Arion Bank

Consolidated Financial Statements 2018

Contents

Arion Bank in brief

2018

3.7%

Return on equity

60.3%

Cost-to-income

21.2%

CET 1

Rating from S&P

Long term: BBB+

Short term: A-2

Outlook: Stable

Equal Pay Certification

iMARK

Marketing company of the year

Arion Bank

- Arion Bank is a leading franchise in financial services in Iceland. Arion Bank is a universal relationship bank which provides a full range of financial services
- Strong economic environment in Iceland with 5.0% GDP growth (9M 2018), 2.4% unemployment (Q4 2018) and 3.4% inflation (January 2019)
- Strong balance sheet with equal split between retail and corporate loans, high capital ratios and improved asset quality
- The Bank was named bank of the year in Iceland for 2017 by Euromoney and the best investment bank in Iceland by Global Finance in 2018
- Arion Bank is the leading bank in digital solutions on the Icelandic market

First bank listed on main list in Iceland and first dual listing on Nasdaq Nordic for more than a decade

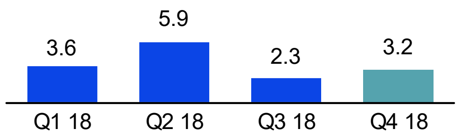
Key figures

(ISK million)

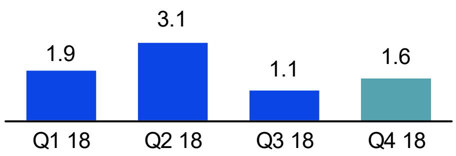
	2018	2017
Net earnings	7,777	14,419
ROE	3.7%	6.6%
Net interest margin	2.8%	2.9%
Cost to income ratio	56.9%	48.9%
	31.12.2018	**31.12.2017**
Total assets	1,164,327	1,147,754
Loans to customers	833,826	765,101
Deposits	466,067	462,161
Borrow ings	417,782	384,998
Stage 3 gross	2.6%	3.5%
Leverage ratio	14.2%	15.4%
Number of employees	904	949
EUR/ISK	133.23	125.05

Winner of three international awards for digital solutions and development

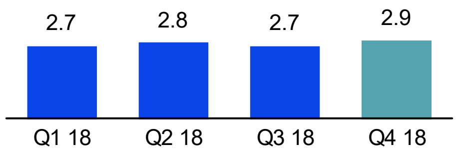
Return on equity (%)



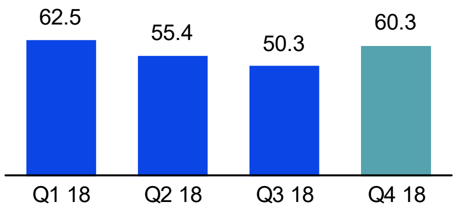
Net earnings (ISK billion)



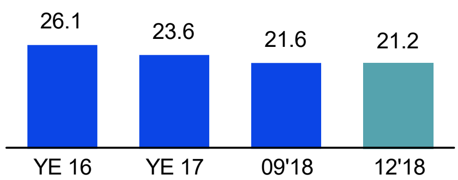
Net interest margin (%)



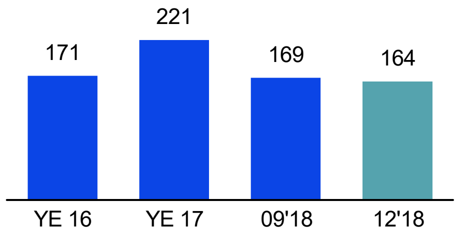
Cost-to-income ratio (%)



CET 1 ratio (%)



LCR ratio (%)



Endorsement and statement
by the Board of Directors and the CEO

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2018 include the Consolidated Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Economic environment

The Icelandic economy was robust in 2018, as evident by 5% GDP growth in the first nine months of the year. The composition of growth has been relatively favorable, with foreign trade making a positive contribution to growth and by so compensating for slower investment growth. Private consumption is, however, still the main driving force, but growth is slowing down. Despite strong growth in the first nine months evidence suggest that growth will slow down in the coming months. Difficulties in airline operations are expected to affect tourism, potentially causing a small decrease in the number of tourist arrivals. Furthermore, payment card turnover indicates slower private consumption growth. Regular business investment decreased in Q3, which is one of the clearest signs that the economy has started to slow down. Inflation is still low in a historical context but is currently above the Central Bank of Iceland's 2.5% inflation target. It is likely that inflationary pressures will continue to pick up, with a weaker króna and challenging general wage negotiations taking place. Arion Research predicts that there is modest GDP growth ahead coupled with a narrowing of the output gap, rising but relatively low unemployment and a rise in inflation in the coming months.

About Arion Bank

Arion Bank is a leading, well balanced, universal relationship bank operating in the Icelandic financial market. The Bank has been listed on Nasdaq Iceland and Nasdaq Stockholm since June 2018. The Bank has a moderate risk profile and enjoys a strong position in all its business segments: Retail Banking, Corporate Banking, Asset Management and Investment Banking. The Bank's core subsidiaries further supplement its service offering. Stefnir hf. is Iceland's largest fund management company and Vördur tryggingar hf. is the fourth largest insurance company in Iceland and provides both non-life and life insurance services. Furthermore Valitor Holding hf. (Valitor) is a subsidiary of the Bank and is a market leader in Iceland in acquiring services and payment solutions and also has operations in Scandinavia and the United Kingdom. Decision has been made by the Board to hold Valitor for sale internationally and that process has now started. Valitor is therefore classified as a disposal group held for sale in these Consolidated Financial Statements at year end.

Arion Bank's balance sheet is strong and the Bank offers its customers universal financial services with the purpose to create value for the future, for customers, shareholders, co-operators and the community. Arion Bank will continue to place emphasis on competitive dividend payments to shareholders.

Arion Bank places great importance on innovation, efficiency and good service in its operations. A key area of focus has been developing digital solutions. The Bank has set itself the goal of being the leading digital bank in Iceland and has retained its leading position in the Icelandic market. Over the last three years the Bank has launched around 20 digital solutions, particularly targeted at retail customers. These solutions have given the Bank a competitive advantage, for example in the mortgage market, where the Bank faces strong competition from pension funds which enjoy a far more beneficial regulatory and tax environment. Arion Bank has been able to maintain its market share by competing on services and dealing swiftly with customer requests. New digital solutions have therefore already had, and will continue to have, a lasting impact on how the Bank meets the needs of its customers. The new solutions will furthermore reduce operating expenses across the Bank in the longer term. The number of branches has been substantially reduced in recent years, mainly in the capital area, housing has been reduced and microbranches established in shopping centers where customers are regular visitors.

Operations during the year

Arion Bank reported earnings of ISK 7,777 million in 2018 and Group equity amounted to ISK 200,859 million at year-end. Return on equity was 3.7% for the full year. The Group's capital ratio, as calculated under the Financial Undertakings Act, was 22.0% and the CET 1 ratio was 21.2%, taking into account the proposed dividend payment following the AGM. These ratios exceed the requirements made by the Financial Supervisory Authority and Icelandic law. The Bank's liquidity position was also strong at year end and well above the regulatory minimum.

The Group’s weaker financial results in 2018 compared to prior year can largely be attributed to the operating difficulties and eventual bankruptcy of Primera Air during the autumn. The Bank made impairments of approximately ISK 3 billion in respect of loans and guarantees in response to this. Investments in the international growth of Valitor also had an impact on the results. Valitor has been expanding its international operation substantially and during this time has been operating at a loss.

Changes to the asset side of the Bank's balance sheet in 2018 were primarily an increase in loans to customers, up 9% in 2018, and a reduction in liquidity as a result of dividends and share buybacks in 2018, which totaled ISK 33.3 billion. On the liabilities side, increased new borrowings, new subordinated borrowing, reduced equity following share buybacks and dividends are the main changes during the year. By re-categorizing the Valitor group as a disposal group held for sale, Valitor's assets are transferred from other categories on the balance sheet, particularly from Loans to credit institutions, Intangible assets and other assets, and are now shown in the line Assets and disposal groups held for sale. On the liabilities side it is primarily Other assets which decrease and Valitor's total liabilities are shown under Liabilities relating to disposal groups held for sale in the balance sheet.

Endorsement and statement
by the Board of Directors and the CEO

In June 2018 Arion Bank was listed on the stock market. Arion Bank shares were admitted to trading on Nasdaq Iceland and Nasdaq Stockholm exchanges following the sale of the 28.7% share of Kaupskil ehf. (a subsidiary of Kaupthing ehf.) in the Bank. The IPO was the culmination of a process that began in 2016 and which required the committed efforts of management and employees and the assistance of Icelandic and international advisors. The IPO was a success and the listing in Stockholm will serve to raise the profile of Iceland and Icelandic investment opportunities among international investors in the future.

In 2018 Arion Bank engaged a team of consultants to help the Bank assess options concerning the future ownership of its subsidiary Valitor. Arion Bank has supported Valitor's international growth strategy but concluded that the time was right to bring on board other investors with more extensive knowledge of this line of business. Citi was appointed to advice on the sale of most or all of the company's share capital. The company is therefore categorized as a disposal group held for sale in the annual financial statement, see Note 4. Stakksberg (United Silicon) is also a disposal group held for sale. The sale of Stakksberg has been delayed due to regulatory complications but the Bank aims to conduct a sales process as soon as possible.

The tax environment for Arion Bank and other major Icelandic banks remains completely out of step with taxation of other limited companies in Iceland. In particular there is a 6% tax calculated on taxable earnings in excess of ISK 1 billion and a special tax imposed on financial institutions, the bank levy, which is calculated on 0.376% of liabilities above ISK 50 billion. The bank levy does not reduce the income tax base.

