **Intangible assets ........** | 669 | 2,383 | 697 | 5,328 | 9,077 |

| 31.12.2019 | Goodwill | Infra-structure | Customer relationship and related agreements | Software | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year ........ | 669 | 2,383 | 787 | 2,558 | 6,397 |
| Additions ........ | - | - | - | 2,291 | 2,291 |
| Additions, capitalized salaries ........ | - | - | - | 459 | 459 |
| Amortization ........ | - | - | (60) | (720) | (780) |
| **Intangible assets ........** | 669 | 2,383 | 727 | 4,588 | 8,367 |

Goodwill is recognized among assets in the operating segment Vördur, see Note 5.

## 28. Tax assets and tax liabilities

| | 30.6.2020 | | 31.12.2019 | |
|---|---|---|---|---|
| | Assets | Liabilities | Assets | Liabilities |
| Current tax ........ | - | 3,599 | - | 3,461 |
| Deferred tax ........ | 2 | 283 | 2 | 943 |
| **Tax assets and tax liabilities ........** | 2 | 3,882 | 2 | 4,404 |

Amounts are in ISK millions

## 29. Assets and disposal groups held for sale and associated liabilities

| *Assets and disposal groups held for sale* | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Valitor Holding hf. | 17,561 | 30,657 |
| Stakksberg ehf. | 3,135 | 2,711 |
| Sólbjarg ehf. | 8,883 | 8,676 |
| **Disposal groups held for sale** | 29,579 | 42,044 |
| Real estate | 1,124 | 1,553 |
| Other assets | 29 | 29 |
| **Assets and disposal groups held for sale** | 30,732 | 43,626 |

| *Liabilities associated with disposal groups held for sale* | | |
|---|---|---|
| Valitor Holding hf. | 19,587 | 22,052 |
| Sólbjarg ehf. | 7,395 | 6,579 |
| **Liabilities associated with disposal groups held for sale** | 26,982 | 28,631 |

Real estates and other assets classified as assets held for sale are generally the result of foreclosures on companies and individuals.

*Valitor Holding hf.*

Arion Bank's shareholding in the subsidiary Valitor Holding (Valitor) is 100%. The Bank is in the process of potentially divesting the Bank's shareholding in Valitor. The Bank is aiming for having completed the sale of Valitor within the next 12 months. In accordance with IFRS 5 Non-current assets and disposal groups held for sale, Valitor is classified as asset held for sale in these Consolidated Interim Financial Statements.

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Cash and balances with Central Bank | - | 9,363 |
| Loans to credit institutions | 19,184 | 12,563 |
| Loans to customers | 1,903 | 2,061 |
| Financial instruments | - | 28 |
| Investments in associates | 66 | 66 |
| Intangible assets | 4,711 | 4,720 |
| Tax assets | 308 | 293 |
| Other assets | 2,377 | 2,986 |
| **Assets** | 28,549 | 32,080 |
| Elimination within Arion Bank Group | (10,988) | (1,423) |
| **Valitor's contribution to the Group** | 17,561 | 30,657 |
| Due to credit institutions and Central Bank | 426 | 2 |
| Financial liabilities at fair value | - | 26 |
| Tax liabilities | 53 | 321 |
| Other liabilities | 18,826 | 21,712 |
| Borrowings | 116 | 3,500 |
| **Liabilities** | 19,421 | 25,561 |
| Elimination within Arion Bank Group | 166 | (3,509) |
| **Valitor's contribution to the Group** | 19,587 | 22,052 |
| **Book value of Valitor** | 9,128 | 6,519 |

In May 2020 Valitor Group sold the operations of Valitor in Denmark, Valitor A/S. The operation of Valitor A/S contributed a net loss for the years 2018 and 2019. The financial effects of the sale of the entity did not have material effects on these Consolidated Interim Financial Statements.

*Sólbjarg ehf., a subsidiary of Eignabjarg ehf.*

On 20 June 2019 Arion Bank acquired all shares in TravelCo hf. and its subsidiaries (hereafter "TravelCo") following an enforcement of pledges. Sólbjarg ehf is the holding company of the TravelCo group in the beneficial ownership of Arion Bank. TravelCo was established following the collapse of Primera Air ehf. and Primera Travel Group hf. with the purpose of owning and operating tour operators in Scandinavia and Iceland. The enforcement primarily represented a change in ownership and does not affect the daily operations or services of the tour operators. Arion Bank's rationale for acquiring TravelCo was to safeguard continued operations and the Bank's interests. Arion Bank is in the process of divesting all of the Bank's shareholding in TravelCo and the company is therefore classified as held for sale in accordance with IFRS 5. In Q1 2020 Arion Bank completed the sale of Terra Nova Sól ehf., a subsidiary of Sólbjarg ehf., with other entities held for sale.

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## 29. Assets and disposal groups held for sale and associated liabilities, continued

*Stakksberg ehf., a subsidiary of Eignabjarg ehf.*

On 22 January 2018 United Silicon was declared bankrupt following serious operational problems which resulted in its operating license being temporarily suspended, after a failed attempt at reaching a composition arrangement with its creditors. In February 2018 an agreement was reached between the administrator of the bankrupt estate of United Silicon and Arion Bank, whereby the Bank foreclosed against its collateral and acquired all the company's main assets. The assets of the silicon plant are currently managed by Stakksberg ehf., which is held by the Bank through the subsidiary Eignabjarg ehf. Stakksberg ehf. has, since the transfer of the assets from United Silicon, worked to reduce uncertainties surrounding the recommissioning of the silicon plant, with measures including the securing of all necessary operating permits, power supply and undertaking further engineering design groundwork necessary for the carrying out of remedial work prior to the reopening of the plant. Stakksberg ehf. is currently engaged in the final stages of concluding a new environmental impact assessment for the plant. The proposed remedial actions fully fit within the scope of the current local plan for Stakksberg's plot in Helguvík. Nevertheless Reykjanesbær will be required to amend the current local plan to reflect building licenses which have already been issued by Reykjanesbær. The Bank's objective is to divest Stakksberg ehf. on the basis of this preparatory work. Stakksberg is therefore classified as held for sale in accordance with IFRS 5.

## 30. Other assets

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Property and equipment | 5,265 | 5,243 |
| Right of use asset | 835 | 902 |
| Accounts receivable | 5,067 | 3,617 |
| Unsettled securities trading | 4,843 | 3,178 |
| Investment for life assurance policyholders where risk is held by policyholder | 1,018 | 1,008 |
| Sundry assets | 3,426 | 2,916 |
| **Other assets** | 20,454 | 16,864 |

## 31. Other liabilities

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Accounts payable | 694 | 654 |
| Unsettled securities trading | 9,797 | 365 |
| Depositors' and Investors' Guarantee Fund | 186 | 167 |
| Technical provision | 16,248 | 14,709 |
| Technical provision for life assurance policyholders were investment risk is held by policyholder | 1,018 | 1,008 |
| Withholding tax | 262 | 1,492 |
| Bank levy | 3,640 | 2,984 |
| Accrued expenses | 3,133 | 3,441 |
| Prepaid income | 1,557 | 1,573 |
| Impairment of off-balance items | 892 | 481 |
| Lease liability | 854 | 914 |
| Sundry liabilities | 6,197 | 4,909 |
| **Other liabilities** | 44,478 | 32,697 |

| *Technical provision* | Technical provision | Reinsurers' share | Total 30.6.2020 | Technical provision | Reinsurers' share | Total 31.12.2019 |
|---|---|---|---|---|---|---|
| Claims reported and loss adjustment expenses | 7,863 | (252) | 7,611 | 7,742 | (221) | 7,521 |
| Claims incurred but not reported | 1,521 | (82) | 1,439 | 1,426 | (82) | 1,344 |
| **Claims outstanding** | 9,384 | (334) | 9,050 | 9,168 | (303) | 8,865 |
| Provision for unearned premiums | 6,864 | (6) | 6,858 | 5,541 | (4) | 5,537 |
| **Own technical provision** | 16,248 | (340) | 15,908 | 14,709 | (307) | 14,402 |

Insurance claim consists of claims outstanding and provision for unearned premiums. Claims outstanding present unsettled claims incurred. Claims outstanding is the total of claims reported and actuarial estimation of claims incurred but not reported. Provision for unearned premiums presents the current insurance risk that will be conditional on future fiscal years.

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## 32. Borrowings

| Currency, original nominal value | First issued | Maturity | Maturity type | Terms of interest | 30.6.2020 | 31.12.2019 |
|---|---|---|---|---|---|---|
| ARION CBI 21, ISK 10,220 million ........ | 2014 | 2021 | At maturity | Fixed, CPI linked, 3.50% ............... | 10,289 | 10,176 |
| ARION CB 22, ISK 28,720 million ......... | 2015 | 2022 | At maturity | Fixed, 6.50% ................................ | 28,193 | 28,264 |
| ARION CB 24 ISK 20,180 million .......... | 2019 | 2024 | At maturity | Fixed, 6.00% ................................ | 16,919 | 16,060 |
| ARION CBI 25, ISK 37,940 million ........ | 2017 | 2025 | At maturity | Fixed, CPI linked, 3.00% ............... | 40,773 | 40,213 |
| ARION CBI 26 ISK 15,460 million ......... | 2019 | 2026 | At maturity | Fixed, CPI linked, 2.00% ............... | 16,815 | 12,320 |
| ARION CBI 29, ISK 25,220 million ........ | 2014 | 2029 | At maturity | Fixed, CPI linked, 3.50% ............... | 28,051 | 27,689 |
| ARION CBI 48, ISK 11,680 million ........ | 2018 | 2048 | Amortizing | Fixed, CPI linked, 2.50% ............... | 10,598 | 10,647 |
| **Statutory covered bonds** ........................................ | | | | | 151,638 | 145,369 |
| NOK 800 million ................................... | 2015 | 2020 | At maturity | Floating, NIBOR +2.95% ............... | 10,162 | 11,143 |
| NOK 320 million ................................... | 2016 | 2020 | At maturity | Floating, NIBOR +1.95% ............... | 4,612 | 4,439 |
| EUR 300 million * ................................. | 2017 | 2020 | At maturity | Fixed, 0.75% ................................ | - | 5,635 |
| SEK 300 million ................................... | 2017 | 2020 | At maturity | Floating, 3 month STIBOR +1.35% | - | 2,598 |
| SEK 250 million ................................... | 2017 | 2020 | At maturity | Floating, 3 month STIBOR +0.75% | 3,715 | 3,241 |
| EUR 500 million * ................................. | 2016 | 2021 | At maturity | Fixed, 1.625% .............................. | 77,974 | 67,713 |
| EUR 13 million ..................................... | 2019 | 2021 | At maturity | Floating, 3. EURIBOR +0.58% ....... | 2,021 | 1,765 |
| NOK 750 million ................................... | 2019 | 2022 | At maturity | Floating, NIBOR +1.82% ............... | 10,794 | 10,382 |
| SEK 150 million ................................... | 2019 | 2022 | At maturity | Floating, 3 month STIBOR +1.33% | 2,237 | 1,949 |
| NOK 250 million ................................... | 2017 | 2023 | At maturity | Fixed, 3.02% ................................ | 3,604 | 3,512 |
| EUR 300 million * ................................. | 2018 | 2023 | At maturity | Fixed, 1.00% ................................ | 44,391 | 41,601 |
| NOK 250 million ................................... | 2017 | 2027 | At maturity | Fixed, 3.40% ................................ | 3,607 | 3,521 |
| **Senior unsecured bonds** ........................................ | | | | | 163,117 | 157,499 |
| Bills issued ........................................ | | | | | - | 1,680 |
| Other borrowings ........................................ | | | | | 197 | 197 |
| **Other loans / bills** ........................................ | | | | | 197 | 1,877 |
| **Borrowings** ........................................ | | | | | 314,952 | 304,745 |

* The Group applies fair value hedge accounting to these bond issuances and uses certain foreign currency denominated interest rate swaps as hedging instruments, see Note 24.

The book value of listed bonds was ISK 315 billion at the end of the period (31.12.2019: ISK 303 billion). The market value of those bonds was ISK 331 billion (31.12.2019: ISK 315 billion). The Group repurchased ISK 4 billion own debts during the period (31.12.2019: ISK 39 billion).

