Íslandsbanki hf.

CONSOLIDATED INTERIM FINANCIAL STATEMENTS 1H18

First half 2018 financial highlights

- Profit after tax was ISK 7.1bn (1H17: ISK 8.0bn) generating an 8.2% annualised return on equity (1H17: 9.2%).
- Earnings from regular operations were ISK 6.8bn (1H17: ISK 7.4bn) with 9.9% annualised return on equity from regular operations normalised for 15% CET1 (1H17: 11.2%).
- Net interest income was ISK 15.3bn (1H17: ISK 15.2bn) and net interest margin was 2.8% (1H17: 2.9%).
- Net fee and commission income was ISK 5.8bn (1H17: ISK 6.8bn), down by 15% from the same time last year mostly due to lower activity levels from two of the Bank's fee-generating subsidiaries.
- Net impairment on financial assets generated a gain of ISK 1.9bn in 1H18, compared to ISK 0.4bn gain in 1H17.
- Administrative costs grew by roughly 3% between years and totalled ISK 13.7bn (1H17: ISK 13.2bn), mainly due to increases in negotiated salary agreements and costs related to new core banking system.
- Loans to customers grew by 5.9% (ISK 44.8bn) to a total of ISK 800bn at the end of June. Total new lending amounted to ISK 98.5bn, split across lending divisions while deposits from customers grew by 2.0% (ISK 11.4bn) to ISK 578bn at the end of June.
- Liquidity and capital positions continue to be strong and to exceed all internal and external requirements.

Second quarter 2018 financial highlights

- Profit after tax was ISK 5bn, same as for 2Q17, generating an 11.6% annualised return on equity (2Q17: 11.3%).
- Earnings from regular operations were ISK 4bn, same as for 2Q17 and annualised return on equity for regular operations normalised for 15% CET1 was 11.6% (2Q17: 11.8%).
- Net interest income amounted to ISK 7.6bn (2Q17: ISK 7.8bn) with 2.8% net interest margin (2Q17: 3%).
- Net fee and commission income was ISK 3bn (2Q17: ISK 3.5bn).

First half 2018 key figures and ratios

		1H18	1H17	2Q18	2Q17	2017
PROFITABILITY	ROE 15% CET1 (regular operations)[1]	**9.9%**	11.2%	**11.6%**	11.8%	10.3%
	ROE (after tax)	**8.2%**	9.2%	**11.6%**	11.3%	7.5%
	Net interest margin (of total assets)	**2.8%**	2.9%	**2.8%**	3.0%	2.9%
	Cost to income ratio[2]	**67.3%**	59.2%	**65.0%**	58.3%	62.5%
	After tax profit, ISK m	**7,130**	8,041	**5,033**	4,997	13,226
	Earnings from regular operations, ISK m[3]	**6,843**	7,365	**3,961**	3,860	13,848

		30.6.2018	31.3.2018	31.12.2017
CAPITAL	Total equity, ISK m	**172,182**	166,337	181,045
	Tier 1 capital ratio	**20.5%**	20.3%	22.6%
	Total capital ratio	**21.6%**	21.4%	24.1%
	Leverage ratio	**14.5%**	14.3%	16.2%
BALANCE SHEET	Total assets, ISK m	**1,111,742**	1,088,308	1,035,822
	Risk exposure amount, ISK m	**819,349**	795,923	775,492
	Loans to customers, ISK m	**799,938**	776,149	755,175
	Total deposits, ISK m	**593,805**	588,759	578,218
	Total deposit / loan ratio	**69.1%**	71.5%	74.0%

1. Return from regular operations on normalised CET1 of 15%, adjusted for risk free interest on excess capital. From January 2018 the definition of regular operations has been revised to include profit from discontinued operations as the Bank has successfully divested most non-core business related assets.
2. Calculated as (Administrative expenses + Contribution to the Depositors' and Investors' Guarantee Fund – One off items) / (Total operating income – one off items).
3. Earnings from regular operations is defined as earnings excluding one-off items e.g. bank tax, one-off costs due to headquarters.

First half 2018 operational highlights

- Continued digital solution development to meet customer preferences. For example, as of end June 2018, 6500 overdraft applications in the Íslandsbanki app for over ISK 2.2bn were automatically approved.
- Upgrade to new core banking system nearly completed with “go live” set for third quarter.
- Active investment bank operations, with the Bank spearheading syndicate loans and issuing large corporate bonds.
- In April, the Center of Corporate Governance recognised Íslandsbanki again for good corporate governance.
- Euromoney named Íslandsbanki Iceland’s best bank for 2018 in July.
- S&P Global Ratings (S&P) affirmed Íslandsbanki's rating of BBB+/A2 with a stable outlook in July.