In July 2018 Standard & Poor's affirmed Arion Bank's credit rating at BBB+ with a stable outlook. The Bank's well publicized intention to optimize its capital structure began with the issuance of subordinated bonds in November.

Employees

The Group had 904 full-time equivalent positions at the end of the year compared with 949 at the end of 2017; 794 of these positions were at Arion Bank, compared with 844 at the end of 2017. The decrease in FTEs from last year is mainly due to the outsourcing of its cash center, in cooperation with the other two major Icelandic banks and streamlining relating to the Bank's digital strategy. In addition there are approximately 400 FTEs at subsidiaries classified as a disposal group held for sale, Stakksberg ehf. and Valitor.

Funding and liquidity

The Bank's liquidity position is strong, with a liquidity coverage ratio of 164%, see Note 45, well above the regulatory minimum of 100%. The Bank elected to hold a strong liquidity position during the IPO process, which was concluded in June, so as not to have to fund in the debt capital markets at the same time.

Deposits, which are the core of the Bank's funding, increased by ISK 4 billion or approximately 1%. The composition of deposits has changed in such a way that retail and SME deposits have proportionally increased but deposits from institutional investors have decreased. The long-standing economic growth and increased purchasing power of the Bank's customers in the main cause of this positive development.

In March Arion Bank issued 5-year senior unsecured bonds for a total of EUR 300 million. The bond issue was oversubscribed, orders were received from over 40 investors with total demand around EUR 375 million. The bonds have a fixed coupon of 1.0% and were sold at rates corresponding to a 0.65% margin over interbank rates.

In December Arion Bank announced tender offer on EUR 300 million notes due in April 2019. The Bank received valid tenders of EUR 155 million and accepted all tenders.

In November concluded an inaugural Tier 2 issuance totaling 500 million Swedish krona. The bonds have a 10NC5 structure. The bonds were priced at a margin of STIBOR 310. The Tier 2 bonds are eligible as Tier 2 capital under the Icelandic Financial Undertakings Act No. 161/2002. The Tier 2 bond issue strengthens the Bank's own funds and is a milestone towards reaching a more optimal capital structure.

Group ownership

The main venue at which the Board and the Bank report information to the shareholders and propose decisions to be made is at legally convened shareholders' meetings. The Bank provides an effective and accessible arrangement for communications between shareholders and the Board of Directors between those meetings. Any information sensitive to the market will be released through the Nasdaq exchange as MAR press releases. As part of the investor relations programme, Arion Bank also arranges quarterly meetings where the CEO, CFO and Investor Relations present the interim financial results.

Arion Bank was listed on Nasdaq Iceland and Nasdaq Stockholm on 15 June 2018, when 28.7% of issued shares were acquired by a diverse group of investors from Iceland, Scandinavia, the United Kingdom, continental Europe and the United States. It was the first IPO by an Icelandic bank in Iceland since 2008 and represented a very important step for Arion Bank. The Bank welcomes the new shareholders. No major changes have occurred to the shareholder base since the IPO in June. At the end of 2018, Kaupskil ehf. was the largest shareholder with a holding of 32.67%. The Bank has more than 6,000 shareholders, see Note 36 for further information.

Endorsement and statement
by the Board of Directors and the CEO

Risk management

The Group faces various risks arising from its day-to-day operations as a financial institution. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as is the ability to ensure that the Group's exposure to risk remains within acceptable levels. The Group's risk management, its structure and main risk factors are described in the notes, starting at Note 43.

Capital and Dividend

In October 2018, the FME's annual Supervisory Review and Evaluation Process (SREP) for Arion Bank was concluded. The additional capital requirement under Pillar 2 is determined on the basis of the Group's internal capital adequacy assessment (ICAAP). The additional requirement is 2.9% of risk-weighted assets (RWA) based on the Group's Financial Statements as at 31 December 2017, excluding insurance subsidiaries. The previous requirement was 3.4% of RWA and the reduction is primarily due to reduced assessment of credit risk and legal risk. As a result, the Bank's total regulatory requirement, including capital buffer requirement is 19.4% on 31 December 2018. The increase in the countercyclical capital buffer rate by 0.5%, which comes into effect in May 2019, will however increase the total capital requirement back to 19.8%. An additional increase of the countercyclical capital buffer of 0.25% will become effective in February 2020. Taking into account the Group's internal management buffer, currently 1.5% of RWA, the Group's capital requirement is 21.3%. The Group's target Common Equity Tier 1 ratio (CET1) is 17%.

The Group's capital ratio at 31 December 2018 was 22.0% and the CET 1 ratio was 21.2%. For the past few years, the Group has operated with own funds well in excess of the minimum requirements, and the requirements have been met primarily by CET1 capital. The Bank has recently taken active steps to reduce capital, which is the first step in the effort to normalize the Bank's capital structure in accordance with its capital policy. Further dividends and share buy-backs amounted to ISK 33.3 billion during 2018 which lowered the Bank's capital ratios. The Bank issued Tier 2 bonds in November of 2018 which strengthen the capital base. The timing of the issuance of capital instruments will depend on, among other things, market pricing and the Bank's liquidity in Icelandic króna. With the Bank now operating on a capital level close to the requirements, the Bank will increase its focus on capital management with the aim to improve profitability.

The Board of Directors proposes that the Bank pay dividends of ISK 140.5% of Net earnings contributable to shareholders of Arion Bank, or ISK 10 billion. This dividend calculates as ISK 5 per share. The Board of Directors has the authority to propose that the Bank pay dividends or other disbursement of equity and may convene a special shareholders' meeting later in the year to propose a payment.

Governance

At the last Annual General Meeting on 15 March 2018, seven members were elected to serve on the Board of Directors until the next annual general meeting, three women and four men. 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. In September 2018, one new board member was elected to replace a board member who resigned in May 2018. One board member resigned in September 2018 and an alternate director will attend board meetings until a new board member has been elected. The ratio of men to women is in compliance with the law which states that companies with more than 50 employees should ensure at least 40% representation of each gender among directors and alternates. Five Directors and two Alternates are independent of Arion Bank and its day-to-day managers as well as of the Bank's largest shareholders.

The Board of Directors of Arion Bank is committed to good corporate governance and endeavors to promote responsible behavior and corporate culture within Arion Bank for the benefit of all stakeholders. Arion Bank has to this end devised a corporate governance statement which is designed to help foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. In December 2015 Arion Bank was recognized as a company which had achieved excellence in corporate governance. The recognition applies for three years unless significant changes are made to the Bank’s management or ownership.

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

The main roles of the Board, as further specified in the rules of procedure of the Board, include approving the Bank's strategy, supervising financial affairs and accounting and ensuring that appropriate internal controls are in place. The Board ensures that the Bank has active Internal Audit, Compliance and Risk Management departments. The Internal Auditor is appointed by the Board of Directors and works independently of other departments of the Bank in accordance with a charter from the Board. The Internal Auditor provides independent and objective assurance and advice designed to add value and improve the Bank's operations. The Compliance Officer, who reports directly to the CEO, works independently within the Bank in accordance with a charter from the Board. The main role of Compliance is to ensure the Bank has in place efficient measures to manage and mitigate compliance risk. The duties of Compliance are carried out under a risk-based compliance plan approved by the Board of Directors, including a training and monitoring schedule.

Corporate governance at Arion Bank is described in more detail in the Bank's Corporate Governance Statement which is contained in the unaudited appendix to the Financial Statement and on the website www.arionbanki.is. The Corporate Governance Statement is based on legislation, regulations and recognized guidelines in force when the Bank's annual financial statements are adopted by Board of Directors. This statement is prepared in accordance with the Financial Undertakings Act No. 161/2002 and Guidelines on Corporate Governance, 5th edition, issued by the Icelandic Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland in May 2015. Corporate governance at Arion Bank complies with the guidelines with one exception, which is explained in more detail in the Corporate Governance Statement.

Endorsement and statement
by the Board of Directors and the CEO

Sustainability and non-financial reporting

Arion Bank is a strongly capitalized bank which provides universal banking services to companies and individuals with the aim of creating future value for the benefit of our customers, shareholders, co-operators and society as a whole. Arion Bank's sustainability policy bears the title Together we make good things happen and indicates that the Bank wants to act as a role model in responsible and profitable business practices, taking into account the environment, the economy and the society in which we live and work.

We refer to Arion Bank's values as cornerstones and they are designed to provide guidance when making decisions and in everything the employees say and do. They refer to the Bank's role, attitude and conduct. The values are we make a difference, we get things done, and we say what we mean. The Bank's code of conduct is designed to support responsible decision making and has been approved by the Board of Directors.

Arion Bank’s activities are governed by the provisions of the Annual Accounts Act on non-financial reporting, which, among other things, apply to the status and influence of the company in respect of environmental, social and human resources issues. These areas of activities are discussed specifically in an appendix to the 2018 Annual Financial Statement. Non-financial information is discussed in more detail in the Annual Report 2018, that will be published 20 February 2019, which takes on board more of the Global Reporting Initiative and the first steps are taken towards reporting using the GRI Core standard. The Annual Report will be available on Arion Bank's website www.arionbanki.is. We also take into account the 10 Principles of the UN Global Compact and the criteria specified by Nasdaq in the Nordic and Baltic region concerning the reporting of non-financial information and key performance indicators.

Endorsement of the Board of Directors and the Chief Executive Officer

The Financial Statements of Arion Bank for the year ended 31 December 2018 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 Consolidated Financial Statements give a true and fair view of the financial performance and cashflow of the Group for the year 2018 and its financial position as at 31 December 2018.