## 33. Subordinated liabilities

| Currency, original nominal value | Issued | Maturity | First Call date | Terms of interest | 30.6.2020 | 31.12.2019 |
|---|---|---|---|---|---|---|
| SEK 500 million ................................... | 2018 | 2028 | 22 Nov '23 | Floating, 3 month STIBOR +3.10% . | 7,424 | 6,472 |
| NOK 300 million ................................... | 2019 | 2029 | 9 Jul '24 | Floating, NIBOR +3.65% ................ | 4,345 | 4,183 |
| SEK 225 million ................................... | 2019 | 2029 | 20 Dec '24 | Floating, 3 month STIBOR +3.70% . | 3,346 | 2,918 |
| ARION T2I 30 ISK 4.800 million ........... | 2019 | 2030 | 4 Jan '25 | Fixed, CPI linked, 3.875% ............. | 4,989 | 4,913 |
| ARION T2 30 ISK 880 million ................ | 2019 | 2030 | 4 Jan '25 | Fixed, 6.75% ................................. | 907 | 907 |
| EUR 5 million ....................................... | 2019 | 2031 | 6 Mar '26 | Fixed, 3.24% ................................. | 778 | 690 |
| **Tier 2 subordinated liabilities** ........................................ | | | | | 21,789 | 20,083 |
| ARION AT1 USD 100 million ............... | 2020 | Perpetual | 26 Feb '25 | Fixed, 6.250% ................................ | 14,705 | - |
| **Additional Tier 1 subordinated liabilities** ........................................ | | | | | 14,705 | - |
| **Subordinated liabilities** ........................................ | | | | | 36,494 | 20,083 |

Additional Tier 1 and Tier 2 subordinated liabilities are eligible as regulatory capital under the Icelandic Financial Undertakings Act No. 161/2002

Amounts are in ISK millions

## 34. Pledged assets

| *Pledged assets against liabilities* | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Assets, pledged as collateral against borrowings | 172,335 | 186,902 |
| Assets, pledged as collateral against loans from credit institutions and short positions | 6,580 | 6,023 |
| **Pledged assets against liabilities** | 178,915 | 192,925 |

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 172 billion at the end of the period (31.12.2019: ISK 187 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 152 billion at the end of the period (31.12.2019: ISK 145 billion).

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.

## 35. Equity

*Share capital and share premium*

According to the Bank's Articles of Association, total share capital amounts to ISK 1,730 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.

| | Share capital | Share premium | Total 30.6.2020 | Share capital | Share premium | Total 31.12.2019 |
|---|---|---|---|---|---|---|
| Shares outstanding at the beginning of the year | 1,773 | 53,942 | 55,715 | 1,814 | 57,196 | 59,010 |
| Purchase of treasury stock | (54) | (4,326) | (4,380) | (41) | (3,242) | (3,283) |
| Employees stock grant | - | (5) | (5) | - | (12) | (12) |
| **Shares outstanding at the end of the period** | 1,719 | 49,611 | 51,330 | 1,773 | 53,942 | 55,715 |
| | | | | | | |
| Own shares at period-end | 11 | | | 41 | | |
| - as proportion of issued share capital | 0.6% | | | 2.3% | | |

In 2019 the Board of Directors authorized the Bank to initiate a share buy-back program in Iceland and Sweden (the Program) to purchase own shares, which is in line with the authorization granted by the AGM on 20 March 2019. The purpose of the Program was to reduce the Bank's share capital (in line with the Bank's dividend policy). When the Program was initiated on 31 October 2020, the Bank was authorized to purchase up to 59 million own shares in total under the Program, corresponding to 3.25% of the issued share capital, or for up to ISK 4.5 billion at market value. In January 2020 the FSA approved the buy-back of an additional 41 million own shares or for up to ISK 3.5 billion at market value, bringing the total amount of the share Program to 100 million shares or ISK 8.0 billion at market value. The Program continued until the AGM in March 2020.

At the AGM in March 2020 a motion was passed to reduce the company's share capital by ISK 84 million at nominal value, by cancelling the company's own shares. The reduction took place in May 2020. The company's share capital was reduced from ISK 1,814 million to ISK 1,730 million at nominal value, divided into an equal number of shares and with one vote attached to each share.

According to a decision made by the Board of Directors, own shares were allocated to employees in connection with the Bank's IPO and listing in 2018. In total approximately 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees' stock grant programme, an employee who resigns within the vesting period of two years, returns the shares to the Bank. The vesting period ended in June 2020.

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## Other information

### 36. Shareholders of Arion Bank

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Taconic Capital (through TCA New Sidecar s.á.r.l.) | 24.67% | 23.53% |
| Sculptor Capital Management | 9.92% | 9.53% |
| Gildi lífeyrissjódur | 9.60% | 8.79% |
| Lífeyrissjódur verzlunarmanna | 5.78% | 3.67% |
| Lífeyrissjódur starfsmanna ríkisins | 5.09% | 3.47% |
| Stodir hf. | 4.99% | 4.96% |
| Goldman Sachs International | 2.97% | 3.72% |
| Eaton Vance funds | 2.91% | 3.23% |
| Frjálsi lífeyrissjódurinn | 2.42% | 2.18% |
| Lansdowne partners | 2.39% | 5.02% |
| Stapi lífeyrissjódur | 2.38% | 1.89% |
| Birta lífeyrissjódur | 2.19% | 1.32% |
| Hvalur hf. | 1.52% | 1.45% |
| Stefnir rekstrarfélag hf. | 1.27% | 2.46% |
| MainFirst Bank AG | 1.14% | 1.09% |
| Júpíter rekstrarfélag hf. | 1.09% | 1.10% |
| Lífsverk pension fund | 1.02% | 0.75% |
| Arion banki hf. | 0.69% | 2.27% |
| Other shareholders with less than 1% shareholding | 17.97% | 19.57% |
| | 100.0% | 100.0% |

At the AGM in March 2020 a motion was passed to reduce the company's share capital by ISK 84 million at nominal value, by cancelling the company's own shares. The reduction took place in May 2020. Shareholdings changed accordingly.

Shareholding of Arion Bank's employees was 0.62% at the end of the period.

### 37. Legal matters

The Group has formal controls and policies in place for managing legal claims. Once professional advice has been obtained and the likelihood and amount of loss reasonably estimated, the Group makes adjustments, if appropriate, to account for any adverse effects the claims may have on its financial standing. Should the Group conclude that it is to the detriment of the Group's case to disclose such potential amounts, relating to the legal claims raised, it elects not to do so. At the end of the period, the Group had several unresolved legal claims.

**Contingent liabilities**

*Legal proceedings regarding damages*

In a lawsuit brought in June 2013, Kortathjónustan hf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and the Bank's subsidiary Valitor hf. in the amount of ISK 1.2 billion plus interest, as a result of damage Kortathjónustan hf. contended the five parties caused the company due to violations of the Competition Act. In June 2017 the Supreme Court dismissed the case on procedural grounds. Kortathjónustan hf. brought a new lawsuit in September 2017 regarding the same matter of dispute, claiming damages in the amount of ISK 922 million plus interest from the same defendants. The Landsréttur Appeal Court dismissed the case in May 2018. Kortathjónustan tried to appeal the dismissal to the Supreme Court but the court dismissed the case as there was no right of complaint. In November 2018 EC-Clear brought a new lawsuit against the same defendants regarding the same matter of dispute, demanding the acknowledgement of liability for damages. EC-Clear was the largest shareholder in Kortathjónustan and according to the writ EC-Clear is now the owner of alleged liability claims against the defendants. The District Court dismissed the case in February 2019. EC-Clear appealed the dismissal to the Appeal Court, which dismissed the case with a ruling in April 2019. In October 2019 EC-Clear brought a new lawsuit against the same defendants regarding the same matter of dispute, claiming damages in the amount of ISK 922 million plus interest from the same defendants, and demanding the acknowledgement of liability for damages. In December 2019 the case was dismissed as EC-Clear did not provide any insurance for legal expenses. In April 2020 EC-Clear has once again brought the same matter of dispute against the same defendants to the District Court. The Appeal Court has ruled that EC-Clear shall, before the end of July 2020, provide an insurance for legal damages. Should the defendants be found liable for damages, they would be jointly responsible. Therefore the Bank has not made any provision.

*Legal matters concluded*

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., has filed two cases against the Bank with a claim for damages in the amount of more than ISK 4 billion, plus interest. The plaintiffs maintain that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagid Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. In April 2018 the District Court of Reykjavík dismissed one of the cases. The plaintiffs appealed the judgment to the Landsréttur Appeal Court. In June 2018 the Appeal Court annulled the judgment of the District Court and ordered the District Court to hear the case again. The District Court acquitted the Bank of all claims with a judgment in September 2018. The plaintiffs appealed the judgment to the Appeal Court. In December 2019 the Appeal Court confirmed the District Court's judgment. An appeal to the Supreme Court has been rejected by the Court. The second case was on hold awaiting the result of this first case and in the beginning of May 2020 the Claimant notified the Court that it had discontinued the case and thereby the case was dismissed.

Amounts are in ISK millions

### 38. Events after the reporting period

On 17 July the Financial Supervisory Authority of the Central Bank of Iceland (FME) published its decision to impose an administrative fine on Arion Bank of ISK 87.7 million due to the Bank´s breach of obligation to disclose insider information in a timely manner. The decision has been published on FME´s website. Arion Bank intends to refer FME´s decision to the courts and demand an invalidation.

## Off balance sheet information

### 39. Commitments

| *Financial guarantees, unused credit facilities and undrawn loan commitments* | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Financial guarantees | 15,214 | 15,097 |
| Unused overdrafts | 48,431 | 44,923 |
| Undrawn loan commitments | 65,760 | 54,101 |
| **Financial guarantees, unused credit facilities and undrawn loan commitments** | 129,405 | 114,121 |

### 40. Assets under management and under custody

| | | |
|---|---|---|
| Assets under management | 1,059,931 | 1,013,101 |
| Assets under custody | 1,518,539 | 1,370,946 |

Assets under management represent the total market value of the financial assets which the Group manages on behalf of its customers.

The Group, acting as custodian, is responsible for safeguarding a firm's or individual's financial assets, hold in safekeeping securities such as stocks, bonds and securities funds, arrange the settlement of trades and movements of securities, process corporate actions such as income on bonds and dividends on shares; and pricing on securities.

## Related party

### 41. Related party

The Group has a related party relationship with an entity with an influence over the Group as the largest shareholder of Arion Bank, which is at the end of the period Taconic Capital (24.67%).

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

Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

*Balances with related parties*

| 30.6.2020 | Assets | Liabilities | Net balance |
|---|---|---|---|
| Board of Directors and key Management personnel | 97 | (610) | (513) |
| Associates and other related parties | - | (68) | (68) |
| **Balances with related parties** | 97 | (678) | (581) |

| 31.12.2019 | | | |
|---|---|---|---|
| Board of Directors and key Management personnel | 184 | (252) | (68) |
| Associates and other related parties | - | (59) | (59) |
| **Balances with related parties** | 184 | (311) | (127) |

Amounts are in ISK millions

## Risk management disclosures

The Group faces unprecedented levels of risk arising from the impact of the Covid-19 pandemic on the Group's operations and its customers. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels.

Further information on risk management and capital adequacy is provided in the Annual Financial Statements for 2019 and in the Pillar 3 Risk Disclosures for 2019. The Pillar 3 Risk Disclosures 2019 are available on the Bank's website, www.arionbanki.is.

### 42. 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 derivatives, and off balance sheet items such as commitments and guarantees.

Managing and analyzing 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.

**Exposure to credit risk**

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position before the effect of mitigation due to collateral agreements or other credit enhancements. The table also shows related collateral and 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 quotas. The quality of collateral is evaluated in the lending process with regards to specialization, location, age and condition and possibilities for reuse.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses. Collateral values are capped by the related exposure amount.

# Notes to the Condensed Consolidated Interim Financial Statements

## Risk management disclosures

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Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses. Collateral values are capped by the related exposure amount.