Birna Einarsdóttir, CEO of Íslandsbanki

Íslandsbanki’s results for the first half of the year exceeded expectations with the Bank delivering a net profit of ISK 7.1bn and an annualised ROE of 8.2%. The parent company continued to deliver stable fee and commission income while favourable conditions in the economy led to positive impairments of the loan portfolio which continues to be robust compared to domestic and international standards.

Investment banking operations were active during the period with the Bank’s seafood team leading an EUR 190m syndicate loan consortium for HB Grandi and the brokerage and corporate finance units teaming up for several large bond issuances for some corporate customers including HS Veitur, Byggðastofnun, Eik Fasteignafélag and Garðabær.

Customers have been pleased with the Bank’s digital solutions, with over 90% now preferring to use the Íslandsbanki online website or apps for their day-to-day bank operations. The Bank introduced several new digital services during the first half of the year, including the option to split credit card payments and an online mortgage loan assessment.

The Bank issued several reports during the period and in July, Euromoney selected Íslandsbanki as Iceland’s best bank in 2018 which is the fifth time that the Bank receives the award. Ahead of us is the Íslandsbanki Reykjavík Marathon on 18 August, which is Iceland’s biggest charity event with last year’s pledges amounting to ISK 118m. We encourage everyone to participate and give pledges for a good cause.

INCOME STATEMENT

ISK m	**1H18**	1H17	Δ	**2Q18**	2Q17	Δ
Net interest income	**15.342**	15.211	131	**7.602**	7.814	(212)
Net fee and commission income	**5.810**	6.813	(1.003)	**3.032**	3.543	(511)
Net financial income	**95**	109	(14)	**378**	97	(281)
Net foreign exchange gain	**(67)**	370	(437)	**(57)**	169	(226)
Other operating income	**1.600**	215	1.385	**1.587**	55	1.532
Total operating income	**22.780**	22.718	62	**12.542**	11.678	864
Salaries and related expenses	**(7.952)**	(7.768)	(184)	**(4.026)**	(4.109)	83
Other operating expenses	**(5.770)**	(5.498)	(272)	**(2.846)**	(2.739)	(107)
Administrative expenses	**(13.722)**	(13.266)	(456)	**(6.872)**	(6.848)	(24)
Depositors' and Investors' Guarantee Fund	**(579)**	(515)	(64)	**(287)**	(262)	(25)
Bank tax	**(1.597)**	(1.472)	(125)	**(812)**	(752)	(60)
Total operating expenses	**(15.898)**	(15.253)	(645)	**(7.971)**	(7.862)	(109)
Profit before net impairment on financial assets	**6.882**	7.465	(583)	**4.571**	3.816	755
Net impairment on financial assets	**1.934**	440	1.494	**1.846**	200	1.646
Profit before tax	**8.816**	7.905	911	**6.417**	4.016	2.401
Income tax expense	**(2.480)**	(2.263)	(217)	**(1.465)**	(1.133)	(332)
Profit for the period from continuing operations	**6.336**	5.642	694	**4.952**	2.883	2.069
Profit from discontinued operations net of income tax	**794**	2.399	(1.605)	**81**	2.114	(2.033)
Profit for the period	**7.130**	8.041	(911)	**5.033**	4.997	36

Income slightly up compared to first half of 2017

Total income amounted to ISK 22.8bn in 1H18, a marginal increase between years.

Net interest income totalled ISK 15.3bn, an increase of 0.9% from the previous year. The net interest margin was 2.8%, 10 basis points below 1H17. The net interest margin is expected to be slightly below 3.0% in the near to medium term.

Net fee and commission income amounted to ISK 5.8bn, compared to ISK 6.8bn in 1H17. Overall net fee income showed a 15% decline year on year, principally due to lower activity levels from two of the Bank's fee generating subsidiaries.

Core income (net interest income and net fee and commission income) contributed 93% to the Bank's total operating income during the first half of 2018. The Bank remains focused on strong core earnings and stable long-term income.

The Bank recorded a net financial income of ISK 95m in 1H18, compared to a gain of ISK 109m in 1H17. The gains derive largely from income through mark-to-market of derivative hedges. The Bank also realised a net foreign exchange loss of ISK 67m in 1H18, compared with profit of ISK 370m in 1H17.

Other operating income totalled ISK 1.6bn in 1H18, as opposed to ISK 215m in 1H17. The gain in the second quarter 2018 derives from the sale of a subsidiary, which owned land.