Furthermore, in our opinion the Consolidated Financial Statements and the Endorsement of the Board of Directors and the CEO give a fair view of the development and performance of the Group's operations and its position and describe the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the Consolidated Financial Statements of Arion Bank for the year 2018 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 13 February 2019

Board of Directors

Eva Cederbalk
Chairman

Benedikt Gíslason

Brynjólfur Bjarnason

Herdís Dröfn Fjeldsted

Måns Höglund

Ólafur Örn Svansson

Steinunn K. Thórdardóttir

Chief Executive Officer

Höskuldur H. Ólafsson

Independent Auditor's report

To the Board of Directors and Shareholders of Arion Bank hf.

Opinion

We have audited the Consolidated Financial Statements of Arion Bank hf. for the year ended December 31, 2018 which comprise the Consolidated Income Statement, Consolidated Statement of Comprehensive Income, Consolidated Statement of Financial Position, Consolidated Statement of Changes in Equity, the Consolidated Statement of Cash Flows for the year then ended and the notes to the Consolidated Financial Statements, including a summary of significant accounting policies.

In our opinion, the accompanying Consolidated Financial Statements give a true and fair view of the consolidated financial position of Arion Bank hf. as at December 31, 2018, its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of Arion Bank hf. in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) and the Icelandic Institute of State Authorized Public Accountants (FLE), Code of Ethics and we have fulfilled our ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the Consolidated Financial Statements of the current period. These matters were addressed in the context of our audit of the Consolidated Financial Statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key Audit Matters	***How the matter was addressed in the audit***
Impairment charges for loans and provisions for guarantees	
Loans for the Group amounted to ISK 843,717 million at 31 December 2018, and the total allowance account for the Group amounted to ISK 10,625 million (including off-balance positions) at 31 December 2018. From 1 January 2018, the Group has adopted IFRS 9, resulting in impairment charges being recognised when losses are expected rather than when they have been incurred. Management has disclosed information regarding the transitional effect of IFRS 9 in note 2. Management has provided further information about the accounting policies for expected credit losses in note 57 and about loan impairment charges and provisions for guarantees in notes 15 and 43. Measurement of loan impairment charges for loans and provisions for guarantees is deemed a key audit matter as the determination of assumptions for expected credit losses is subjective due to the level of judgement applied by Management. The most significant judgements are: • Assumptions used in the expected credit loss models to assess the credit risk related to the exposure and the expected future cash flows of the customer. • Timely identification of exposures with significant increase in credit risk and credit impaired exposures. • Valuation of collateral and assumptions used for manually assessed credit-impaired exposures.	Based on our risk assessment and industry knowledge, we have examined the impairment charges for loans and provisions for guarantees and evaluated the methodology applied as well as the assumptions made according to the description of the key audit matter. As part of our audit, we have examined the Group's implementation of IFRS 9. As part of our review of the implementation we performed substantive procedures on the Group's impairment models and reviewed the methodology implemented for expected credit loss calculations. We used risk modelling specialists as well as IFRS specialists as part of our audit. Our examination included the following elements: • Testing of key controls over key assumptions used in the expected credit loss models to assess the credit risk related to the exposure and the expected future cash flows of the customer. • Substantively testing evidence to support the assumptions used in the expected credit loss models applied in stage allocation, assumptions applied to derive lifetime possibility of default and methods applied to derive loss given default. • Testing of key controls and substantive testing of timely identification of exposures with significant increase in credit risk and timely identification of credit impaired exposures. • Testing of key controls over models and manual processes for valuation of collateral used in the expected credit loss calculations. • Substantively testing evidence to support appropriate determination of assumptions for loan impairment charges and provisions for guarantees including valuation of collateral and assumptions of future cash flows on manually assessed credit impaired exposures.

Independent Auditor's report

Key Audit Matters	How the matter was addressed in the audit
Revenue recognition	
Interest income is a key element to the core business of the bank. This is the single largest item of the consolidated income statement. Interest income is subject to contractual terms and highly reliant on IT controls and other controls within the Bank's control environment. Therefore, we consider the interest income as key audit matter. The basis for revenue recognition and accounting policies are presented in Note 52 to the consolidated financial statements.	We reviewed the policies, processes and controls surrounding the revenue recognition. We have tested relevant controls related to accounting for interest income. We have tested the appropriateness of the interest calculation in accordance with IFRS. We tested interest income by select sample of loans and compare the underlying data to the loans system. In addition, we performed analytical procedures on interest income. Furthermore, we selected sample of loans to ensure that interest is being accrued correctly.
IT controls	
Arion Bank is significantly dependent on their IT-systems to serve customers, support their business processes, ensure complete and accurate processing of financial transactions and support the overall internal control framework. Many of the Bank's internal controls over financial reporting are dependent on automated application controls, completeness, and integrity of reports generated by the IT-systems. Given the high dependency on technology, we consider this a key audit matter for our audit.	We have reviewed the policies and processes related to IT applications. We have tested relevant controls related to change management, access rights and IT operation of material IT systems related to financial reporting.

Other information

The Board of Directors and CEO are responsible for the other information. The other information comprises the unaudited appendix to the Financial Statements, 5-year overview, key figures, unaudited quarterly statements in Note number 6 and Endorsement and statements by the Board of Directors and the CEO.

Our opinion on the Consolidated Financial Statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon, except the confirmation regarding the Endorsement and statements by the Board of Directors and the CEO as stated below.

In connection with our audit of the Consolidated Financial Statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the Consolidated Financial Statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information; we are required to report that fact. We have nothing to report in this regard.

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

Responsibilities of the Board of Directors and the CEO for the Consolidated Financial Statements

The Board of Directors and the CEO are responsible for the preparation and fair presentation of the Consolidated Financial Statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act, and for such internal control as the Board of Directors and the CEO determines is necessary to enable the preparation of Consolidated Financial Statements that are free from material misstatement, whether due to fraud or error.

In preparing the Consolidated Financial Statements, the Board of Directors and the CEO are responsible for assessing Arion Bank hf.'s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the company or to cease operations, or has no realistic alternative but to do so.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the Consolidated Financial Statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Consolidated Financial Statements.

Independent Auditor's report

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the Consolidated Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Arion Banks hf.'s internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the Consolidated Financial Statements, including the disclosures, and whether the Consolidated Financial Statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the Consolidated and Separate Financial Statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with the Board of Directors and the Board Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the Board of Directors and the Board Audit Committee with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with the Board of Directors and the Board Audit committee, we determine those matters that were of most significance in the audit of the Consolidated Financial Statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Kópavogur, 13 February 2019

Deloitte ehf.

Páll Grétar Steingrímsson
State Authorized Public Accountant

Gunnar Þorvarðarson

Gunnar Thorvardarson
State Authorized Public Accountant

Consolidated Income Statement

	Notes	2018	2017
Interest income		59,316	56,028
Interest expense		(29,997)	(27,108)
Net interest income	7	**29,319**	**28,920**
Fee and commission income		11,658	11,619
Fee and commission expense		(1,308)	(1,408)
Net fee and commission income	8	**10,350**	**10,211**
Net financial income	9	2,302	4,045
Net insurance income	10	2,589	2,093
Share of profit of associates and net impairment	26	27	(927)
Other operating income	11	1,584	2,521
Other net operating income		**6,502**	**7,732**
Operating income		**46,171**	**46,863**
Salaries and related expenses	12	(14,278)	(13,602)
Other operating expenses	13	(12,000)	(9,291)
Operating expenses		**(26,278)**	**(22,893)**
Bank levy	14	(3,386)	(3,172)
Net impairment	15	(3,525)	312
Earnings before income tax		**12,982**	**21,110**
Income tax expense	16	(4,046)	(5,966)
Net earnings from continuing operations		**8,936**	**15,144**
Discontinued operations held for sale, net of income tax	17	(1,159)	(725)
Net earnings		**7,777**	**14,419**

Attributable to

Shareholders of Arion Bank hf.		7,116	14,400
Non-controlling interest		661	19
Net earnings		**7,777**	**14,419**

Earnings per share from continuing operations

Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	18	4.49	7.56

Comparative figures have been restated as the subsidiary Valitor Holding hf. has been classified as disposal group held for sale, see Note 4.

The Notes on pages 17 to 89 are an integral part of these Consolidated Financial Statements

Arion Bank Consolidated Financial Statements 2018 11 Amounts are in ISK millions

Consolidated Statement of Comprehensive Income

	Notes	2018	2017
Net earnings		**7,777**	**14,419**
Net gain on financial assets carried at fair value through OCI, net of tax		89	-
Realized net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement		(112)	-
Changes to reserve for financial instruments at fair value through OCI		**(23)**	**-**
Exchange difference on translating foreign subsidiaries		123	(5)
Other comprehensive income, net of tax	35	**100**	**(5)**
Total comprehensive income		**7,877**	**14,414**

Attributable to

		2018	2017
Shareholders of Arion Bank		7,216	14,395
Non-controlling interest		661	19
Total comprehensive income		**7,877**	**14,414**

The Notes on pages 17 to 89 are an integral part of these Consolidated Financial Statements

Arion Bank Consolidated Financial Statements 2018 12 Amounts are in ISK millions

Consolidated Statement of Financial Position

Assets	Notes	2018	2017
Cash and balances with Central Bank	19	83,139	139,819
Loans to credit institutions	20	56,322	86,609
Loans to customers	21	833,826	765,101
Financial instruments	22-24	114,557	109,450
Investment property	24	7,092	6,613
Investments in associates	26	818	760
Intangible assets	27	6,397	13,848
Tax assets	28	90	450
Assets and disposal groups held for sale	29	48,584	8,138
Other assets	30	13,502	16,966
Total Assets		**1,164,327**	**1,147,754**