## 42. Credit risk, continued

*Maximum exposure to credit risk and collateral held against different types of financial instruments subject to the impairment requirements of IFRS 9*

| | | Collateral | | | | |
|---|---|---|---|---|---|---|
| 30.6.2020 | Maximum exposure | Cash and securities | Real estate | Fishing vessels | Other collateral | Total collateral |
| Cash and balances with Central Bank | 103,432 | - | - | - | - | - |
| Loans to credit institutions | 33,597 | - | - | - | - | - |
| Loans to customers at amortized cost | 779,902 | 21,128 | 559,739 | 44,833 | 88,086 | 713,786 |
| *Individuals* | *388,747* | *18* | *349,592* | *1* | *11,945* | *361,556* |
| *Corporates* | *391,155* | *21,110* | *210,147* | *44,832* | *76,141* | *352,230* |
| *Real estate activities and construction* | *129,168* | *868* | *116,208* | *57* | *8,033* | *125,166* |
| *Fishing industry* | *76,313* | *243* | *12,676* | *44,371* | *17,413* | *74,703* |
| *Information and communication technology* | *19,042* | *481* | *4,264* | *-* | *4,507* | *9,252* |
| *Wholesale and retail trade* | *57,193* | *169* | *34,339* | *2* | *19,521* | *54,031* |
| *Financial and insurance activities* | *35,412* | *19,260* | *6,444* | *-* | *8,882* | *34,586* |
| *Industry, energy and manufacturing* | *30,630* | *44* | *16,820* | *-* | *10,967* | *27,831* |
| *Transportation* | *12,625* | *8* | *881* | *314* | *3,384* | *4,587* |
| *Services* | *16,662* | *27* | *9,425* | *88* | *2,879* | *12,419* |
| *Public sector* | *6,473* | *9* | *2,155* | *-* | *213* | *2,377* |
| *Agriculture and forestry* | *7,637* | *1* | *6,935* | *-* | *342* | *7,278* |
| Other assets with credit risk | 12,222 | - | - | - | - | - |
| Financial guarantees | 15,214 | 2,017 | 5,201 | 35 | 3,932 | 11,185 |
| Undrawn loan commitments and unused overdrafts | 114,191 | - | - | - | - | - |
| Fair value through OCI | 122,186 | - | - | - | - | - |
| *Government bonds* | *113,567* | - | - | - | - | - |
| *Corporate and finance bonds* | *8,619* | - | - | - | - | - |
| **Balance at the end of the period** | 1,180,744 | 23,145 | 564,940 | 44,868 | 92,018 | 724,971 |
| 31.12.2019 | | | | | | |
| Cash and balances with Central Bank | 95,717 | - | - | - | - | - |
| Loans to credit institutions | 17,947 | - | - | - | - | - |
| Loans to customers at amortized cost | 773,955 | 20,792 | 544,723 | 54,601 | 73,091 | 693,207 |
| *Individuals* | *368,569* | *198* | *328,243* | *13* | *10,996* | *339,450* |
| *Corporates* | *405,386* | *20,594* | *216,480* | *54,588* | *62,095* | *353,757* |
| *Real estate activities and construction* | *129,856* | *1,972* | *113,465* | *55* | *8,022* | *123,514* |
| *Fishing industry* | *82,941* | *17* | *12,365* | *54,121* | *9,946* | *76,449* |
| *Information and communication technology* | *19,102* | *375* | *3,529* | *-* | *4,308* | *8,212* |
| *Wholesale and retail trade* | *54,989* | *375* | *32,508* | *7* | *15,980* | *48,870* |
| *Financial and insurance activities* | *33,669* | *17,726* | *7,254* | *-* | *7,622* | *32,602* |
| *Industry, energy and manufacturing* | *39,909* | *60* | *28,183* | *-* | *6,711* | *34,954* |
| *Transportation* | *11,066* | *-* | *1,048* | *313* | *3,285* | *4,646* |
| *Services* | *17,580* | *61* | *9,137* | *92* | *5,669* | *14,959* |
| *Public sector* | *8,617* | *4* | *2,194* | *-* | *289* | *2,487* |
| *Agriculture and forestry* | *7,657* | *4* | *6,797* | *-* | *263* | *7,064* |
| Other assets with credit risk | 8,675 | - | - | - | - | - |
| Financial guarantees | 15,097 | 2,232 | 6,322 | 1,403 | 2,262 | 12,219 |
| Undrawn loan commitments and unused overdrafts | 99,024 | - | - | - | - | - |
| Fair value through OCI | 48,894 | - | - | - | - | - |
| *Government bonds* | *41,417* | - | - | - | - | - |
| *Corporate and finance bonds* | *7,477* | - | - | - | - | - |
| **Balance at the end of the year** | 1,059,309 | 23,024 | 551,045 | 56,004 | 75,353 | 705,426 |

Amounts are in ISK millions

## 42. Credit risk, continued

*LTV ratio for residential mortgage lending*

The following table describes the loan to value (LTV) and impairment status of the Group's mortgage loan book. LTV is calculated as the ratio of the gross amount of the loan to the value of the collateral without adjusting for possible costs of obtaining and selling the collateral. The collateral value is based on the value at origination, the most recent appraisal or official property valuation from the Icelandic Property Registry. For credit impaired loans the value of collateral is based on the most recent appraisal.

| | 30.6.2020 | | 31.12.2019 | |
|---|---|---|---|---|
| | Gross carrying amount | Thereof credit impaired | Gross carrying amount | Thereof credit impaired |
| Less than 50% | 114,712 | 1,630 | 119,734 | 1,283 |
| 50-70% | 135,413 | 2,303 | 130,257 | 2,546 |
| 70-90% | 84,601 | 1,190 | 63,099 | 1,131 |
| 90-100% | 8,924 | 305 | 7,369 | 170 |
| 100-110% | 3,002 | 73 | 2,658 | 60 |
| More than 110% | 10,475 | 672 | 10,873 | 698 |
| Not classified | 63 | - | 47 | - |
| **Balance at the end of the period** | 357,190 | 6,173 | 334,037 | 5,888 |

At the end of the period the gross carrying amount of assets in stage 3 are ISK 26,564 million (31.12.2019: ISK 20,155 million) with ISK 19,807 million in collateral (31.12.2019: ISK 13,618 million), there of ISK 17,295 million in real estates (31.12.2019: 11,791 million).

*Collateral repossessed*

During the period the Group took possession of assets due to foreclosures. The total value of real estate the Group took possession of during the period and still holds at the end of the period is ISK 62 million (30.6.2019: ISK 275 million) and in other assets ISK 6 million (30.6.2019: ISK 3 million). The assets are held for sale, see Note 29.

**Credit quality**

The Group uses internal credit ratings and external credit ratings if available to monitor credit risk. The Group's internal credit rating system rates customers through application of statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgment for large corporate exposures. Six exposure type models rate individuals' exposures – mortgages, consumer loans, auto loans, guarantees, loans to individuals for work purposes and other loans. The models are updated at least annually and recalibrated with current data with the aim of maintaining their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement. All internal models were updated during 2019 and new models and model structure first deployed at the end of 2019. External ratings are primarily used for marketable securities and loans to credit institutions. For further information on the rating scales used, see Note 56 in the Annual Financial Statements 2019.

The following tables show financial instruments subject to the impairment requirements of IFRS 9 broken down by rating scale, where risk class 5, DD denotes, the highest risk. Assets carried at fair value through profit and loss are not subject to the impairment requirements of IFRS 9. The tables below sum up the gross carrying amount of assets by rating class and current impairment stage. The gross carrying amount net of loss allowance shows the book value of the underlying assets.

Exposures that are 'Unrated' are typically due to newly formed entities, entities for which the Bank's rating models are not applicable or no external rating is available.

Amounts are in ISK millions

## 42. Credit risk, continued

Credit quality profile by rating class

| 30.6.2020 | Cash and balances with CB | Loans to credit institutions | Financial instru-ments at FVOCI |
|---|---|---|---|
| *Loans to credit institutions, securities and cash* | | | |
| Investment grade | 103,432 | 30,206 | 122,194 |
| Non-investment grade | - | 3,498 | - |
| **Gross carrying amount** | 103,432 | 33,704 | 122,194 |
| Loss allowance | - | (107) | (7) |
| **Book value** | 103,432 | 33,597 | 122,187 |

| *Loans to customers* | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| Risk class 0 to 1 (Grades AAA to BBB-) | 380,463 | 11,358 | - | - | 391,821 |
| Risk class 2 (Grades BB+ to BB-) | 160,639 | 50,338 | - | 89 | 211,066 |
| Risk class 3 (Grades B+ to B-) | 71,332 | 54,447 | 16 | 88 | 125,883 |
| Risk class 4 (Grades CCC+ to CCC-) | 17,027 | 15,503 | 321 | 84 | 32,935 |
| Risk class 5 (DD) | 1 | - | 26,226 | 468 | 26,695 |
| Unrated | 3,731 | 467 | 1 | - | 4,199 |
| **Gross carrying amount** | 633,193 | 132,113 | 26,564 | 729 | 792,599 |
| Loss allowance | (2,122) | (2,282) | (8,065) | (228) | (12,697) |
| **Book value** | 631,071 | 129,831 | 18,499 | 501 | 779,902 |
| *Loans to customers - Individuals* | | | | | |
| Risk class 0 to 1 (Grades AAA to BBB-) | 284,047 | 2,507 | - | - | 286,554 |
| Risk class 2 (Grades BB+ to BB-) | 66,994 | 4,065 | - | 89 | 71,148 |
| Risk class 3 (Grades B+ to B-) | 14,750 | 3,882 | 16 | 88 | 18,736 |
| Risk class 4 (Grades CCC+ to CCC-) | 2,896 | 4,904 | 321 | 84 | 8,205 |
| Risk class 5 (DD) | - | - | 7,055 | 468 | 7,523 |
| Unrated | 13 | 3 | - | - | 16 |
| **Gross carrying amount** | 368,700 | 15,361 | 7,392 | 729 | 392,182 |
| Loss allowance | (938) | (524) | (1,745) | (228) | (3,435) |
| **Book value** | 367,762 | 14,837 | 5,647 | 501 | 388,747 |
| *Loans to customers - Companies and sovereign* | | | | | |
| Risk class 0 to 1 (Grades AAA to BBB-) | 96,416 | 8,851 | - | - | 105,267 |
| Risk class 2 (Grades BB+ to BB-) | 93,645 | 46,273 | - | - | 139,918 |
| Risk class 3 (Grades B+ to B-) | 56,582 | 50,565 | - | - | 107,147 |
| Risk class 4 (Grades CCC+ to CCC-) | 14,131 | 10,599 | - | - | 24,730 |
| Risk class 5 (DD) | 1 | - | 19,171 | - | 19,172 |
| Unrated | 3,718 | 464 | 1 | - | 4,183 |
| **Gross carrying amount** | 264,493 | 116,752 | 19,172 | - | 400,417 |
| Loss allowance | (1,184) | (1,758) | (6,320) | - | (9,262) |
| **Book value** | 263,309 | 114,994 | 12,852 | - | 391,155 |

| *Loan commitments, guarantees and unused credit facilities* | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| Risk class 0 to 1 (Grades AAA to BBB-) | 55,143 | 1,311 | - | - | 56,454 |
| Risk class 2 to 4 (Grades BB+ to CCC-) | 39,151 | 17,949 | 1,849 | - | 58,949 |
| Unrated | 13,775 | 227 | - | - | 14,002 |
| **Gross carrying amount** | 108,069 | 19,487 | 1,849 | - | 129,405 |
| Loss allowance | (371) | (503) | (17) | - | (891) |
| **Book value** | 107,698 | 18,984 | 1,832 | - | 128,514 |