Administrative expenses, excluding one-off expenses, are at comparable levels to previous year

Administrative expenses grew by ISK 0.5bn year-on-year or 3.4% but when adjusted for inflation, the increase is 0.8%. This can be explained by various factors, such as wage increases coming through the collective wage agreements at the beginning of May and costs related to the implementation of a new core banking system.

The average number of full-time equivalent positions (FTE) in 1H18 was 868 for the parent company (926 in 1H17) and 1,052 (1,103 in 1H17) for the Group. The number of FTE's at the close of the period excluding summer employees was 826 (874 at June 2017) in the parent company and 1,013 (1,071 at June 2017) for the Group.

The cost-to-income (C/I) ratio in 1H18 was 67.3%, compared with 59.2% in 1H17, which is above the Bank's long-term target of 55%. The C/I ratio excludes the bank tax and other one-off cost items. The C/I in the parent company was 57.6% in 1H18.

The after-tax profit from discontinued operations was ISK 0.8bn in 1H18, compared with ISK 2.4bn in 1H17. The profit derives from the sale of the Bank's assets and income from foreclosed assets. The 2.4bn gain in 2017 stems mostly from gain realised from disposal of assets within subsidiaries in 2Q17.

Net impairment on financial assets

Net impairment on financial assets generated a gain of ISK 1.9bn in 1H18, compared to ISK 0.4bn gain in 1H17, mostly deriving from the lifting of the Bank's provisions in relation to foreign currency-based loans. Other changes in net impairment on financial assets are results of normal business operations, including net remeasurement of loss allowance.

Taxes and levies continue to affect profitability

The tax on the profit for the period amounted to ISK 2.5bn, compared to ISK 2.3bn in 1H17. The effective tax rate was 28.1%, compared to 28.6% in 1H17, when there was a larger amount of non-taxable income. The bank tax accounted for ISK 1.6bn in 1H18, compared with ISK 1.5bn in 1H17. The bank tax increased significantly in 2013 as a temporary measure, but the government has recently announced that its long-term plans to gradually decrease the tax from 0.376% to 0.145% during the 2018-2023 period. In addition, the Bank is subject to the special financial tax of 6% on taxable profits in excess of ISK 1bn and makes contributions to the Debtors' and Investors' Guarantee Fund, the Financial Supervisory Authority, and the Office of the Debtors' Ombudsman. The contribution to the Depositors' and Investors' Guarantee Fund, was at ISK 0.6bn, marginally higher than previous year. Total taxes and levies amounted to ISK 5.3bn in 1H18, compared to ISK 4.9bn in 1H17.

Standard international NPL measurement not yet available since adoption of IFRS 9

Following the implementation of IFRS 9, a new standard measure for non-performing loans (NPL's) has not been fully established at the international level. It is therefore currently difficult to compare the quality of the Bank's loan book to other banks and to analyse historical development. However, the European Banking Authority (EBA) has published a measure of NPL's as the ratio of the gross carrying amount of loans and advances in Stage 3 as a proportion of the total gross carrying amount of loans and advances. At the end of the reporting period this ratio was 2.3% for the Group compared to a 3.9% weighted average for European banks at the end of March 2018.

Profitability above the Bank's expectations

Profit after tax was ISK 7.1bn in 1H18 (1H17: ISK 8.0bn) and annualised return on equity (after tax) was 8.2% in 1H18 (1H17: 9.2%) which was above the Bank's expectations. Earnings from regular operations were ISK 6.8bn, (1H17: ISK 7.4bn) and annualised return on equity from regular operations normalised for 15% CET1 was 9.9% in 1H18, compared to 11.2% in 1H17. Regular earnings decreased by ISK 0.6bn between years, mainly due to underperformance from two of the Bank's fee generating subsidiaries.

BALANCE SHEET

Assets – growing balance sheet through continued strong loan growth

The balance sheet grew by 7.3% from year-end 2017, to ISK 1,112bn with loans to customers growing by 5.9%, or ISK 44.8bn. Demand for new credit came from all of the Bank's lending units. Mortgage loans rose by ISK 10.4bn from year-end 2017. New lending amounted to ISK 98.5bn in 1H18, as opposed to ISK 107.7bn in the previous year, a decrease of 8.6%. Outstanding loans to the tourism industry in Iceland are 13% of the loan portfolio which is well diversified, unchanged from year-end 2017.

Loans are generally well covered by stable collateral, majority in residential and commercial real estate while the second most important collateral type is fishing vessels. The weighted average loan-to-value (LTV) ratio for the residential mortgage portfolio was 60.8% at end June 2018 compared to 63.2% at end March 2018. The Bank's asset encumbrance ratio was 16.5% at June 2018 compared to 15.8% at March 2018.