Liabilities			
Due to credit institutions and Central Bank	23	9,204	7,370
Deposits	23	466,067	462,161
Financial liabilities at fair value	23	2,320	3,601
Tax liabilities	28	5,119	6,828
Liabilities associated with disposal groups held for sale	29	26,337	-
Other liabilities	31	30,107	57,062
Borrowings	23,32	417,782	384,998
Subordinated liabilities	23.33	6,532	-
Total Liabilities		**963,468**	**922,020**

Equity			
Share capital and share premium	34	59,010	75,861
Other reserves	34	14,822	16,774
Retained earnings		126,897	132,971
Total Shareholders' Equity		**200,729**	**225,606**
Non-controlling interest		130	128
Total Equity		**200,859**	**225,734**
Total Liabilities and Equity		**1,164,327**	**1,147,754**

The Notes on pages 17 to 89 are an integral part of these Consolidated Financial Statements

Arion Bank Consolidated Financial Statements 2018 13 Amounts are in ISK millions

Consolidated Statement of Changes in Equity

			Restricted reserves							
	Share capital	Share premium	Gain in subs. & assoc., unrelized	Gain in securities, unrelized	Financial assets at fair value thr. OCI unrelized	Other reserves	Retained earnings	**Total share-holders' equity**	Non-controlling interest	**Total equity**
Equity 31 December 2017	2,000	73,861	14,050	903	-	1,822	132,971	**225,606**	128	**225,734**
Impact of adopting IFRS 9	-	-	-	(108)	110	-	939	**941**	-	**941**
Restated opening balance under IFRS 9	**2,000**	**73,861**	**14,050**	**795**	**110**	**1,822**	**133,910**	**226,548**	**128**	**226,676**
Net earnings	-	-	-	-	-	-	7,116	**7,116**	661	**7,777**
Net fair value gain	-	-	-	-	89	-	-	**89**	-	**89**
Realized net gain transferred										
to the Income Statement	-	-	-	-	(112)	-	-	**(112)**	-	**(112)**
Translation difference	-	-	-	-	-	123	-	**123**	-	**123**
Total comprehensive income	**-**	**-**	**-**	**-**	**(23)**	**123**	**7,116**	**7,216**	**661**	**7,877**
Dividend paid	-	-	-	-	-	-	(16,184)	**(16,184)**	-	**(16,184)**
Purchase of treasury stock *	(190)	(16,949)	-	-	-	-	-	**(17,139)**	-	**(17,139)**
Employee stock grant **	4	284	-	-	-	-	-	**288**	-	**288**
Changes in reserves	-	-	(1,677)	(378)	-	-	2,055	**-**	-	**-**
Decrease due to sale of subsidiary	-	-	-	-	-	-	-	**-**	(659)	**(659)**
Equity 31 December 2018	**1,814**	**57,196**	**12,373**	**417**	**87**	**1,945**	**126,897**	**200,729**	**130**	**200,859**
Equity 1 January 2017	2,000	73,861	17,035	899	-	1,827	115,590	**211,212**	172	**211,384**
Net earnings	-	-	-	-	-	-	14,400	**14,400**	19	**14,419**
Translation difference	-	-	-	-	-	(5)	-	**(5)**	-	**(5)**
Total comprehensive income	**-**	**-**	**-**	**-**	**-**	**(5)**	**14,400**	**14,395**	**19**	**14,414**
Changes in reserves	-	-	(2,985)	4	-	-	2,981	**-**	-	**-**
Dividend to non-controlling interest	-	-	-	-	-	-	-	**-**	(63)	**(63)**
Equity 31 December 2017	**2,000**	**73,861**	**14,050**	**903**	**-**	**1,822**	**132,971**	**225,606**	**128**	**225,734**

* Refers to the changes in the holding of own shares related to the decision to accept an offer from Kaupskil ehf., a subsidiary of Kaupthing ehf., to buy back 9.5% of issued share capital in Arion Bank, or 190 million shares. The decision to accept the offer from Kaupskil ehf. is in line with the decision taken at a shareholders' meeting on 12 February 2018 to amend the Bank's articles of association with a temporary authorization for the Board of Directors to buy back shares issued by the Bank. Arion Bank paid ISK 90.087 a share, a total of ISK 17,139 million.

** Refers to the decision made by the Board of Directors to allocate own shares to employees in connection with the Bank's IPO and listing in 2018. In total close to 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 Notes on pages 17 to 89 are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Cash flows

Operating activities	2018	2017
Net earnings	7,777	14,419
Non-cash items included in net earnings	(14,194)	(22,888)
Changes in operating assets and liabilities	(37,916)	46,355
Interest received	47,119	59,367
Interest paid *	(24,712)	(28,478)
Dividend received	3,082	320
Income tax paid	(5,667)	(6,432)
Net cash (to) from operating activities	**(24,511)**	**62,663**

Investing activities		
Acquisition of associates	(60)	(961)
Proceeds from sale of associates	-	41
Dividend received from associates	-	74
Acquisition of subsidiary	-	(2,123)
Proceeds from sale of subsidiary	265	-
Cash and cash equivalents acquired through business combinations	-	127
Acquisition of intangible assets	(1,372)	(1,657)
Acquisition of property and equipment	(374)	(776)
Proceeds from sale of property and equipment	12	239
Net cash to investing activities	**(1,529)**	**(5,036)**

Financing activities		
Issued subordinated liabilities	6,780	-
Dividend paid to shareholders of Arion Bank	(16,184)	-
Purchase of treasury stock	(17,139)	-
Dividend paid to non-controlling interest	-	(63)
Net cash used in financing activities	**(26,543)**	**(63)**
Net (decrease) increase in cash and cash equivalents	(52,583)	57,564
Cash and cash equivalents at beginning of the year	181,898	123,933
Cash and cash equivalents transferred to Assets and disposal groups held for sale	(22,198)	-
Effect of exchange rate changes on cash and cash equivalents	3,472	401
Cash and cash equivalents	**110,589**	**181,898**

Non-cash changes due to acquisition of United Silicon		
Assets and disposal groups held for sale	-	4,537
Loans to customers	-	(4,537)

Comparative figures have been restated as the subsidiary Valitor Holding hf. has been classified as disposal group held for sale, see Note 4.

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

The Notes on pages 17 to 89 are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Notes to the Consolidated Statement of Cash flows

Non-cash items included in net earnings

	2018	2017
Net interest income	(29,319)	(28,920)
Net impairment	3,525	(312)
Income tax expense	4,046	5,966
Bank levy	3,386	3,172
Net foreign exchange gain	(405)	(231)
Net gain on financial instruments	1,448	(3,604)
Changes in provisions for unearned premiums and claims	1,128	1,912
Depreciation and amortization	1,321	1,288
Share of profit of associates and net impairment	(27)	927
Investment property, fair value change	(471)	(1,036)
Revised Depositors' and Investors' Guarantee Fund expense	-	(2,669)
Discontinued operations held for sale, net of income tax	1,159	725
Other changes	15	(106)
Non-cash items included in net earnings	**(14,194)**	**(22,888)**

Changes in operating assets and liabilities

Mandatory reserve deposit with Central Bank	(1,364)	108
Loans to credit institutions, excluding bank accounts	14,863	(2,879)
Loans to customers	(50,267)	(59,413)
Financial instruments and financial liabilities at fair value	(9,846)	15,512
Investment property	(8)	(204)
Assets and disposal groups held for sale and associated liabilities	(202)	872
Other assets	(699)	474
Due to credit institutions and Central Bank	1,693	(702)
Deposits	(2,802)	50,653
Borrowings	14,867	42,071
Other liabilities	(4,151)	(137)
Changes in operating assets and liabilities	**(37,916)**	**46,355**

Cash and cash equivalents

Cash and balances with Central Bank	83,139	139,819
Bank accounts	38,038	51,303
Mandatory reserve deposit with Central Bank	(10,588)	(9,224)
Cash and cash equivalents	**110,589**	**181,898**

The Notes on pages 17 to 89 are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

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Notes to the Consolidated Financial Statements

General information

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Consolidated Financial Statements for the year ended 31 December 2018 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

The Consolidated Financial Statements were approved and authorized for issue by the Board of Directors of Arion Bank on 13 February 2019.

In preparing the Consolidated 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 Consolidated Financial Statements.

Statement of compliance

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS), 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 same accounting policies, presentation and methods of computation are followed in these Consolidated Financial Statements in 2018 as were applied in the Consolidated Financial Statements for the year ended 31 December 2017, except for new and amended IFRS and new interpretations (IFRIC) effective for 2018, see note 2.

Due to the reclassification of the subsidiary Valitor Holding hf. as disposal group hefl for sale, in accordance with IFRS 5, comparative figures in the Income Statement have been restated, see Note 4.

Basis of measurement

The Consolidated Financial Statements have been prepared on a historical cost basis except for assets and liabilities measured under IFRS 9. For further details on the accounting policy for assets and liabilities under IFRS 9, see note 57. For further details on accounting policy under IAS 39 see the Annual Financial Statements 2017.

Functional and presentation currency

The Consolidated Financial Statements are presented in Icelandic krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the year the exchange rate of the ISK against USD was116.34 and 133.20 for EUR (31.12.2017: USD 103.70 and EUR 124.52).

2. Changes in accounting policies

Arion Bank initially adopted IFRS 15 Revenues from contracts with customers and IFRS 9 Financial instruments from 1 January 2018. Several other amendments and interpretations apply for the first time in 2018, but have a minor impacts on the Consolidated Financial Statements of the Group. The Group has not early adopted any standards, interpretations or amendments that have been issued but are not effective.