Amounts are in ISK millions

## 42. Credit risk, continued

| 31.12.2019 | Cash and balances with CB | Loans to credit institutions | Financial instru-ments at FVOCI |
|---|---|---|---|
| *Loans to credit institutions, securities and cash* | | | |
| Investment grade | 95,717 | 16,099 | 48,900 |
| Non-investment grade | - | 1,864 | - |
| **Gross carrying amount** | 95,717 | 17,963 | 48,900 |
| Loss allowance | - | (16) | (6) |
| **Book value** | 95,717 | 17,947 | 48,894 |

| *Loans to customers* | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| Risk class 0 to 1 - (Grades AAA to BBB-) | 369,623 | 981 | - | - | 370,604 |
| Risk class 2 - (Grades BB+ to BB-) | 196,133 | 35,291 | - | 81 | 231,505 |
| Risk class 3 - (Grades B+ to B-) | 94,515 | 37,100 | - | 39 | 131,654 |
| Risk class 4 - (Grades CCC+ to CCC-) | 11,669 | 15,828 | - | 114 | 27,611 |
| Risk class 5 - (DD) | 2 | - | 20,158 | 503 | 20,663 |
| Unrated | 661 | 426 | 2 | - | 1,089 |
| **Gross carrying amount** | 672,603 | 89,626 | 20,160 | 737 | 783,126 |
| Loss allowance | (974) | (921) | (7,067) | (209) | (9,171) |
| **Book value** | 671,629 | 88,705 | 13,093 | 528 | 773,955 |
| *Loans to customers - Individuals* | | | | | |
| Risk class 0 to 1 (Grades AAA to BBB-) | 272,967 | 723 | - | - | 273,690 |
| Risk class 2 (Grades BB+ to BB-) | 60,165 | 2,257 | - | 81 | 62,503 |
| Risk class 3 (Grades B+ to B-) | 13,882 | 3,125 | - | 39 | 17,046 |
| Risk class 4 (Grades CCC+ to CCC-) | 4,156 | 6,573 | - | 114 | 10,843 |
| Risk class 5 (DD) | - | - | 6,450 | 503 | 6,953 |
| Unrated | 25 | 54 | 2 | - | 81 |
| **Gross carrying amount** | 351,195 | 12,732 | 6,452 | 737 | 371,116 |
| Loss allowance | (418) | (319) | (1,601) | (209) | (2,547) |
| **Book value** | 350,777 | 12,413 | 4,851 | 528 | 368,569 |
| *Loans to customers - Companies and sovereign* | | | | | |
| Risk class 0 to 1 (Grades AAA to BBB-) | 96,656 | 258 | - | - | 96,914 |
| Risk class 2 (Grades BB+ to BB-) | 135,968 | 33,034 | - | - | 169,002 |
| Risk class 3 (Grades B+ to B-) | 80,633 | 33,975 | - | - | 114,608 |
| Risk class 4 (Grades CCC+ to CCC-) | 7,513 | 9,255 | - | - | 16,768 |
| Risk class 5 (DD) | 2 | - | 13,708 | - | 13,710 |
| Unrated | 636 | 372 | - | - | 1,008 |
| **Gross carrying amount** | 321,408 | 76,894 | 13,708 | - | 412,010 |
| Loss allowance | (556) | (602) | (5,466) | - | (6,624) |
| **Book value** | 320,852 | 76,292 | 8,242 | - | 405,386 |
| *Loan commitments, guarantees and unused credit facilities* | | | | | |
| Risk class 0 to 1 - (Grades AAA to BBB-) | 53,650 | 1 | - | - | 53,651 |
| Risk class 2 to 4 - (Grades BB+ to CCC-) | 43,205 | 8,349 | 1,790 | - | 53,344 |
| Unrated | 5,688 | 1,438 | - | - | 7,126 |
| **Gross carrying amount** | 102,543 | 9,788 | 1,790 | - | 114,121 |
| Loss allowance | (165) | (244) | (73) | - | (482) |
| **Book value** | 102,378 | 9,544 | 1,717 | - | 113,639 |

Amounts are in ISK millions

## 42. Credit risk, continued

*Sector split, Gross carrying value against loss allowance*

| | Stage 1 | | Stage 2 | | Stage 3 | | | |
|---|---|---|---|---|---|---|---|---|
| 30.6.2020 | Gross Carrying amount | Loss allowance | Gross Carrying amount | Loss allowance | Gross Carrying amount | Loss allowance | Total Loss allowance | Book value |
| Loans to credit instit., securities & cash ... | 259,330 | (114) | - | - | - | - | (114) | 259,216 |
| Individuals ..... | 368,699 | (937) | 15,623 | (524) | 7,859 | (1,973) | (3,434) | 388,747 |
| *Mortgage .....* | *317,329* | *(190)* | *11,248* | *(105)* | *4,669* | *(165)* | *(460)* | *332,786* |
| *Other .....* | *51,370* | *(747)* | *4,375* | *(419)* | *3,190* | *(1,808)* | *(2,974)* | *55,961* |
| Companies and sovereign ..... | 264,493 | (1,184) | 116,752 | (1,758) | 19,172 | (6,320) | (9,262) | 391,155 |
| *Real estate activities and construction .* | *84,633* | *(446)* | *42,893* | *(292)* | *3,176* | *(796)* | *(1,534)* | *129,168* |
| *Fishing industry .....* | *61,197* | *(181)* | *14,686* | *(79)* | *1,162* | *(472)* | *(732)* | *76,313* |
| *Information and communication technolo* | *18,336* | *(35)* | *639* | *(29)* | *361* | *(230)* | *(294)* | *19,042* |
| *Wholesale and retail trade .....* | *25,015* | *(130)* | *26,538* | *(679)* | *8,065* | *(1,616)* | *(2,425)* | *57,193* |
| *Financial and insurance activities .....* | *26,931* | *(92)* | *8,020* | *(142)* | *847* | *(152)* | *(386)* | *35,412* |
| *Industry, energy and manufacturing .....* | *25,235* | *(74)* | *5,059* | *(124)* | *1,276* | *(742)* | *(940)* | *30,630* |
| *Transportation .....* | *2,782* | *(42)* | *9,375* | *(152)* | *1,325* | *(663)* | *(857)* | *12,625* |
| *Services .....* | *9,275* | *(56)* | *7,155* | *(131)* | *1,713* | *(1,294)* | *(1,481)* | *16,662* |
| *Public Sector .....* | *5,459* | *(94)* | *1,066* | *(109)* | *210* | *(59)* | *(262)* | *6,473* |
| *Agriculture and forestry .....* | *5,630* | *(34)* | *1,321* | *(21)* | *1,037* | *(296)* | *(351)* | *7,637* |
| **Balance at the end of the period .....** | 892,522 | (2,235) | 132,375 | (2,282) | 27,031 | (8,293) | (12,810) | 1,039,118 |
| | | | | | | | | |
| 31.12.2019 | | | | | | | | |
| Loans to credit instit., securities & cash ... | 162,580 | (22) | - | - | - | - | (22) | 162,558 |
| Individuals ..... | 351,193 | (418) | 12,967 | (319) | 6,957 | (1,811) | (2,548) | 368,569 |
| *Mortgage .....* | *296,826* | *(45)* | *9,095* | *(62)* | *4,641* | *(260)* | *(367)* | *310,195* |
| *Other .....* | *54,367* | *(373)* | *3,872* | *(257)* | *2,316* | *(1,551)* | *(2,181)* | *58,374* |
| Companies and sovereign ..... | 321,408 | (554) | 76,894 | (602) | 13,705 | (5,464) | (6,620) | 405,386 |
| *Real estate activities and construction .* | *106,568* | *(152)* | *21,473* | *(58)* | *2,733* | *(708)* | *(918)* | *129,856* |
| *Fishing industry .....* | *54,934* | *(105)* | *27,846* | *(205)* | *1,105* | *(634)* | *(944)* | *82,941* |
| *Information and communication technolo* | *18,323* | *(35)* | *737* | *(10)* | *291* | *(204)* | *(249)* | *19,102* |
| *Wholesale and retail trade .....* | *43,397* | *(92)* | *9,171* | *(126)* | *3,710* | *(1,071)* | *(1,289)* | *54,989* |
| *Financial and insurance activities .....* | *24,792* | *(19)* | *8,867* | *(139)* | *277* | *(109)* | *(267)* | *33,669* |
| *Industry, energy and manufacturing .....* | *37,071* | *(23)* | *2,131* | *(19)* | *1,218* | *(469)* | *(511)* | *39,909* |
| *Transportation .....* | *9,259* | *(27)* | *1,252* | *(13)* | *1,162* | *(567)* | *(607)* | *11,066* |
| *Services .....* | *13,138* | *(35)* | *4,077* | *(20)* | *1,795* | *(1,375)* | *(1,430)* | *17,580* |
| *Public Sector .....* | *8,093* | *(58)* | *445* | *(4)* | *197* | *(56)* | *(118)* | *8,617* |
| *Agriculture and forestry .....* | *5,832* | *(8)* | *895* | *(8)* | *1,217* | *(271)* | *(287)* | *7,657* |
| **Balance at the end of the year .....** | 835,181 | (994) | 89,861 | (921) | 20,662 | (7,275) | (9,190) | 936,513 |

Amounts are in ISK millions

## 42. Credit risk, continued

The table below reconciles the opening and closing allowance balance for loans to customers and debt securities at amortized cost and FVOCI and loan commitments, guarantees and unused credit facilities by their impairment requirements. The reconciliation includes:

*Transfers of financial assets between impairment requirements*

Include transfers to 12 month expected credit losses, to lifetime expected credit losses and credit impaired financial assets. All transfers are presumed to occur before any corresponding remeasurement of the loss allowance.

*Net remeasurement of loss allowance*

Comprise the impact of changes in model inputs or assumptions, including changes in forward-looking macroeconomic conditions, partial repayments and additional draws on existing facilities, inflation, changes in the measurement following a transfer between stages, impairment of interest income due to impaired debt instruments and unwinding of the time value discount due to the passage of time.

*New financial assets*

Include purchases and originations and reflect the allowance related to assets newly recognized during the period.

*Derecognitions and maturities*

Reflect the allowance related to assets derecognized during the period without a credit loss being incurred, including those assets that were derecognized following a modification of terms.

*Write-offs*

The amount after net remeasurements of loss allowance written off during the period.

*Foreign exchange*

The effects of foreign exchange on the loss allowance between periods.

*Macroeconomic outlook*

Regarding macroeconomic outlook, see Note 3, Significant accounting estimates and judgements.

30.6.2020

| *Impairment loss allowance ** | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year | 1,137 | 1,166 | 7,141 | 209 | 9,653 |
| Transfers of financial assets: | | | | | |
| Transfers to Stage 1 (12-month ECL) | 1,599 | (1,523) | (76) | - | - |
| Transfers to Stage 2 (lifetime ECL) | (537) | 544 | (7) | - | - |
| Transfers to Stage 3 (credit impaired financial assets) | (48) | (598) | 646 | - | - |
| Net remeasurement of loss allowance ** | 14 | 3,173 | 1,008 | 15 | 4,210 |
| New financial assets, originated or purchased | 528 | 139 | 783 | - | 1,450 |
| Derecognitions and maturities | (209) | (167) | (1,014) | - | (1,390) |
| Write-offs *** | - | (1) | (710) | (1) | (712) |
| Foreign exchange difference | 9 | 52 | 312 | 5 | 378 |
| **Impairment loss allowance ******** | 2,493 | 2,785 | 8,083 | 228 | 13,589 |
| | | | | | |
| Impairment loss allowances for assets only carrying 12-month ECL | 114 | - | - | - | 114 |
| **Total impairment loss allowance** | 2,607 | 2,785 | 8,083 | 228 | 13,703 |

* These amounts are a combination of all impairments, including an allowance for loan commitments and guarantees presented as a liability in these Condensed Consolidated Interim Financial Statements.

** During the period the loss allowance balance for stage 3 loans was raised by ISK 306 million due to unwinding of interest income.

*** During the period an amount of ISK 477 million was written off but is still subject to enforcement activities subject to Icelandic law.