Liquidity levels remained very strong during the quarter, benefitting among others from reduced concentration in the deposit base. Three items – cash and balances with the Central Bank, bonds and debt instruments, and loans to credit institutions – amount to about ISK 275bn, some ISK 244bn of which are liquid assets.

ISK m	30.6.2018	31.3.2018	31.12.2017
Cash and balances w ith CB	**166.194**	177.029	189.045
Bonds and debt instruments	**48.603**	49.140	27.090
Shares and equity instruments	**13.581**	10.208	10.177
Derivatives	**3.209**	4.673	2.896
Loans to credit institutions	**59.858**	47.220	26.617
Loans to customers	**799.938**	776.149	755.175
Investment in associates	**614**	672	704
Property and equipment	**5.058**	7.025	7.128
Intangible assets	**4.774**	4.412	4.231
Other assets	**8.512**	10.732	9.993
Non-current assets held for sale	**1.401**	1.048	2.766
Total assets	**1.111.742**	1.088.308	1.035.822

Liabilities – diversified funding strategy

Total liabilities amount to ISK 940bn, an increase of 9.9% from year-end 2017. The Bank maintained strong liquidity levels into 2018, and all regulatory and internal metrics were well above the set limits. At June 2018, the Bank's liquidity coverage ratio (LCR) was 154% for the Group. The net stable funding ratio (NSFR) in foreign currency was 147% and the total NSFR was 117% for the Group.

Total deposits increased by 2.7% from year-end 2017, to ISK 594bn. Deposits are still the Bank's main source of funding, and concentration levels are monitored closely. The increase was due mainly to a rise in pension fund positions and from SMEs and individuals. The ratio of customer deposits to customer loans lowered to 72.3% at June 2018, compared to 74.1% at March 2018. The deposit-to-loan ratio was 69.1% at end June 2018 compared to 71.5% at March 2018.

ISK m	30.6.2018	31.3.2018	31.12.2017	Δ
Deposits from CB and credit inst.	**15.391**	13.563	11.189	2.374
Deposits from customers	**578.414**	575.196	567.029	8.167
Derivatives and short positions	**7.075**	8.104	5.492	2.612
Debt issued and other borrow ed funds	**288.360**	269.255	217.748	51.507
Subordinated loans	**8.872**	8.838	9.505	(667)
Tax liabilities	**8.925**	7.908	7.787	121
Other liabilities	**32.447**	39.028	35.947	3.081
Non-current liabilities held for sale	**76**	79	80	(1)
Total liabilities	**939.560**	921.971	854.777	67.194
Total equity	**172.182**	166.337	181.045	(14.708)
Total liabilities and equity	**1.111.742**	1.088.308	1.035.822	52.486

The Bank's debt issuance continued to be successful in the first half of 2018, primarily through its Global Medium-Term Notes (GMTN) and covered bond programmes, with an eye to mitigate risk through diversification of funding. Apart from deposits, the main domestic funding vehicles were covered bonds and short-term unsecured bonds. Market access for covered bonds remains solid, with issuance of ISK 13.0bn in the first half of 2018, reinforcing the Bank's position as Iceland's largest covered bond issuer.

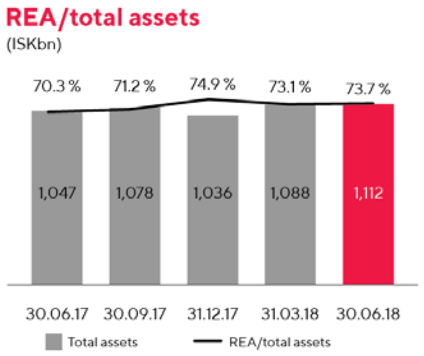
In January 2018, Íslandsbanki issued a EUR 300m 6NC5 1.125% fixed rate senior unsecured bond, at a spread of 75 basis points over 5-year mid-swaps. The issue was more than four times oversubscribed, with total demand for the transaction amounting to EUR 1,255m from 121 investors. The bonds were sold to a diversified spectrum of investors, including in the UK, continental Europe, Scandinavia and Asia. This issue, the longest-dated and most tightly-priced benchmark bond from an Icelandic financial institution since 2008, was a significant achievement for the Bank. In January 2018 the Bank issued three private placements, each SEK 100. In April, the Bank issued a SEK 1 billion 4NC3 Floating Rate Note senior unsecured bond, at a spread of 80 basis points over 3-month STIBOR. The transaction was sold to a wide range of investors across the Nordic region and the bond was listed on the Irish Stock Exchange in April 2018. In late June 2018, the Bank issued two private placements, a SEK 300m and a SEK 350m.