IFRS 15 Revenue recognition

The Group adopted IFRS 15 Revenue recognition on 1 January 2018. IFRS 15 establishes a model to account for revenue arising from contracts with customers and requires that revenue be recognized at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. The timing and amount of the Group's fee and commission income from contracts with customers was not impacted by the adoption of IFRS 15. The adoption of IFRS 15 had minor impacts on the Consolidated Financial Statements of the Group.

2. Changes in accounting policies, continued

IFRS 9 Financial Instruments

The Group adopted IFRS 9 Financial Instruments on 1 January 2018. As a result of the implementation, the Group changed the accounting policies for classification and impairment calculations. The Group has elected to continue to apply the hedge accounting principles under IAS 39 instead of those under IFRS 9. As permitted by the transition provisions of IFRS 9, the Group elected not to restate comparative figures; accordingly, the comparative period is presented in accordance with IAS 39. For further detail on the accounting policy under IAS 39 see the Consolidated Financial Statements for the year ended 31 December 2017. Adjustments to carrying amounts of financial assets and liabilities at the date of initial application were recognized in Retained earnings and Other reserves within Equity, a total effect of ISK 942 million was recognized. New or amended disclosures have been provided for the current year, where applicable, comparative period disclosures are consistent with those disclosed in the previous year.

Reconciliation of changes on Consolidated Statement of Financial Position due to transition from IAS 39 to IFRS 9 as at 1 January 2018

Assets	IAS 39 31.12.2017	Impact of classifi-cation and measure-ment	Impact of impair-ment	**Total impact**	IFRS 9 1.1.2018
Cash and balances with Central Bank	139,819	-	(7)	(7)	139,812
Loans to credit institutions	86,609	-	(3)	(3)	86,606
Loans to customers	765,101	486	930	1,416	766,517
Financial instruments	109,450	-	-	-	109,450
Investment property	6,613	-	-	-	6,613
Investments in associates	760	-	-	-	760
Intangible assets	13,848	-	-	-	13,848
Tax assets	450	-	-	-	450
Assets and disposal groups held for sale	8,138	-	-	-	8,138
Other assets	16,966	-	-	-	16,966
Total Assets	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**
Liabilities					
Due to credit institutions and Central Bank	7,370	-	-	-	7,370
Deposits	462,161	-	-	-	462,161
Financial liabilities at fair value	3,601	-	-	-	3,601
Tax liabilities	6,828	97	138	235	7,063
Other liabilities	57,062	-	229	229	57,291
Borrowings	384,998	-	-	-	384,998
Total Liabilities	**922,020**	**97**	**367**	**464**	**922,484**
Equity					
Share capital and share premium	75,861	-	-	-	75,861
Other reserves	16,774	-	3	3	16,777
Retained earnings	132,971	389	550	939	133,910
Total Shareholders' Equity	**225,606**	**389**	**553**	**942**	**226,548**
Non-controlling interest	128	-	-	-	128
Total Equity	**225,734**	**389**	**553**	**942**	**226,676**
Total Liabilities and Equity	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**

Arion Bank Consolidated Financial Statements 2018 Amounts are in ISK millions

2. Changes in accounting policies, continued

Original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Group's financial assets and financial liabilities on 1 January 2018.

Financial assets	Measurement category under IAS 39	Measurement category under IFRS 9	Carrying amount under IAS 39	Reclassi-fication	Re-measure-ment**	Carrying amount under IFRS 9
Cash and balances with Central Bank ..	Loans	Amortized cost	139,819	-	(7)	139,812
Loans to credit institutions	Loans	Amortized cost	86,609	-	(3)	86,606
Loans to customers			765,101	486	930	766,517
Overdrafts	*Loans*	*Amortized cost*	*30,942*	-	*(50)*	*30,892*
Credit cards	*Loans*	*Amortized cost*	*12,040*	-	*(11)*	*12,029*
Mortgage loans	*Loans*	*Amortized cost*	*329,735*	-	*276*	*330,011*
Other loans	*Loans*	*Amortized cost*	*386,606*	-	*715*	*387,321*
Other loans	*Loans*	*FVTPL (mandatory)****	*5,778*	*486*	-	*6,264*
Financial instruments			109,450	-	-	109,450
Bonds and debt instruments	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*11,347*	-	-	*11,347*
Bonds and debt instruments	*FVTPL (designated)*	*FVOCI**	*40,408*	-	-	*40,408*
Shares and equity instruments	*FVTPL (designated)*	*FVTPL (mandatory)*	*36,190*	-	-	*36,190*
Derivatives	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*7,624*	-	-	*7,624*
Securities for economic hedging	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*13,881*	-	-	*13,881*
Other financial assets	Amortized cost	Amortized cost	8,948	-	-	8,948
Total financial assets			**1,109,927**	**486**	**920**	**1,111,333**

Financial liabilities						
Due to credit institutions and CB	Amortized cost	Amortized cost	7,370	-	-	7,370
Deposits	Amortized cost	Amortized cost	462,161	-	-	462,161
Financial liabilities at fair value	FVTPL (held for trading	FVTPL (mandatory)	3,601	-	-	3,601
Other liabilities			33,291	-	229	33,520
Accounts payable	*Amortized cost*	*Amortized cost*	*26,394*	-	-	*26,394*
Unsettled securities trading	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*527*	-	-	*527*
Depositors and investors guarantee fund	*Amortized cost*	*Amortized cost*	*218*	-	-	*218*
Sundry financial liabilities	*Amortized cost*	*Amortized cost*****	*6,152*	-	*229*	*6,381*
Borrowings	Amortized cost	Amortized cost	384,998	-	-	384,998
Total financial liabilities			**891,421**	**-**	**229**	**891,650**

Other liabilities				
Tax liabilities	6,828	97	138	7,063

The impact of adopting IFRS 9 is twofold: the effect of reclassification and the effect of Implementing the new impairment requirements of IFRS 9.

* Treasury liquidity portfolio previously designated at fair value through profit and loss under IAS 39, will be held at fair value through OCI under IFRS 9.

** Transition to IFRS 9 resulted in lower impairments. The key difference lies within the methods used to value collateral in the calculation process.

*** The effects of the SPPI testing on the banks loan portfolio resulted in assets to be reclassified from amortized cost to fair value through profit and loss.

**** Increase in other liabilities is due to impairment calculations for loan commitments, guarantees and other off balance facilities committed to by the group.

FVTPL - Fair value through profit and loss
FVOCI - Fair value through other comprehensive income

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

3. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Consolidated Financial Statements requires management to make judgements, 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 Consolidated Financial Statements 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.

- *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, as there is a lack of comparable market data because of the nature of the properties, or the investment properties were valued by reference to transactions involving properties of a similar nature, location and condition.

- *Impairment of intangible assets*

  The carrying amounts of goodwill, infrastructure and customer relationship and related agreements are reviewed annually to determine whether there is 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 profit or loss. The recoverable amount of an assets 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.

- *Assets and disposal groups held for sale*

  Legal entities acquired exclusively with 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 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 impact on the value of these disposal

  Real estates acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less costs 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 uncertainty about the actual fair value of assets.

- *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 five years, how those factors affect each model and how to estimate a significant increase in credit risk. The assumptions for macroeconomic development is 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 57.

Notes to the Consolidated Financial Statements

4. The Group

Shares in the main subsidiaries in which Arion Bank held a direct interest at the end of the year			Equity interest	
	Operating activity	Currency	2018	2017
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland	Retail banking	ISK	100.0%	100.0%
BG12 slhf., Katrínartún 2, Reykjavík, Iceland	Holding company	ISK	62.0%	62.0%
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	-	100.0%
Eignarhaldsfélagid Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland	Real estate	ISK	100.0%	100.0%
Eignabjarg ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
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%	-
Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland	Insurance	ISK	100.0%	100.0%

The subsidiaries Eignabjarg ehf. (holding company of Stakksberg ehf.) and Valitor Holding hf. are classified as a disposal groups held for sale, see Note 29.

The subsidiary EAB 1 ehf. had two classes of share capital. Arion Bank held 100% of the shareholding in class B until June 2018 when the class was settled. The remaining shareholding of Arion Bank was 30% in class A but Arion Bank controlled the entity and thus it was classified as a subsidiary of the Bank until October 2018 when Arion Bank sold its shareholding to other shareholders, with minor effects on the Income Statement.

In March 2018 the Bank acquired Valitor Holding's 100% shareholding in VISA Ísland ehf. Combinations of entities under common control, i.e. transactions in which all the combining entities are under the control of the Group both before and after the combination, and that control is not transitory, are outside the scope of the IFRS 3 *business combinations*. Currently, there is no specific guidance for these transactions under IFRS, therefore, as permitted by IAS 8 *accounting policies*, *changes in accounting and errors*, the Group has developed an accounting policy considering pronouncements of other standard-setting bodies. The assets and liabilities recognized as a result of transactions between entities under common control are recognized at the carrying value on the transferor's financial statements.

Valitor Holding hf.

Arion Bank's shareholding in the subsidiary Valitor Holding hf. (Valitor) was 100% at 31 December 2018. The Bank is in the process of potentially divesting the Bank's shareholding in Valitor and has appointed Citi as a sales advisor. According to the Bank is aiming for having completed the sale of Valitor within the 12 months set as requirement for classification as held for sale asset in IFRS. The sales process will be based on invitations only.

In accordance with IFRS 5 Non-current assets and disposal groups held for sale Valitor has been classified as disposal group held for sale in the Consolidated Financial Statements, resulting in a change in the presentation in the Consolidated Income Statement. Net earnings of Valitor are recognized in a single line item as Discontinued operations held for sale, net of income tax. The comparative figures in the Consolidated Income Statement for the year 2017 have been restated.