**** Loss allowance for all assets other than cash, bonds and loans to credit institutions.

Amounts are in ISK millions

## 42. Credit risk, continued

| *Impairment loss allowance for loans to customers* | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year | 974 | 921 | 7,067 | 209 | 9,171 |
| Transfers of financial assets: | | | | | |
| Transfers to Stage 1 (12-month ECL) | 1,485 | (1,416) | (69) | - | - |
| Transfers to Stage 2 (lifetime ECL) | (513) | 520 | (7) | - | - |
| Transfers to Stage 3 (credit impaired financial assets) | (47) | (596) | 643 | - | - |
| Net remeasurement of loss allowance | (68) | 2,894 | 1,044 | 15 | 3,885 |
| New financial assets, originated or purchased | 397 | 48 | 780 | - | 1,225 |
| Derecognitions and maturities | (111) | (139) | (985) | - | (1,235) |
| Write-offs | - | (1) | (710) | (1) | (712) |
| Foreign exchange differences | 5 | 51 | 303 | 5 | 364 |
| **Total loss allowance for loans to customers** | 2,122 | 2,282 | 8,066 | 228 | 12,698 |

| *Impairment loss allowance for loans to customers - Individuals* | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year | 418 | 319 | 1,601 | 209 | 2,547 |
| Transfers of financial assets | | | | | |
| Transfers to Stage 1 (12-month ECL) | 679 | (614) | (65) | - | - |
| Transfers to Stage 2 (lifetime ECL) | (234) | 241 | (7) | - | - |
| Transfers to Stage 3 (credit impaired financial assets) | (33) | (184) | 217 | - | - |
| Net remeasurement of loss allowance | 37 | 785 | 345 | 15 | 1,181 |
| New financial assets, originated or purchased | 126 | 14 | 9 | - | 149 |
| Derecognitions and maturities | (56) | (36) | (123) | - | (215) |
| Write-offs | - | (1) | (263) | (1) | (265) |
| Foreign exchange differences | 1 | - | 31 | 5 | 37 |
| **Total loss allowance for individuals** | 938 | 524 | 1,745 | 228 | 3,435 |

| *Impairment loss allowance for loans to customers - Companies and sovereign* | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year | 556 | 602 | 5,466 | - | 6,624 |
| Transfers of financial assets | | | | | |
| Transfers to Stage 1 (12-month ECL) | 806 | (802) | (4) | - | - |
| Transfers to Stage 2 (lifetime ECL) | (279) | 279 | - | - | - |
| Transfers to Stage 3 (credit impaired financial assets) | (14) | (412) | 426 | - | - |
| Net remeasurement of loss allowance | (105) | 2,109 | 699 | - | 2,703 |
| New financial assets, originated or purchased | 271 | 34 | 771 | - | 1,076 |
| Derecognitions and maturities | (55) | (103) | (862) | - | (1,020) |
| Write-offs | - | - | (447) | - | (447) |
| Foreign exchange differences | 4 | 51 | 272 | - | 327 |
| **Total loss allowance for companies and sovereign** | 1,184 | 1,758 | 6,321 | - | 9,262 |

| *Impairment loss allowance for loan commitments, guarantees and unused credit facilities* | Stage 1 | Stage 2 | Stage 3 | POCI | Total |
|---|---|---|---|---|---|
| Balance at the beginning of the year | 163 | 245 | 74 | - | 482 |
| Transfers | | | | | |
| Transfers to 12-month ECL | 114 | (107) | (7) | - | - |
| Transfers to lifetime ECL | (24) | 24 | - | - | - |
| Transfers to credit impaired | (1) | (2) | 3 | - | - |
| Net remeasurement of loss allowance | 82 | 279 | (36) | - | 325 |
| New financial commitments originated | 131 | 91 | 3 | - | 225 |
| Derecognitions and maturities | (98) | (28) | (29) | - | (155) |
| Foreign exchange differences | 4 | 1 | 9 | - | 14 |
| **Total loss allowance for loan commit., guarantees, unused cr. facilitie** | 371 | 503 | 17 | - | 891 |

**Large exposures**

A large exposure is defined as an exposure to a group of financially related borrowers which is equal to or exceeds 10% of the Group's eligible capital according to Financial Undertakings Act No. 161/2002 and Regulation No. 233/2017 on prudential requirements. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible credit risk mitigation.

The Group has one large exposure at the end of the period, totaling ISK 20.4 billion (10.2% of eligible capital) before taking into account eligible credit risk mitigation (31.12.2019: two large exposures, totaling ISK 36.8 billion). The total exposure is ISK 20.3 billion (10.1% of eligible capital) after taking into account eligible credit risk mitigation.

Amounts are in ISK millions

## 43. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates adversely affect the Group's earnings and equity position due to changes to the value and cash flows of its assets and liabilities.

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 close track of market risk and separates its exposures for the trading book and the banking book. Market risk in the trading book arises from market making activities and non-strategic derivatives positions arising from the Bank's operations of meeting customers' investment and risk management needs. 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.

Market risk allowance is set by the Board in the Bank's risk appetite and limit frameworks are in place for each trading desk. The Asset and Liability Committee (ALCO) 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 aims to manage and limit market exposures and imbalances between assets and liabilities in accordance with its risk appetite and strategic goals for net profit.

### Interest rate risk

Interest rate risk arises from the possibility that changes in market rates adversely affect net interest income and fair value of interest-bearing instruments on the Group's balance sheet. The Group's operations are subject to interest rate risk due to mismatches in the fixing of interest rates between assets and liabilities, resulting in a reprising 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.

The Group's interest rate risk for foreign currencies is limited as foreign denominated assets predominantly have short fixing periods and the Group generally applies cash flow hedging for its foreign denominated fixed rate borrowings. For domestic rates, longer fixing periods are more common. The sale of the Arion Bank Mortgage Institutional Fund mortgage portfolio, executed in October 2019, with resulting full prepayment of the remaining matched structural covered bonds issuance, significantly shortened the interest fixing profile of the Bank for indexed rates.

Due to favorable refinancing spreads, prepayments and/or refinancing of loans have been considerable over the past few years, resulting in reduced average duration of fixed rates for the Bank's assets. Prepayment risk is mitigated by prepayment fees and the Group's own prepayment options. The Group's prepayment of structured covered bonds is a reaction to mortgage prepayments and mortgage refinancing. Decreasing domestic interest rates furthermore put pressure on the Group's net interest income as a result of tighter margins for deposit funding.

*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 24, and are therefore different from the amounts shown in these Condensed Consolidated Interim Financial Statements. The fair value reflects the likelihood of prepayment. 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 assets and liabilities of Valitor Holding hf. are not included in the figures as they are classified as held for sale.

| 30.6.2020 | Up to 3 | 3-12 | 1-5 | 5-10 | Over 10 | |
|---|---|---|---|---|---|---|
| *Assets* | months | months | years | years | years | Total |
| Balances with Central Bank | 99,515 | - | - | - | - | 99,515 |
| Loans to credit institutions | 33,597 | - | - | - | - | 33,597 |
| Loans to customers | 495,323 | 95,969 | 151,791 | 8,989 | 32,985 | 785,057 |
| Financial instruments | 51,285 | 48,491 | 16,316 | 1,438 | 4,680 | 122,210 |
| **Assets** | 679,720 | 144,460 | 168,107 | 10,427 | 37,665 | 1,040,379 |
| *Liabilities* | | | | | | |
| Due to credit institutions and Central Bank | 7,661 | - | - | - | - | 7,661 |
| Deposits | 518,073 | 25,595 | 9,523 | 1,518 | 1,146 | 555,855 |
| Borrowings | 31,915 | - | 232,978 | 54,434 | 11,823 | 331,150 |
| Subordinated liabilities | 14,441 | - | 5,325 | 13,590 | - | 33,356 |
| **Liabilities** | 572,090 | 25,595 | 247,826 | 69,542 | 12,969 | 928,022 |
| Derivatives and other off-balance sheet items (net position) | (121,058) | - | 119,496 | 5,548 | - | 3,986 |
| **Net interest gap** | (13,428) | 118,865 | 39,777 | (53,567) | 24,696 | 116,343 |

Amounts are in ISK millions

## 43. Market risk, continued

| 31.12.2019 *Assets* | Up to 3 months | 3-12 months | 1-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|
| Balances with Central Bank | 91,511 | - | - | - | - | 91,511 |
| Loans to credit institutions | 17,947 | - | - | - | - | 17,947 |
| Loans to customers | 497,936 | 84,260 | 148,015 | 9,076 | 38,033 | 777,320 |
| Financial instruments | 24,470 | 9,625 | 9,743 | 1,150 | 3,925 | 48,913 |
| **Assets** | 631,864 | 93,885 | 157,758 | 10,226 | 41,958 | 935,691 |
| *Liabilities* | | | | | | |
| Due to credit institutions and Central Bank | 5,984 | - | - | - | - | 5,984 |
| Deposits | 449,627 | 30,875 | 9,826 | 1,474 | 1,114 | 492,916 |
| Borrowings | 35,359 | 5,668 | 174,814 | 89,264 | 11,484 | 316,589 |
| Subordinated liabilities | 13,975 | - | - | 6,202 | - | 20,177 |
| **Liabilities** | 504,945 | 36,543 | 184,640 | 96,940 | 12,598 | 835,666 |
| Derivatives and other off-balance sheet items (net position) | (102,295) | 25 | 104,180 | 869 | - | 2,779 |
| **Net interest gap** | 24,624 | 57,367 | 77,298 | (85,845) | 29,360 | 102,804 |

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

The following table shows the sensitivity of the Group's net present value (NPV) of interest-bearing assets and liabilities and variation of annual net interest income (NII), due to changes in interest rates by currencies. The variation is calculated on the basis of simultaneous parallel shifts upwards or downwards of yield curves. The choice of shifts is not an estimate of risk likelihood. Behavioral maturities are taken into account in the NPV calculations, including prepayment likelihood and expected behavior of non-maturing deposits. The change to NII is however primarily based on contractual interest rate adjustments where it is simplistically assumed that all rates are equally sensitive to the presumed change in market rates. Behavioral maturity assumptions are however applied for non-maturing deposits and a zero percentage floor is applied to krona deposit interest rates.

| | 30.6.2020 | | 31.12.2019 | |
|---|---|---|---|---|
| *NPV change* | -100 bps | +100 bps | -100 bps | +100 bps |
| ISK, CPI index-linked | (3,457) | 3,102 | (3,198) | 2,651 |
| ISK, Non index-linked | 186 | (193) | (135) | 210 |
| Foreign currencies | 657 | (665) | 365 | (392) |
| *NII change* | | | | |
| ISK, CPI index-linked | (1,323) | 720 | (751) | 719 |
| ISK, Non index-linked | (3,061) | 622 | (1,078) | 434 |
| Foreign currencies | 109 | (109) | 200 | (200) |

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

The following table shows the interest sensitivity of the Group's net positions in the trading book by currencies. Sensitivity is quantified as the net change in value 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.

| | 30.6.2020 | | 31.12.2019 | |
|---|---|---|---|---|
| *Currency* | -100 bps | +100 bps | -100 bps | +100 bps |
| ISK, CPI index-linked | 185 | (164) | 83 | (74) |
| ISK, Non index-linked | 101 | (93) | 107 | (100) |
| Foreign currencies | 33 | (33) | (77) | 73 |

Amounts are in ISK millions

## 43. Market risk, continued

**Indexation risk**

A significant part of the Group's balance sheet is linked to the Icelandic Consumer Price Index (CPI). For index-linked instruments, principal and interest payments are adjusted proportionally to the CPI. The Group is exposed to indexation risk as indexed assets exceed indexed liabilities. Financial instruments held for liquidity or market making purposes are assumed to be on demand.

*Book value and maturity profile of indexed assets and liabilities*

| 30.6.2020 | Up to 1 year | 1 to 5 years | Over 5 years | Total |
|---|---|---|---|---|
| *Assets, CPI index-linked* | | | | |
| Loans to customers | 19,138 | 56,966 | 207,721 | 283,825 |
| Financial instruments | 14,640 | - | - | 14,640 |
| Off-balance sheet position | (278) | (897) | - | (1,175) |
| **Assets, CPI index-linked** | 33,500 | 56,069 | 207,721 | 297,290 |
| *Liabilities, CPI index-linked* | | | | |
| Deposits | 72,314 | 13,277 | 2,660 | 88,251 |
| Borrowings | 274 | 52,238 | 54,211 | 106,723 |
| Subordinated liabilities | - | - | 4,989 | 4,989 |
| Other | 1,144 | 208 | 1,428 | 2,780 |
| Off-balance sheet position | 830 | 4,969 | 89 | 5,888 |
| **Liabilities, CPI index-linked** | 74,562 | 70,692 | 63,377 | 208,631 |
| Net on-balance sheet position | (39,954) | (8,757) | 144,433 | 95,722 |
| Net off-balance sheet position | (1,108) | (5,866) | (89) | (7,063) |
| **CPI Balance** | (41,062) | (14,623) | 144,344 | 88,659 |
| **CPI Balance for prudential consolidation, which excludes insurance operations *** | (41,145) | (16,985) | 140,223 | 82,095 |

| 31.12.2019 | Up to 1 year | 1 to 5 years | Over 5 years | Total |
|---|---|---|---|---|
| *Assets, CPI index-linked* | | | | |
| Loans to customers | 18,945 | 57,405 | 207,514 | 283,864 |
| Financial instruments | 13,647 | - | - | 13,647 |
| **Assets, CPI index-linked** | 32,592 | 57,405 | 207,514 | 297,511 |
| *Liabilities, CPI index-linked* | | | | |
| Deposits | 75,944 | 13,381 | 2,582 | 91,907 |
| Borrowings | 269 | 11,329 | 89,644 | 101,242 |
| Subordinated liabilities | - | - | 4,913 | 4,913 |
| Other | 1,046 | 210 | 1,427 | 2,683 |
| Off-balance sheet position | 1,036 | 6,675 | 125 | 7,836 |
| **Liabilities, CPI indexed linked** | 78,295 | 31,595 | 98,691 | 208,581 |
| Net on-balance sheet position | (44,667) | 32,485 | 108,948 | 96,766 |
| Net off-balance sheet position | (1,036) | (6,675) | (125) | (7,836) |
| **CPI Balance** | (45,703) | 25,810 | 108,823 | 88,930 |
| **CPI Balance for prudential consolidation, which excludes insurance operations *** | (52,586) | 26,020 | 109,256 | 82,689 |

* Consolidated situation as per EU Regulation No 575/2013 (CRR)

Amounts are in ISK millions

# Notes to the Condensed Consolidated Interim Financial Statements

## 43. 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 consists of foreign currency denominated loans to customers. Net exposures per currency are monitored centrally in the Bank.