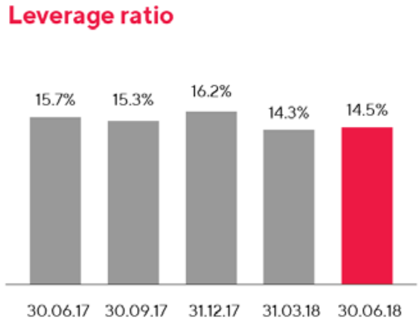
Equity

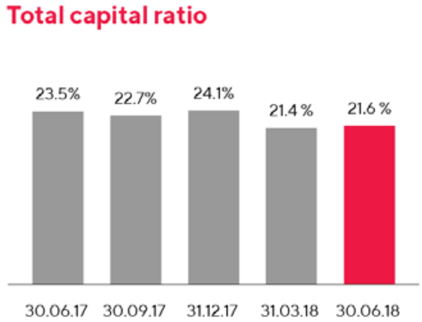
Total equity amounted to ISK 172bn at June 2018, compared to ISK 181bn at the end of 2017. Of that total, ISK 2.4bn is attributable to non-controlling interests. The nominal value of the Bank's authorised share capital was ISK 10bn at the end of the quarter, and total share capital amounted to ISK 65bn.

At the end of June, the Bank's total capital ratio was 21.6%, compared to 21.4% at March 2018, slightly above its target range of 20.3-21.3%. The Bank's Tier 1 ratio was 20.5% at June 2018, compared to 20.3% at March 2018. The Icelandic Financial Supervisory Authority (FME) sets the minimum requirement for total capital at 19.8%.

The Bank has introduced a new long-term capital target, which is based on its internal capital adequacy assessment (ICAAP) and the supervisory review and evaluation process (SREP). The target assumes that the Bank will maintain a capital management buffer of 0.5%-1.5% in excess of the SREP results to ensure that short-term fluctuations do not bring the ratio below the regulatory minimum. The capital target supports the Bank's business strategy and takes into account changes or uncertainties in the operating environment. It can change over time, reflecting changes in the Bank's risk profile, business strategy, and external environment. It is worth noting that the Financial Stability Board has recommended that FME increases the countercyclical capital buffer from 1.25% to 1.75%, which will be effective in May 2019.







Íslandsbanki uses the standardised method to calculate its risk exposure amount (REA), which amounted to ISK 819.3bn at June 2018, or 73.7% of total assets, an increase of 2.9% from March 2018. The leverage ratio was 14.5% at end June compared to 14.3% at March 2018, indicating low leverage.

Ratings

Íslandsbanki is the only bank in Iceland with credit ratings from two international rating agencies, Fitch Ratings and S&P Global Ratings (S&P).

Fitch Ratings upgraded the Bank to BBB/F3 in January 2017, with a stable outlook, and affirmed the ratings in December 2017.

In June 2018 S&P affirmed Iceland's A sovereign rating in recognition of its continued progress towards capital account liberalisation and its declining debt levels.

In October 2017, S&P upgraded Íslandsbanki's credit ratings to BBB+/A-2 with a stable outlook and affirmed the ratings in July 2018.

INVESTOR RELATIONS

Investor call in English at 9.30 am (GMT)

Today, 2 August, the Bank will host an investor call in English to present the financial results at 9.30 am (GMT). The call will start with a short macro update on the Icelandic economy, followed by a review of the financial results and Q&A.

Please register by replying to: ir@islandsbanki.is. Dial-in details and presentation will be sent out prior to the call.

Market participants meeting in Icelandic at 10.30 am (GMT)

A meeting with market participants in Icelandic will take place at Íslandsbanki headquarters, Hagasmári 3, 201 Kópavogur, 9 floor at 10.30 am (GMT) on 2 August.

Registration to the meeting is required for participation. Please register here

Financial calendar

Íslandsbanki plans to publish its interim and annual financial statements according to the below financial calendar:

- Q3 2018 results – 8 November 2018
- Q4 2018 and year-end results – 14 February 2019
- Annual General Meeting – 21 March 2019

Please note that the dates are subject to change.

Additional investor material

All presentation material will subsequently be available and archived on the Bank's investor relations website where other material is also available: https://www.islandsbanki.is/english/investor-relations/

Financial calendar and silent periods

Information on Íslandsbanki's financial calendar and silent periods can be found on the IR website