Restated Consolidated Income Statement for the year 2017	Published accounts	Valitor operation	Restated accounts
Interest income	57,089	(1,061)	56,028
Interest expense	(27,254)	147	(27,107)
Net interest income	**29,835**	**(914)**	**28,921**
Fee and commission income	29,777	(18,158)	11,619
Fee and commission expense	(14,420)	13,012	(1,408)
Net fee and commission income	**15,357**	**(5,146)**	**10,211**
Net financial income	4,091	(46)	4,045
Net insurance income	2,093	-	2,093
Share of profit of associates and net impairment	(925)	(2)	(927)
Other operating income	2,927	(407)	2,520
Other net operating income	8,186	(455)	7,731
Operating income	**53,378**	**(6,515)**	**46,863**
Salaries and related expenses	(17,189)	3,587	(13,602)
Other operating expenses	(12,772)	3,481	(9,291)
Operating expenses	**(29,961)**	**7,068**	**(22,893)**
Bank levy	(3,172)	-	(3,172)
Net impairment	186	126	312
Earnings before income tax	**20,431**	**679**	**21,110**
Income tax expense	(5,806)	(160)	(5,966)
Net earnings from continuing operations	**14,625**	**519**	**15,144**
Discontinued operations held for sale, net of income tax	(206)	(519)	(725)
Net earnings	**14,419**	**-**	**14,419**

Amounts are in ISK millions

4. The Group, continued

Prior to the restatement the operations of Valitor were presented as the operating segment Subsidiaries and other divisions, see Note 5.

In the Consolidated Statement of Financial Position the total assets of Valitor are recognized as Assets and disposal groups held for sale and the total liabilities as Liabilities associated with disposal groups held for sale, see Note 29.

Total assets and total liabilities of Valitor at 31 December 2018

	2018
Assets	
Cash and balances with Central Bank	7,441
Loans to credit institutions	19,300
Loans to customers	2,258
Financial instruments	174
Investments in associates	58
Intangible assets	8,267
Tax assets	101
Other assets	2,404
Total Assets	**40,003**
Liabilities	
Financial liabilities at fair value	8
Tax liabilities	136
Other liabilities	26,185
Borrowings	8
Total Liabilities	**26,337**
Elimination within Arion Bank Group	2,116
Book value of Valitor	**15,782**

Income Statement of Valitor

2018	Valitor Group	Elimi-nation	Valitor Group contri-bution
Net interest income	854	(34)	820
Net fee and commission income	5,401	810	6,211
Net financial income	(202)	-	(202)
Other operating income	178	(154)	24
Operating income	**6,231**	**622**	**6,853**
Salaries and related expense	(4,366)	-	(4,366)
Other operating expense	(3,871)	2	(3,869)
Operating expenses	**(8,237)**	**2**	**(8,235)**
Net impairment	(40)	-	(40)
Earnings before income tax	**(2,046)**	**624**	**(1,421)**
Income tax expense	150	-	150
Net earnings	**(1,896)**	**624**	**(1,271)**

2017	Valitor Group	Elimi-nation	Valitor Group contri-bution
Net interest income	981	(67)	914
Net fee and commission income	4,510	637	5,146
Net financial income	46	-	46
Other operating income	410	(1)	409
Operating income	**5,947**	**569**	**6,515**
Salaries and related expense	(3,587)	-	(3,587)
Other operating expense	(3,483)	2	(3,481)
Operating expenses	**(7,070)**	**2**	**(7,068)**
Net impairment	(126)	-	(126)
Earnings before income tax	**(1,248)**	**570**	**(679)**
Income tax expense	160	-	160
Net earnings	**(1,088)**	**570**	**(519)**

Amounts are in ISK millionS

Notes to the Consolidated 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. In presenting the geographic information, segment revenue has been based on the geographic location of customers or assets.

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

The Group comprises the following operating segments:

Asset Management comprises Institutional Asset Management, Private Banking, Investment Services and Pension Fund Administration. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors and also distributes funds managed by international fund management companies. Asset Management also administers pension funds. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

Corporate Banking services larger corporate clients, both in Iceland and abroad. Experienced account managers specializing in key economic sectors such as retail and services, seafood, energy and real estate are responsible for conducting larger transactions and developing strong business relationships with clients. 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, mainly in syndicates with other Icelandic banks and international banks.

Investment Banking comprises Corporate Finance, Capital Markets and Research. Investment Banking is a leading Icelandic brokerage house and financial advisor, providing a full and diverse range of investment banking services to a broad range of customers. Corporate Finance offers various financial advisory and capital raising services including M&A and financial restructuring advice and IPO management services. Capital Markets is a leading securities and foreign exchange brokerage and provides clients with a diverse range of fixed income services and risk management products. Research is an independent research team producing in-depth analysis of the Icelandic economy and financial markets.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of products and services, including mortgage loans, savings and checking 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, including internet banking, the Arion Bank app and automated teller machines. As of 31 December 2018, Retail Banking operated out of 20 branches across Iceland over 100,000 customers during the year.

Treasury is responsible for the Bank's liquidity, currency and interest rate management. Other functions of Treasury are funds' transfer pricing and hedging and pricing of financial products.

Subsidiaries and other divisions include the subsidiaries Vördur tryggingar hf., which is a insurance company, Eignarhaldsfélagid Landey ehf., which holds the main part of investment property of the Group and the holdnig companies VISA Ísland ehf., EAB 1 ehf. (sold in October 2018), BG12 slhf. and other smaller entities of the Group and Market Making in domestic securities and currencies. The subsidiary Valitor Holding is classified as Disposal group held for sale.

In addition to the above operating segments, the Group presents information for units at the corporate headquarters which carry out support functions such as Overhead, Risk Management, Finance (excluding Treasury and Market Making), Legal and IT. The information presented relating to the headquarters 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.

Notes to the Consolidated Financial Statements

5. Operating segments, continued

2018	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Subsidi- aries and Other divisions	Head- quarters and Elimination	Total
Net interest income	702	5,932	297	17,665	4,553	323	(153)	29,319
Net fee and commission income	3,393	1,191	1,866	4,976	(324)	(882)	130	10,350
Net financial income	50	(823)	5	4	480	2,098	488	2,302
Net insurance income	-	-	-	-	-	2,632	(43)	2,589
Share of profit of associates and net impairment	-	5	-	-	-	4	18	27
Other operating income	19	1	-	696	-	564	304	1,584
Operating income	4,164	6,306	2,168	23,341	4,709	4,739	744	46,171
Operating expense	(1,522)	(526)	(876)	(6,830)	(216)	(2,092)	(14,216)	(26,278)
Allocated expense	(835)	(2,899)	(672)	(6,382)	(1,032)	(7)	11,827	-
Bank levy	(165)	(693)	(46)	(1,192)	(1,290)	-	-	(3,386)
Net impairment	-	(3,753)	16	220	(22)	16	(2)	(3,525)
Earnings (loss) before income tax	1,642	(1,565)	590	9,157	2,149	2,656	(1,647)	12,982
Net seg. rev. from ext. customers	1,341	16,416	1,727	37,984	(17,551)	5,298	956	46,171
Net seg. rev. from other segments	2,823	(10,110)	441	(14,643)	22,260	(559)	(212)	-
Operating income	4,164	6,306	2,168	23,341	4,709	4,739	744	46,171
Depreciation and amortization	1	5	1	392	-	140	782	1,321
Total assets	71,244	289,076	16,302	594,154	486,982	91,852	(385,283)	1,164,327
Total liabilities	66,028	223,176	15,685	512,992	475,811	58,976	(389,200)	963,468
Allocated equity	5,216	65,900	617	81,162	11,171	32,876	3,917	200,859

2017	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Subsidi- aries and Other divisions	Head- quarters and Elimination	Total
Net interest income	502	6,002	240	15,502	6,536	354	(216)	28,920
Net fee and commission income	4,011	1,171	1,298	4,703	(312)	(933)	273	10,211
Net financial income	145	224	(71)	19	(13)	4,006	(265)	4,045
Net insurance income	-	-	-	-	-	2,224	(131)	2,093
Share of profit of associates and net impairment	-	-	-	-	-	13	(940)	(927)
Other operating income	19	1,146	-	927	5	72	352	2,521
Operating income (loss)	4,677	8,543	1,467	21,151	6,216	5,736	(927)	46,863
Operating expense	(1,138)	(357)	(780)	(5,134)	161	(2,249)	(13,396)	(22,893)
Allocated expense	(1,019)	(2,424)	(652)	(5,905)	(887)	(15)	10,902	-
Bank levy	(182)	(671)	(39)	(1,097)	(1,183)	-	-	(3,172)
Net impairment	-	(1,794)	(53)	2,489	70	(401)	1	312
Earnings (loss) before income tax	2,338	3,297	(57)	11,504	4,377	3,071	(3,420)	21,110
Net seg. rev. from ext. customers	2,638	15,689	1,003	30,765	(9,044)	6,433	(621)	46,863
Net seg. rev. from other segments	2,039	(7,146)	464	(9,614)	15,260	(697)	(306)	-
Operating income (loss)	4,677	8,543	1,467	21,151	6,216	5,736	(927)	46,863
Depreciation and amortization	1	-	-	359	-	130	798	1,288
Total assets	75,564	274,917	16,165	527,652	483,794	89,936	(320,274)	1,147,754
Total liabilities	70,233	218,243	15,164	461,724	421,930	59,609	(324,883)	922,020
Allocated equity	5,331	56,674	1,001	65,928	61,864	30,327	4,609	225,734

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

Arion Bank Consolidated Financial Statements 2018 25 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