*Breakdown of assets and liabilities by currency*

30.6.2020

| *Financial assets* | ISK | EUR | USD | GBP | DKK | NOK | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with CB | 101,597 | 726 | 431 | 224 | 111 | 67 | 276 | 103,432 |
| Loans to credit institutions | 4,829 | 12,574 | 8,590 | 1,064 | 527 | 2,122 | 3,891 | 33,597 |
| Loans to customers | 617,921 | 108,590 | 38,726 | 4,404 | 4,440 | 1 | 5,820 | 779,902 |
| Financial instruments | 116,412 | 31,304 | 45,953 | 30 | 40 | 3,283 | 119 | 197,141 |
| Other financial assets | 10,924 | 700 | 446 | 137 | 1 | 3 | 11 | 12,222 |
| **Financial assets** | 851,683 | 153,894 | 94,146 | 5,859 | 5,119 | 5,476 | 10,117 | 1,126,294 |
| | | | | | | | | |
| *Financial liabilities* | | | | | | | | |
| Due to credit inst. and Central Bank | 3,903 | 366 | 3,378 | 14 | - | - | - | 7,661 |
| Deposits | 476,445 | 30,010 | 39,238 | 2,295 | 2,456 | 3,072 | 2,339 | 555,855 |
| Financial liabilities at fair value | 1,677 | 1,098 | 300 | - | - | 8 | 35 | 3,118 |
| Other financial liabilities | 13,091 | 960 | 1,148 | 166 | 313 | 1,769 | 132 | 17,579 |
| Borrowings | 151,835 | 124,387 | - | - | - | 32,778 | 5,952 | 314,952 |
| Subordinated liabilities | 5,896 | 778 | 14,705 | - | - | 4,345 | 10,770 | 36,494 |
| **Financial liabilities** | 652,847 | 157,599 | 58,769 | 2,475 | 2,769 | 41,972 | 19,228 | 935,659 |
| | | | | | | | | |
| Net on-balance sheet position | 198,836 | (3,705) | 35,377 | 3,384 | 2,350 | (36,496) | (9,111) | |
| Net off-balance sheet position | (7,572) | 1,535 | (34,005) | (3,437) | (2,143) | 36,413 | 9,209 | |
| **Net position** | 191,264 | (2,170) | 1,372 | (53) | 207 | (83) | 98 | |
| | | | | | | | | |
| *Non-financial assets* | | | | | | | | |
| Investment property | 7,051 | - | - | - | - | - | - | 7,051 |
| Investments in associates | 861 | - | - | - | - | - | - | 861 |
| Intangible assets | 9,077 | - | - | - | - | - | - | 9,077 |
| Tax assets | 2 | - | - | - | - | - | - | 2 |
| Assets and disposal groups held for sale | 10,466 | 13,325 | 403 | 4,928 | 318 | 510 | 782 | 30,732 |
| Other non financial assets | 8,037 | 136 | 22 | 31 | - | 15 | (9) | 8,232 |
| **Non-financial assets** | 35,494 | 13,461 | 425 | 4,959 | 318 | 525 | 773 | 55,955 |
| | | | | | | | | |
| *Non-financial liabilities and equity* | | | | | | | | |
| Tax liabilities | 3,882 | - | - | - | - | - | - | 3,882 |
| Liabilities associated with disposal groups held for sale | 10,559 | 9,814 | 159 | 3,729 | 1,113 | 868 | 740 | 26,982 |
| Other non-financial liabilities | 26,665 | 138 | 89 | - | 5 | - | 2 | 26,899 |
| Shareholders' equity | 188,656 | - | - | - | - | - | - | 188,656 |
| Non-controlling interest | 171 | - | - | - | - | - | - | 171 |
| **Non-financial liabilities and equity** | 229,933 | 9,952 | 248 | 3,729 | 1,118 | 868 | 742 | 246,590 |
| Intangible assets of Valitor in foreign operation excluded * | 1,534 | - | - | (1,534) | - | - | - | |
| **Management reporting of currency risk **** | (1,641) | 1,339 | 1,549 | (357) | (593) | (426) | 129 | |

* Based on an authorization from the Icelandic FSA to exclude Valitor's intangible assets in the currency balance.

** The net position of the currency risk is presented in accordance with IFRS. The management monitors currency risk with more assets and liabilities underlying, such as tax assets and liabilities and intangible assets, as it is considered to be a more accurate measurement of the Group's currency exposure. The net position, as seen by the management, is the position used for managing the currency imbalance.

Amounts are in ISK millions

## 43. Market risk, continued

31.12.2019

| *Financial assets* | ISK | EUR | USD | GBP | DKK | NOK | Other | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with CB ...................... | 94,363 | 534 | 286 | 173 | 65 | 53 | 243 | 95,717 |
| Loans to credit institutions ....................... | 2,024 | 5,845 | 4,835 | 1,355 | 628 | 656 | 2,604 | 17,947 |
| Loans to customers ................................ | 608,144 | 116,793 | 35,113 | 3,956 | 4,578 | 2 | 5,369 | 773,955 |
| Financial instruments ............................... | 73,482 | 18,253 | 22,618 | 35 | 2 | 2,868 | 148 | 117,406 |
| Other financial assets ............................. | 5,354 | 160 | 3,096 | - | 22 | 4 | 39 | 8,675 |
| **Financial assets ....................................** | 783,367 | 141,585 | 65,948 | 5,519 | 5,295 | 3,583 | 8,403 | 1,013,700 |
| | | | | | | | | |
| *Financial liabilities* | | | | | | | | |
| Due to credit inst. and Central Bank ........ | 2,548 | 1,748 | 1,675 | 13 | - | - | - | 5,984 |
| Deposits ................................................. | 424,136 | 28,730 | 30,729 | 2,071 | 2,504 | 2,900 | 1,846 | 492,916 |
| Financial liabilities at fair value ............... | 1,665 | 561 | 66 | 17 | - | 192 | 69 | 2,570 |
| Other financial liabilities ........................... | 4,178 | 335 | 967 | 201 | 371 | 53 | 303 | 6,408 |
| Borrowings .............................................. | 147,245 | 116,712 | - | - | - | 32,999 | 7,789 | 304,745 |
| Subordinated liabilities ............................ | 5,820 | 690 | - | - | - | 4,183 | 9,390 | 20,083 |
| **Financial liabilities ................................** | 585,592 | 148,776 | 33,437 | 2,302 | 2,875 | 40,327 | 19,397 | 832,706 |
| | | | | | | | | |
| Net on-balance sheet position ................ | 197,775 | (7,191) | 32,511 | 3,217 | 2,420 | (36,744) | (10,994) | |
| Net off-balance sheet position ................ | (2,575) | 1,522 | (36,242) | (4,825) | (4,694) | 36,252 | 10,562 | |
| | | | | | | | | |
| **Net position ...........................................** | 195,200 | (5,669) | (3,731) | (1,608) | (2,274) | (492) | (432) | |
| | | | | | | | | |
| *Non-financial assets* | | | | | | | | |
| Investment property ................................ | 7,119 | - | - | - | - | - | - | 7,119 |
| Investments in associates ....................... | 852 | - | - | - | - | - | - | 852 |
| Intangible assets ..................................... | 8,367 | - | - | - | - | - | - | 8,367 |
| Tax assets .............................................. | 2 | - | - | - | - | - | - | 2 |
| Assets and disposal groups | | | | | | | | - |
| held for sale ......................................... | 20,632 | 13,080 | 1,302 | 5,637 | 1,206 | 307 | 1,462 | 43,626 |
| Other non financial assets ...................... | 7,963 | 119 | 27 | 56 | 1 | 18 | 5 | 8,189 |
| **Non-financial assets .............................** | 44,935 | 13,199 | 1,329 | 5,693 | 1,207 | 325 | 1,467 | 68,155 |
| | | | | | | | | |
| *Non-financial liabilities and equity* | | | | | | | | |
| Tax liabilities ........................................... | 4,404 | - | - | - | - | - | - | 4,404 |
| Liabilities associated with disposal groups held for sale ............................. | 11,442 | 8,667 | 71 | 2,849 | 2,597 | 496 | 2,509 | 28,631 |
| Other non-financial liabilities .................... | 26,097 | 141 | 46 | - | 5 | - | - | 26,289 |
| Shareholders' equity ............................... | 189,644 | - | - | - | - | - | - | 189,644 |
| Non-controlling interest ........................... | 181 | - | - | - | - | - | - | 181 |
| **Non-financial liabilities and equity .......** | 231,768 | 8,808 | 117 | 2,849 | 2,602 | 496 | 2,509 | 249,149 |
| Intangible assets of Valitor in foreign operation excluded * ........................... | 1,534 | - | - | (1,455) | (79) | - | - | |
| **Management reporting of currency risk ** ..............................** | 9,901 | (1,278) | (2,519) | (219) | (3,748) | (663) | (1,474) | |

* Based on an authorization from the Icelandic FSA to exclude Valitor's intangible assets in the currency balance.

* The net position of the currency risk is presented in accordance with IFRS. The management monitors currency risk with more assets and liabilities underlying, such as tax assets and liabilities and intangible assets, as it is considered to be a more accurate measurement of the Group's currency exposure. The net position, as seen by the management, is the position used for managing the currency imbalance.

Amounts are in ISK millions

## 43. Market risk, continued

*Sensitivity analysis for currency risk*

The table below indicates the currencies to which the Group had significant exposure at the end of the period. 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 Consolidated Interim 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 the Consolidated Interim 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).

| | 30.6.2020 | | 31.12.2019 | |
|---|---|---|---|---|
| *Currency* | -10% | +10% | -10% | +10% |
| EUR | (134) | 134 | 128 | (128) |
| USD | (155) | 155 | 252 | (252) |
| GBP | 36 | (36) | 22 | (22) |
| DKK | 59 | (59) | 375 | (375) |
| NOK | 43 | (43) | 66 | (66) |
| Other | (13) | 13 | 147 | (147) |

**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. For information on assets seized and held for sale and equity exposures, see Notes 30 and 23 respectively.

*Sensitivity analysis for equity risk*

The analysis below calculates the effect of a reasonable possible movement in equity prices that affect the Condensed Consolidated Interim Financial Statements. A negative amount in the table reflects a potential net reduction in the Consolidated Income Statement or equity, while a positive amount reflects a potential net increase. Investments in associates are excluded. The result of value-at-risk calculations for the trading book are shown in the Group's Pillar 3 Disclosures.

| | 30.6.2020 | | 31.12.2019 | |
|---|---|---|---|---|
| *Equity* | -10% | +10% | -10% | +10% |
| Trading book - listed | (285) | 285 | (301) | 301 |
| Banking book - listed | (514) | 514 | (486) | 486 |
| Banking book - unlisted | (295) | 295 | (296) | 296 |

**Derivatives**

Derivatives are a part of the Group's customer product offering. The types of derivatives currently offered are forward contracts, swaps and options. Eligible underlying market factors are interest rates, foreign exchange rates, equities and commodities. Exposure limits, hedging requirements and collateral requirements are determined in accordance with the Group's risk appetite and monitored by Risk Management on a daily basis. The Group also uses derivatives to hedge market risk on its balance sheet. Note 24 provides a breakdown of the Group's derivative positions by type.