5. Operating segments, continued

Geographic information

2018	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	31,870	563	528	(3,738)	63	33	29,319
Net fee and commission income	9,974	48	(70)	373	21	4	10,350
Net financial income	2,466	(51)	925	(822)	(216)	-	2,302
Net insurance income	2,589	-	-	-	-	-	2,589
Share of profit of associates and net impairment .	27	-	-	-	-	-	27
Other operating income	1,584	-	-	-	-	-	1,584
Operating income (loss)	48,510	560	1,383	(4,187)	(132)	37	46,171

2017	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	32,152	436	230	(4,268)	339	31	28,920
Net fee and commission income	9,898	42	(88)	340	16	3	10,211
Net financial income	2,333	(8)	411	339	961	9	4,045
Net insurance income	2,093	-	-	-	-	-	2,093
Share of profit of associates and net impairment .	(927)	-	-	-	-	-	(927)
Other operating income	2,521	-	-	-	-	-	2,521
Operating income (loss)	48,070	470	553	(3,589)	1,316	43	46,863

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Notes to the Consolidated Financial Statements

Quarterly statements

6. Operations by quarters

2018	Q1	Q2	Q3	Q4	Total
Net interest income	6,827	7,314	7,209	7,969	29,319
Net fee and commission income	2,205	2,712	2,687	2,746	10,350
Net financial income	1,387	1,119	570	(774)	2,302
Net insurance income	143	758	984	704	2,589
Share of profit (loss) of associates and net impairment	(20)	2	34	11	27
Other operating income	268	600	422	294	1,584
Operating income	10,810	12,505	11,906	10,950	46,171
Salaries and related expense	(3,616)	(3,949)	(3,129)	(3,584)	(14,278)
Other operating expense	(3,143)	(2,978)	(2,864)	(3,015)	(12,000)
Operating expenses	(6,759)	(6,927)	(5,993)	(6,599)	(26,278)
Bank levy	(804)	(879)	(938)	(765)	(3,386)
Net impairment	(135)	(166)	(2,651)	(573)	(3,525)
Earnings before income tax	3,112	4,533	2,324	3,013	12,982
Income tax expense	(890)	(1,302)	(973)	(881)	(4,046)
Net earnings from continuing operations	2,222	3,231	1,351	2,132	8,936
Discontinued operations, net of tax	(273)	(169)	(201)	(516)	(1,159)
Net earnings	1,949	3,062	1,150	1,616	7,777

2017	Q1	Q2	Q3	Q4	Total
Net interest income	6,904	7,920	7,033	7,063	28,920
Net fee and commission income	2,198	2,410	2,479	3,124	10,211
Net financial income	1,433	1,744	(687)	1,555	4,045
Net insurance income	447	606	716	324	2,093
Share of profit (loss) of associates and net impairment	(34)	(900)	17	(10)	(927)
Other operating income	456	1,629	346	90	2,521
Operating income	11,404	13,409	9,904	12,146	46,863
Salaries and related expense	(3,437)	(3,650)	(3,054)	(3,461)	(13,602)
Other operating expense	(3,041)	(391)	(2,877)	(2,982)	(9,291)
Operating expenses	(6,478)	(4,041)	(5,931)	(6,443)	(22,893)
Bank levy	(797)	(777)	(814)	(784)	(3,172)
Net impairment	907	401	(2,500)	1,504	312
Earnings before income tax	5,036	8,992	659	6,423	21,110
Income tax expense	(1,405)	(1,891)	(713)	(1,957)	(5,966)
Net earnings from continuing operations	3,631	7,101	(54)	4,466	15,144
Discontinued operations, net of tax	(278)	12	(58)	(401)	(725)
Net earnings	3,353	7,113	(112)	4,065	14,419

The half-year results and the first quarter of 2018 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.

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Notes to the Consolidated Financial Statements

Notes to the Consolidated Income Statement

7. Net interest income

Interest income	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total 2018	Total 2017
Cash and balances with Central Bank	4,625	-	-	4,625	6,315
Loans	53,457	354	-	53,811	47,538
Securities	-	249	358	607	1,964
Other	273	-	-	273	211
Interest income	58,355	603	358	59,316	56,028
Interest expense					
Deposits	(13,323)	-	-	(13,323)	(12,579)
Borrowings	(16,524)	-	-	(16,524)	(14,449)
Subordinated liabilities	(19)	-	-	(19)	-
Other	(131)	-	-	(131)	(80)
Interest expense	(29,997)	-	-	(29,997)	(27,108)
Net interest income	28,358	603	358	29,319	28,920
Net interest income from financial assets and liabilities at fair value	-	603	358	961	1,964
Interest income from financial assets at amortized cost	58,355	-	-	58,355	54,064
Interest expense from financial liabilities at amortized cost	(29,997)	-	-	(29,997)	(27,108)
Net interest income	28,358	603	358	29,319	28,920

	2018	2017
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	2.8%	2.9%

8. Net fee and commission income

	2018			2017		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	3,950	(433)	3,517	4,529	(366)	4,163
Lending and financial guarantees	2,050	-	2,050	2,198	-	2,198
Collection and payment services	1,597	(89)	1,508	1,563	(94)	1,469
Cards and payment solution	1,374	(139)	1,235	1,151	(165)	986
Investment banking	1,207	(34)	1,173	808	(43)	765
Other	1,480	(613)	867	1,370	(740)	630
Net fee and commission income	11,658	(1,308)	10,350	11,619	(1,408)	10,211

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

Fee and commission income from lending and financial guarantees are 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 due to billing services, such as issuing invoices and payment collection notices, wire transfer services and other payment services.

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

Fee and commission income on investment banking activities include miscellaneous corporate advisory services plus commission from capital markets relating to sales of shares, bonds and derivatives.

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

Arion Bank Consolidated Financial Statements 2018 28 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

9. Net financial income

	2018	2017
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	1,073	320
Net gain on fair value hedge of interest rate swap	673	336
Realized gain on financial assets carried at fair value through OCI *	151	-
Net gain on financial assets and financial liabilities classified as held for trading (IAS 39)	-	155
Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)	-	3,003
Net foreign exchange gain	405	231
Net financial income	2,302	4,045

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

	2018	2017
Equity instruments mandatorily measured at fair value	1,146	320
Debt instruments mandatorily measured at fair value	216	-
Derivatives	72	-
Loans	(361)	-
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	1,073	320

Net gain on fair value hedge of interest rate swap

	2018	2017
Fair value change of interest rate swaps designated as hedging instruments	1,182	(400)
Fair value change on bonds issued by the Group attributable to interest rate risk	(509)	736
Net gain on fair value hedge of interest rate swap	673	336

Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)

	2018	2017
Equity instruments designated at fair value	-	2,816
Interest rate instruments designated at fair value	-	187
Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)	-	3,003

* Realized gain on financial assets carried at fair value through OCI comprises gain previously recognized in the Income Statement under IAS 39. With the adoption of IFRS 9 1 January 2018 the total amount of unrealized gain on financial assets carried at fair value through OCI, net of tax was transferred to reserve for financial instruments carried at fair value, net of tax, see Note 35. Upon disposal realized gain on financial assets carried at fair value through OCI was transferred to the Income Statement in accordance with IFRS 9, as the Bank elected not to restate comparative figures.

10. Net insurance income

Earned premiums, net of reinsurers' share

	2018	2017
Premiums written	10,974	10,406
Premiums written, reinsurers' shares	(347)	(428)
Change in provision for unearned premiums	(385)	(810)
Change in provision for unearned premiums, reinsurers' share	(15)	1
Earned premiums, net of reinsurers' share	10,227	9,169

Claims incurred, net of reinsurers' share

	2018	2017
Claims paid	(7,018)	(6,115)
Claims paid, reinsurers' share	108	142
Change in provision for claims	(813)	(1,057)
Changes in provision for claims, reinsurers' share	85	(46)
Claims incurred, net of reinsurers' share	(7,638)	(7,076)
Net insurance income	2,589	2,093

Arion Bank Consolidated Financial Statements 2018 29 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

11. Other operating income

	2018	2017
Fair value changes on investment property	471	1,051
Net gain on assets held for sale	680	958
Other income	433	512
Other operating income	1,584	2,521

Net gain on assets held for sale

	2018	2017
Income from real estates and other assets	838	1,184
Expense related to real estates and other assets	(158)	(226)
Net gain on assets held for sale	680	958

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

	2018	2017
Number of employees		
Average number of full-time equivalent positions during the year	928	939
Full-time equivalent positions at the end of the year	904	949
Number of employees at the parent company		
Average number of full-time equivalent positions during the year	820	830
Full-time equivalent positions at the end of the year	794	844

Salaries and related expense

	2018	2017
Salaries	11,038	10,561
Defined contribution pension plans	1,577	1,516
Salary-related expense	1,663	1,525
Salaries and related expense	14,278	13,602

Salaries and related expense for the parent company

	2018	2017
Salaries	9,634	9,123
Defined contribution pension plans	1,377	1,300
Salary-related expense	1,463	1,346
Salaries and related expense	12,474	11,769

In June 2018 Arion Bank adopted a new 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 is paid in the form of deferred shares with a vesting period of two years. The aim of the remuneration programme is to build long-term engagement among employees through share ownership. 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 81 million each quarter. The market value of shares at granting date was ISK 295 million, which was deducted from the Bank's own shares.

In 2018 the Group made a provision of ISK 67 million (2017: ISK 311 million) for performance plan payments, including salary-related expense, of which the Bank made no provision (2017: ISK 223 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for Financial Undertakings. At the end of the year the Group's accrual for performance plan payments amounted to ISK 608 million (31.12.2017: ISK 942 million), of which the Bank's accrual amounts to ISK 452 million (31.12.2017: ISK 762 million).