Amounts are in ISK millions

## 44. Liquidity and Funding 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.

A primary source of funding for the Group is from deposits from individuals, businesses and financial undertakings. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 71% is on-demand.

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 (ALCO) is responsible for managing liquidity and funding risk within the risk appetite set by the Board of Directors. The Bank's Treasury manages liquidity positions on a day-to-day basis. Risk Management measures, monitors and reports the Bank's liquidity and funding risk on a daily basis.

The Group's strategy in relation to liquidity risk is to actively manage its liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. The Group seeks to maintain a stable funding profile which supports its business strategy and liquidity profile, ensuring that the Group can withstand periods of market turbulence, without reliance on volatile funding or external support.

**Maturity analysis of assets and liabilities**

The maturity analysis is based on contractual cash flows. The amounts are not discounted and include future interest payments, but CPI-linked amounts do not include accrued indexation due to future inflation. The total amount for each item is higher than the corresponding amount on the Bank's balance sheet, since the amounts on the balance sheet are either at amortized cost and do not contain future interest payments, or at fair value where future cash flows have been discounted.

Contractual cash flows differ in many ways from expected cash flows. The difference is most significant for deposits on the liability side and bonds on the asset side. Deposits are always assumed to be withdrawn at the earliest possible date, despite the fact that a large part of the deposit base is considered to be stable funding where behavioral maturity considerably exceeds contractual maturity. Furthermore, although contractual cash flows are presented for bonds held by the Bank, a large portion of the bonds are a part of the Bank's liquidity buffer and are considered to be highly liquid and can be sold and/or pledged to the Central Bank of Iceland and thus converted into cash at very short notice.

*Contractual cash flow of assets and liabilities*

| 30.6.2020 | On | Up to 3 | 3-12 | 1-5 | Over 5 | With no | | Book |
|---|---|---|---|---|---|---|---|---|
| *Financial assets* | demand | months | months | years | years | maturity | Total | value |
| Cash and balances with CB .................... | 15,217 | 82,615 | 5,684 | - | - | - | 103,516 | 103,432 |
| Loans to credit institutions ...................... | 28,000 | 5,596 | - | - | - | - | 33,596 | 33,597 |
| Loans to customers ................................ | 8,050 | 114,166 | 109,175 | 280,845 | 555,892 | - | 1,068,128 | 779,902 |
| Financial instruments .............................. | 23,639 | 54,052 | 51,920 | 30,789 | 14,923 | 29,626 | 204,949 | 197,141 |
| *Derivatives - assets leg* .............................. | - | *59,867* | *17,628* | *44,770* | *11,617* | - | *133,882* | *129,424* |
| *Derivatives - liabilities leg* ........................... | - | *(57,392)* | *(17,015)* | *(38,792)* | *(10,392)* | - | *(123,591)* | *(120,513)* |
| *Other financial instruments* ........................ | *23,639* | *51,577* | *51,307* | *24,811* | *13,698* | *29,626* | *194,658* | *188,230* |
| Other financial assets ............................. | 445 | 7,871 | 3,084 | 824 | - | - | 12,224 | 12,222 |
| **Financial assets** .................................... | 75,351 | 264,300 | 169,863 | 312,458 | 570,815 | 29,626 | 1,422,413 | 1,126,294 |
| | | | | | | | | |
| *Financial liabilities* | | | | | | | | |
| Due to credit inst. and Central Bank ......... | 7,712 | - | 28 | - | - | - | 7,740 | 7,661 |
| Deposits ................................................. | 396,435 | 107,573 | 36,188 | 13,675 | 2,953 | - | 556,824 | 555,855 |
| Financial liabilities at fair value ................ | - | 2,164 | 1,241 | 1,817 | (161) | - | 5,061 | 3,118 |
| *Derivatives - assets leg* .............................. | - | *(63,148)* | *(2,161)* | *(8,942)* | *(2,128)* | - | *(76,379)* | *(70,608)* |
| *Derivatives - liabilities leg* ........................... | - | *65,291* | *3,402* | *10,759* | *1,967* | - | *81,419* | *73,578* |
| *Short position bonds* .................................. | - | *21* | - | - | - | - | *21* | *21* |
| *Short position in bonds used for hedging* .... | - | *127* | - | - | - | - | *127* | *127* |
| Other financial liabilities ........................... | 171 | 13,823 | 283 | 1,284 | 2,015 | - | 17,576 | 17,580 |
| Borrowings .............................................. | - | 16,073 | 15,302 | 254,563 | 65,450 | - | 351,388 | 314,952 |
| Subordinated liabilities ............................ | - | 1,191 | 996 | 6,720 | 39,983 | - | 48,890 | 36,494 |
| **Financial liabilities** ................................ | 404,318 | 140,824 | 54,038 | 278,059 | 110,240 | - | 987,479 | 935,660 |
| **Net position for assets and liab.** ........... | (328,967) | 123,476 | 115,825 | 34,399 | 460,575 | 29,626 | 434,934 | 190,634 |
| | | | | | | | | |
| *Off-balance sheet items* | | | | | | | | |
| Financial guarantees .............................. | - | 722 | 3,593 | 3,262 | 7,637 | - | 15,214 | 15,214 |
| Unused overdraft .................................... | - | 48,431 | - | - | - | - | 48,431 | 48,431 |
| Undrawn loan commitments ..................... | - | 54,452 | 10,643 | 665 | - | - | 65,760 | 65,760 |
| **Off-balance sheet items** ....................... | - | 103,605 | 14,236 | 3,927 | 7,637 | - | 129,405 | 129,405 |
| **Net contractual cash flow** ...................... | (328,967) | 19,871 | 101,589 | 30,472 | 452,938 | 29,626 | 305,529 | 61,229 |

Amounts are in ISK millions

## 44. Liquidity and Funding risk, continued

| 31.12.2019<br>*Financial assets* | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | With no maturity | Total | Book value |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with CB | 6,352 | 84,434 | 5,059 | - | - | - | 95,845 | 95,717 |
| Loans to credit institutions | 15,652 | 2,295 | - | - | - | - | 17,947 | 17,947 |
| Loans to customers | 6,191 | 124,040 | 105,974 | 299,695 | 578,647 | - | 1,114,547 | 773,955 |
| Financial instruments | 16,381 | 28,346 | 11,451 | 22,612 | 10,238 | 34,063 | 123,091 | 117,406 |
| *Derivatives - assets leg* | - | *69,432* | *12,020* | *48,571* | *357* | - | *130,380* | *124,911* |
| *Derivatives - liabilities leg* | - | *(66,935)* | *(11,006)* | *(43,875)* | *(294)* | - | *(122,110)* | *(118,295)* |
| *Other financial instruments* | *16,381* | *25,849* | *10,437* | *17,916* | *10,175* | *34,063* | *114,821* | *110,790* |
| Other financial assets | 577 | 4,618 | 2,656 | 824 | - | - | 8,675 | 8,675 |
| **Financial assets** | 45,153 | 243,733 | 125,140 | 323,131 | 588,885 | 34,063 | 1,360,105 | 1,013,700 |
| | | | | | | | | |
| *Financial liabilities* | | | | | | | | |
| Due to credit inst. and Central Bank | 5,997 | - | 26 | - | - | - | 6,023 | 5,984 |
| Deposits | 350,451 | 78,459 | 42,423 | 14,318 | 9,279 | - | 494,930 | 492,916 |
| Financial liabilities at fair value | - | 1,506 | 1,318 | 1,812 | 44 | - | 4,680 | 2,570 |
| *Derivatives - assets leg* | - | *(48,335)* | *(6,983)* | *(8,218)* | *(1,360)* | - | *(64,896)* | *(63,456)* |
| *Derivatives - liabilities leg* | - | *49,326* | *8,301* | *10,030* | *1,404* | - | *69,061* | *65,510* |
| *Short position bonds and derivatives* | - | *408* | - | - | - | - | *408* | *409* |
| *Short position securities used for economic hedging* | - | *107* | - | - | - | - | *107* | *107* |
| Other financial liabilities | 141 | 3,856 | 119 | 559 | 1,733 | - | 6,408 | 6,408 |
| Borrowings | - | 7,416 | 32,028 | 202,725 | 101,862 | - | 344,031 | 304,745 |
| Subordinated liabilities | - | 479 | 566 | 3,316 | 23,908 | - | 28,269 | 20,083 |
| **Financial liabilities** | 356,589 | 91,716 | 76,480 | 222,730 | 136,826 | - | 884,341 | 832,706 |
| **Net position for assets and liab.** | (311,436) | 152,017 | 48,660 | 100,401 | 452,059 | 34,063 | 475,764 | 180,994 |
| | | | | | | | | |
| *Off-balance sheet items* | | | | | | | | |
| Financial guarantees | 554 | 2,617 | 1,202 | 3,560 | 7,164 | - | 15,097 | 15,097 |
| Unused overdraft | - | 44,923 | - | - | - | - | 44,923 | 44,923 |
| Undrawn loan commitments | - | 43,406 | 9,455 | 1,240 | - | - | 54,101 | 54,101 |
| **Off-balance sheet items** | 554 | 90,946 | 10,657 | 4,800 | 7,164 | - | 114,121 | 114,121 |
| **Net contractual cash flow** | (311,990) | 61,071 | 38,003 | 95,601 | 444,895 | 34,063 | 361,643 | 66,873 |

**Net Stable Funding Ratio**

The Net Stable Funding Ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per the definition of the Central Bank of Iceland rules No. 1032/2014. In general, RSF is determined by applying different weights to different asset classes depending on the level of liquidity. ASF however is calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness. The NSFR for foreign currency shall exceed 100%.

The NSFR calculations are based solely on figures for the parent company. The Bank's subsidiaries have a negligible impact on the funding ratio. When calculating the ratio for foreign currencies, a negative foreign currency balance is subtracted from the numerator and a positive balance is subtracted from the denominator. The foreign currency balance used is different from the one in this Consolidated Financial Statement due to the sub-consolidation applied.

| 30.6.2020 | ISK | Foreign currency | Total |
|---|---|---|---|
| Available stable funding | 672,130 | 188,618 | 860,748 |
| Required stable funding | 568,022 | 134,212 | 702,234 |
| Foreign currency balance | | (2,502) | |
| **Net stable funding ratio** | 118% | 139% | 123% |

| 31.12.2019 | | | |
|---|---|---|---|
| Available stable funding | 640,719 | 182,728 | 823,447 |
| Required stable funding | 566,797 | 141,533 | 708,330 |
| Foreign currency balance | | (4,122) | |
| **Net stable funding ratio** | 113% | 126% | 116% |

Amounts are in ISK millions

## 44. Liquidity and Funding risk, continued

**Liquidity coverage ratio**

The Liquidity Coverage Ratio (LCR) is one of the standards introduced in the Basel III Accord. 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 precisely, 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, traded on an active market and not issued by the Group or related entities.

The Bank complies with the Central Bank of Iceland's liquidity rules No. 266/2017, which effectively adopt the liquidity rules of the EU Capital Requirements Regulation (CRR). The Bank is required to maintain a 100% minimum LCR ratio for both the aggregate position in all foreign currencies and all currencies.

The following table shows the breakdown for the Group's LCR calculations. The ratio at 30 June 2020 is based on consolidated figures for the Bank and Valitor Holding hf. The ratio at 31 December 2019 is based on consolidated figures for the Bank and Valitor Holding hf.

| 30.6.2020 | ISK | Foreign currency | Total |
|---|---|---|---|
| Liquid assets level 1 * | 139,283 | 63,388 | 202,671 |
| Liquid assets level 2 | 242 | - | 242 |
| **Liquid assets** | 139,525 | 63,388 | 202,913 |
| Deposits | 102,938 | 32,569 | 135,507 |
| Borrowings | 283 | 10,878 | 11,161 |
| Other cash outflows | 7,120 | 10,757 | 14,425 |
| **Cash outflows** | 110,341 | 54,204 | 161,093 |
| Short-term deposits with other banks ** | 1,278 | 27,499 | 28,777 |
| Other cash inflows | 17,432 | 16,525 | 33,957 |
| **Cash inflows** | 18,710 | 44,024 | 62,734 |
| **Liquidity coverage ratio (LCR) ***** | 152% | 468% | 206% |

| 31.12.2019 | ISK | Foreign currency | Total |
|---|---|---|---|
| Liquid assets level 1 * | 107,918 | 28,973 | 136,891 |
| Liquid assets level 2 | 291 | - | 291 |
| **Liquid assets** | 108,209 | 28,973 | 137,182 |
| Deposits | 89,609 | 23,655 | 113,264 |
| Borrowings | 2,081 | 10 | 2,091 |
| Other cash outflows | 7,479 | 11,082 | 18,561 |
| **Cash outflows** | 99,169 | 34,747 | 133,916 |
| Short-term deposits with other banks ** | - | 18,185 | 18,185 |
| Other cash inflows | 30,743 | 9,201 | 39,944 |
| **Cash inflows** | 30,743 | 27,386 | 58,129 |
| **Liquidity coverage ratio (LCR) ***** | 158% | 334% | 188% |

* Level 1 assets include the Group's cash and balances with the Central Bank, domestic bonds eligible as collateral at the Central Bank and foreign government bonds which receive 100% weight. Under Rules No. 266/2017 the Group's foreign covered bonds also classify as Level 1 assets and receive 93% weight.

** Short-term deposits with other banks are defined as cash inflows in LCR calculations.

*** LCR is defined as: LCR = Weighted liquid assets / (weighted cash outflows - weighted cash inflows) where weighted cash inflows are capped at 75% of weighted cash outflows.

Amounts are in ISK millions

## 44. Liquidity and Funding risk, continued

*Composition of liquid assets*

The following table shows the composition of the Group's liquidity buffer.

| 30.6.2020 | ISK | USD | EUR | Other | Total |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | 101,597 | 431 | 726 | 678 | 103,432 |
| Short-term deposits in other banks | 1,278 | 8,352 | 12,601 | 6,546 | 28,777 |
| Domestic bonds eligible as collateral at the Central Bank | 38,153 | - | - | - | 38,153 |
| Foreign government bonds | - | 34,546 | 24,134 | 2,869 | 61,549 |
| **Liquidity reserve** | 141,028 | 43,329 | 37,461 | 10,093 | 231,911 |

| 31.12.2019 | ISK | USD | EUR | Other | Total |
|---|---|---|---|---|---|
| Cash and balances with Central Bank | 103,726 | 286 | 534 | 534 | 105,080 |
| Short-term deposits in other banks | - | 5,410 | 5,771 | 7,004 | 18,185 |
| Domestic bonds eligible as collateral at the Central Bank | 11,878 | - | - | - | 11,878 |
| Foreign government bonds | - | 13,930 | 12,234 | 1,373 | 27,537 |
| **Liquidity reserve** | 115,604 | 19,626 | 18,539 | 8,911 | 162,680 |

*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 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.

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

| *LCR categorization - amounts and LCR outflow weights* | Deposits maturing within 30 days | | | | | |
|---|---|---|---|---|---|---|
| 30.6.2020 | Less Stable | Weight % | Stable | Weight % | Term deposits* | Total deposits |
| Individuals | 138,184 | 11% | 58,108 | 5% | 73,491 | 269,783 |
| Small and medium enterprises | 56,399 | 11% | 5,609 | 5% | 5,944 | 67,952 |
| Operational relationship | - | 25% | - | 5% | 2,035 | 2,035 |
| Corporations | 67,403 | 40% | 952 | 20% | 7,928 | 76,283 |
| Sovereigns, central banks and PSE | 36,942 | 40% | - | - | 10,930 | 47,872 |
| Pension funds | 46,808 | 100% | - | - | 15,471 | 62,279 |
| Domestic financial entities | 15,983 | 100% | - | - | 18,603 | 34,586 |
| Foreign financial entities | 2,726 | 100% | - | - | - | 2,726 |
| **Total** | 364,445 | | 64,669 | | 134,402 | 563,516 |

| 31.12.2019 | Less Stable | Weight % | Stable | Weight % | Term deposits* | Total deposits |
|---|---|---|---|---|---|---|
| Individuals | 130,942 | 10% | 52,735 | 5% | 74,580 | 258,257 |
| Small and medium enterprises | 50,339 | 10% | 4,998 | 5% | 6,156 | 61,493 |
| Corporations | 56,694 | 40% | 829 | 20% | 7,170 | 64,693 |
| Sovereigns, central banks and PSE | 13,501 | 40% | - | - | 716 | 14,217 |
| Pension funds | 34,024 | 100% | - | - | 16,431 | 50,455 |
| Domestic financial entities | 20,857 | 100% | - | - | 27,051 | 47,908 |
| Foreign financial entities | 1,877 | 100% | - | - | - | 1,877 |
| **Total** | 308,234 | | 58,562 | | 132,104 | 498,900 |

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

Amounts are in ISK millions

## 45. Capital management

**Capital adequacy**

The focus of capital management at the Group is to normalize the capital structure in the medium term and consequently maintain the Group's capitalization comfortably above the regulatory requirement, including capital buffers and Pillar 2 requirements.

The Group's capital ratios are calculated in accordance with the Icelandic Financial Undertakings Act No. 161/2002 and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR). On 1 January 2020, CRR was incorporated into the EEA Agreement, effectively introducing the SME supporting factor for capital adequacy for Icelandic institutions, which was previously excluded. The Group applies the standardized approach to calculate capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

The Group's consolidated situation as stipulated in CRR is the Group's accounting consolidation excluding insurance subsidiaries. The capital position and solvency requirements of Vördur tryggingar hf. should be viewed independently from capital adequacy for the Group's consolidated situation.

On 4 May 2020 the Icelandic Ministry of Finance ratified Regulation (EU) 2017/2395 into Icelandic law. The regulation introduces transitional arrangements for IFRS9 to allow the regulatory capital impact of expected credit loss to be phased in over time. These arrangements have been available to European banks since 2017. Institutions that elect to make use of these transitional arrangements can in 2020 add back CET1 equivalent to up to 70% of provisions incurred from the application of IFRS9. The Bank has opted to make use of the transitional arrangements, thus reflected in the Group's capital ratios as of 30 June 2020. The transitional arrangements increase the capital adequacy ratio by 0.2 percentage points.

Valitor Holding hf. is classified as held for sale in these Consolidated Interim Financial Statements. This does not affect the Group's capital adequacy calculations. For disclosure, assuming a cash sale of the subsidiary at book value, the Group's capital adequacy ratio would increase from 28.1% to 29.3%. The sale of Valitor would result in reduction in the Group's regulatory own funds adjustments, with positive effect on capital adequacy.

| *Own funds* | 30.6.2020 | 31.12.2019 |
|---|---|---|
| Total equity | 188,827 | 189,825 |
| Deductions related to the consolidated situation | (10,823) | (10,159) |
| Non-controlling interest not eligible for inclusion in CET1 capital | (171) | (181) |
| **Common Equity Tier 1 capital before regulatory adjustments** | 177,833 | 179,485 |
| Intangible assets | (11,371) | (10,604) |
| Tax assets | (310) | (296) |
| Cash flow hedges | (3,110) | (1,616) |
| Additional value adjustments | (204) | (125) |
| Foreseeable dividend * | - | (14,153) |
| Adjustment under IFRS 9 transitional arrangements | 1,550 | - |
| **Common equity Tier 1 capital** | 164,388 | 152,691 |
| Non-controlling interest not eligible for inclusion in CET1 capital | 171 | 181 |
| Additional Tier 1 capital | 14,705 | - |
| **Tier 1 capital** | 179,264 | 152,872 |
| Tier 2 capital | 21,789 | 20,083 |
| **Total own funds** | 201,053 | 172,955 |
| *Risk-weighted exposure amount (REA)* | | |
| Credit risk, loans | 557,208 | 561,602 |
| Credit risk, securities and other | 51,286 | 49,163 |
| Counterparty credit risk | 4,169 | 3,347 |
| Market risk due to currency imbalance | 3,119 | 10,070 |
| Market risk, other | 15,207 | 10,609 |
| Credit valuation adjustment | 1,874 | 1,477 |
| Operational risk | 83,487 | 83,487 |
| **Total risk-weighted exposure amount** | 716,350 | 719,755 |
| *Capital ratios* | | |
| CET1 ratio | 22.9% | 21.2% |
| Tier 1 ratio | 25.0% | 21.2% |
| Capital adequacy ratio | 28.1% | 24.0% |

* On 31 December 2019, the foreseeable dividend was the aggregation of the Bank's planned equity reduction in Q1 2020 through dividend distribution and buy-back of own shares. Due to the Covid-19 crisis, the plan was halted and no dividend is to be paid for the fiscal year 2019 according to an approval at the extended annual general meeting on May 14 2020. As a result, the own funds deduction is rescinded on 30 June 2020.

Amounts are in ISK millions

## 45. Capital management, continued

| *Capital ratios of the parent company* | 30.6.2020 | 31.12.2019 |
|---|---|---|
| CET1 ratio | 25.2% | 23.5% |
| Tier 1 ratio | 27.2% | 23.5% |
| Capital adequacy ratio | 30.2% | 26.2% |

The following table outlines the implementation of the capital buffer requirements in accordance with the Icelandic Financial Undertakings Act No. 161/2002, as prescribed by the Financial Stability Council (FSC) and approved by the FSA.

| *Capital buffer requirement, % of REA* | 18.3.2020 | 1.2.2020 | 31.12.2019 |
|---|---|---|---|
| Capital conservation buffer | 2.50% | 2.50% | 2.50% |
| Capital buffer for systematically important institutions | 2.00% | 2.00% | 2.00% |
| Systemic risk buffer * | 3.00% | 3.00% | 3.00% |
| Countercyclical capital buffer * | - | 2.00% | 1.75% |
| **Combined capital buffer requirement** | 7.50% | 9.50% | 9.25% |

The Bank carries out an ongoing process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Group has in place sufficient risk management processes and systems to identify, manage and measure the Group'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 with its risk profile. The FSA supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole following the Supervisory Review and Evaluation Process (SREP). The Group's own funds exceeds the FSA's SREP requirements.

The Bank's Pillar 2R capital add-on, which is the result of the ICAAP/SREP, may comprise 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital.

*Capital requirement, % of REA*

| 30.6.2020 | CET1 | Tier 1 | Total |
|---|---|---|---|
| Pillar 1 capital requirement | 4.5% | 6.0% | 8.0% |
| Pillar 2R capital requirement ** | 1.7% | 2.3% | 3.1% |
| Combined buffer requirement * | 7.3% | 7.3% | 7.3% |
| **Regulatory capital requirement** | 13.6% | 15.6% | 18.4% |
| Available capital | 22.9% | 25.0% | 28.1% |

* The Icelandic buffer value shown. In the combined buffer requirement, the effective countercyclical capital buffer is determined by calculating the weighted average of the corresponding buffer levels of each country, the weights being the total risk-weighted exposures for credit risk against counterparties residing in those countries. The systemic risk buffer only applies to domestic exposures and is calculated using the same weighting method.

** The SREP result based on the Group's Financial Statement at 31.12.2018. The Pillar 2 requirement is 3.1% of risk-weighted assets based on the Group's prudential consolidation under CRR, which excludes Vördur tryggingar hf.

*Leverage ratio*

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The ratio is calculated on the basis of the Group's consolidated situation as per the CRR, which excludes the Group's insurance subsidiaries. The minimum leverage ratio requirement is 3% as stated in the Icelandic Financial Undertakings Act No. 161/2002.

| | 30.6.2020 | 31.12.2019 |
|---|---|---|
| On-balance sheet exposures | 1,130,553 | 1,022,521 |
| Derivative exposures | 12,153 | 10,217 |
| Securities financing transaction exposures | 525 | 577 |
| Off-balance sheet exposures | 62,666 | 52,299 |
| **Total exposure** | 1,205,897 | 1,085,614 |
| **Tier 1 capital** | 179,264 | 152,872 |
| Leverage ratio | 14.9% | 14.1% |

Amounts are in ISK millions

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