Arion Bank Consolidated Financial Statements 2018 30 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

12. Personnel and salaries, continued

Remuneration to the Board of Directors	2018 Fixed remuner-ation*	2018 Additional remuner-ation**	2018 Total	2017 Fixed remuner-ation*	2017 Additional remuner-ation**	2017 Total
Eva Cederbalk, Chairman of the Board from 23.6.2017	21.5	3.1	24.6	10.4	0.2	10.6
Benedikt Gíslason, Director from 5.9.2018	1.7	1.2	3.0	-	-	-
Brynjólfur Bjarnason, Vice Chairman of the Board	8.1	4.9	13.0	5.2	4.6	9.8
Herdís Dröfn Fjeldsted, Director from 15.3.2018	4.3	3.7	8.0	-	-	-
Måns Höglund, Director	10.7	4.9	15.7	10.0	4.6	14.6
Steinunn K. Thórdardóttir, Director from 30.11.2017	5.4	3.4	8.8	0.4	-	0.4
Monica Caneman, Chairman of the Board until 10.5.2017	-	-	-	7.3	0.9	8.2
Benedikt Olgeirsson, Director until 9.3.2017	-	-	-	1.0	1.2	2.2
Gudrún Johnsen, Director until 29.11.2017	-	-	-	7.2	4.2	11.4
Jakob Már Ásmundsson, Director 9.3.2017 to 30.5.2018	2.2	1.9	4.1	4.2	1.2	5.4
John P. Madden, Director until 5.9.2018	2.4	0.9	3.3	-	-	-
Kirstín Th. Flygenring, Director until 15.3.2018	1.1	0.9	1.9	5.0	4.0	9.0
Thóra Hallgrímsdóttir, Director until 15.3.2018	1.1	1.0	2.0	5.0	4.4	9.4
Alternate directors of the Board	3.7	0.9	4.6	3.0	-	3.0
Total remuneration	62.1	27.0	89.1	58.7	25.3	84.0

John P. Madden, a member of the Board of Directors, received no remunerations in 2017.

Remuneration to key management personnel	2018 Salaries	2018 Performance-based payments	2017 Salaries	2017 Performance-based payments
Höskuldur H. Ólafsson, CEO	67.5	7.2	62.0	9.2
Ida Brá Benediktsdóttir, MD of Retail banking	36.9	4.3	31.5	3.5
Lýdur Thorgeirsson, MD of Investment banking from 25.10.2017	36.4	0.2	6.0	-
Margrét Sveinsdóttir, MD of Asset management	34.1	5.8	38.1	5.2
Rúnar Magni Jónsson, MD of Corporate banking	6.8	-	-	-
Stefán Pétursson, CFO	43.6	6.0	38.3	5.3
Freyr Thórdarson, MD of Corporate banking until 31.5.2018	24.7	2.4	33.9	3.4
Helgi Bjarnason MD of Retail banking until 2.5.2018	-	-	24.0	4.4
Three managing directors of the Bank's divisions who are members of the Bank's Executive Committee (2017: four)	104.0	7.2	123.8	12.4
Total remuneration	354.0	33.1	357.6	43.4

Head of Investor relation, Sture Stölen was a contractor of the Bank in 2018.

Performance based payments in 2018 are based on the Group's performance in 2017 and deferred payments based on the performance in 2014.

Board Members receive remuneration for their involvement in board committees. In addition to 21 Board meetings (2017: 16) during the year 20 Board Credit Committee meetings (2017: 16), 5 Board Audit Committee meetings (2017: 8), 9 Board Risk Committee meetings (2017: 10) and 7 Board Remuneration Committee meetings (2017: 5) were held. Four committee meetings with alternate directors of the Board were held in 2018 (2017: 4).

The 2018 Annual General Meeting of the Bank held on 15 March 2018 approved the monthly salaries for 2018 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 907,423, ISK 680,793 and ISK 453,900 (2017: ISK 849,647; 637,447; 425,000) respectively. It was also approved that the salary of Alternate Board Members would be ISK 229,912 (2017: ISK 215,273) per meeting, up to a maximum of ISK 453,900 (2017: ISK 425,000) per month. For Board Members resident abroad, the aforementioned amounts are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 181,560 (2017: ISK 170,000) per month for each committee they serve on and the Chairman of the board committees ISK 235,777 (2017: ISK 220,765).

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

** Additional remuneration represents Board Member compensation for their participation in Board Committees.

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Notes to the Consolidated Financial Statements

13. Other operating expense

	2018	2017
IT expense	4,074	4,676
Professional services	1,351	2,084
Housing expense	1,220	1,499
Other administration expense	3,162	1,573
Depositors' and Investors' Guarantee Fund	872	(1,829)
Depreciation of property and equipment	556	564
Amortization of intangible assets	765	724
Other operating expense	12,000	9,291

The Bank had recognized a liability of ISK 2,669 million against the Depositors' and Investors' Guarantee Fund. At the end of June 2017 the Bank received confirmation from the Fund stating that the claim would not be collected and thus it was reversed through the Income Statement.

Auditor's fee

	2018	2017
Audit and review of the Consolidated Financial Statements for the relevant fiscal year	182	151
Other audit related services for the relevant fiscal year	56	45
Auditor's fee	238	196
Of which fee to others than the auditor of the Parent company	1	4

In connection with the IPO and listing of Arion Bank in 2018 the Interim Consolidated Financial Statements for the first quarter of 2018 were reviewed and additional other audit related service was provided in 2017 and 2018.

14. Bank levy

The Bank levy is 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

	2018
Net change in impairment of cash and balances with Central Bank	5
Net change in impairment of loans to credit institutions	(32)
Net change in impairment of loans to corporates	(4,435)
Net change in impairment of loans to individuals	197
Net change in impairment of financial instruments carried at fair value through OCI, net of tax	(5)
Net change in impairment of loan commitments, guarantees and unused credit facilities	(215)
Net impairment on financial instruments	(4,485)
Increase in book value of loans to corporates	54
Increase in book value of loans to individuals	906
Other value changes of loans	960
Net impairment	(3,525)

Net impairment under IAS 39

	2017
Net change in impairment of loans to corporates	(3,197)
Net change in impairment of loans to individuals	168
Net change in collective impairment on loans	1,488
Provision for losses	(1,541)
Other impairment	(3)
Increase in book value of loans to corporates	364
Increase in book value of loans to individuals	1,492
Net impairment	312

Increase in book value of loans to individuals and corporates is mainly due to release of discount form 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 during the year.

Arion Bank Consolidated Financial Statements 2018 32 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

16. Income tax expense

	2018	2017
Current tax expense	3,716	6,132
Deferred tax expense	330	(166)
Income tax expense	**4,046**	**5,966**

Reconciliation of effective tax rate

	2018		2017	
Earnings before tax		12,982		21,110
Income tax using the Icelandic corporate tax rate	20.0%	2,596	20.0%	4,221
Additional 6% tax on Financial Undertakings	5.5%	709	6.5%	1,319
Non-deductible expenses	0.0%	4	0.4%	86
Tax exempt revenue	(2.9%)	(376)	(1.6%)	(190)
Non-deductible taxes	5.2%	677	3.1%	634
Tax incentives not recognized in the Income Statement	1.7%	222	0.6%	-
Other changes	1.6%	214	(0.5%)	(104)
Effective tax rate	**31.2%**	**4,046**	**28.3%**	**5,966**

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

Tax exempt revenues consist mainly of profit from equity positions.

Bank levy of 0.376% on liabilities exceeding ISK 50 billion is non-deductible.

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

	2018	2017
Net loss from discontinued operations held for sale	(1,269)	(906)
Income tax expense	110	181
Discontinued operations held for sale, net of income tax	**(1,159)**	**(725)**

Discontinued operations held for sale, net of income tax

	2018	2017
Valitor Holding hf.	(1,271)	(519)
Stakksberg ehf.	112	(206)
Discontinued operations held for sale, net of income tax	**(1,159)**	**(725)**

For further information about Valitor Holding hf., see Note 4, and Note 29 for Stakksberg ehf.

18. Earnings per share

	Continued operations		Discontinued operations		Continued and discontinued operations	
	2018	2017	2018	2017	2018	2017
Net earnings attributable to the shareholders of Arion Bank	8,275	15,125	(1,159)	(725)	7,116	14,400
Weighted average number of outstanding shares for the year, million	1,841	2,000	1,841	2,000	1,841	2,000
Basic earnings per share	4.49	7.56	(0.63)	(0.36)	3.86	7.20

There were no instruments at the end of the year that could potentially dilute basic earnings per share (2017: none).

Arion Bank Consolidated Financial Statements 2018 33 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

Notes to the Consolidated Statement of Financial Position

19. Cash and balances with Central Bank

	2018	2017
Cash on hand	5,059	9,954
Cash with Central Bank	67,492	120,641
Mandatory reserve deposit with Central Bank	10,588	9,224
Cash and balances with Central Bank	83,139	139,819

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

20. Loans to credit institutions

	2018	2017
Bank accounts	38,038	51,303
Money market loans	17,101	32,309
Other loans	1,183	2,997
Loans to credit institutions	56,322	86,609

21. Loans to customers

	Individuals		Corporates		Total	
2018	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	14,536	13,616	19,200	18,267	33,736	31,883
Credit cards	12,958	12,706	1,348	1,305	14,306	14,011
Loans to customers at fair value	-	-	4,812	4,812	4,812	4,812
Mortgage loans	343,119	342,469	23,417	23,351	366,536	365,820
Other loans	33,560	31,692	390,767	385,608	424,327	417,300
Loans to customers	404,173	400,483	439,544	433,343	843,717	833,826
2017						
Overdrafts	14,469	13,438	18,778	17,504	33,247	30,942
Credit cards	11,133	10,931	1,123	1,109	12,256	12,040
Mortgage loans	311,507	310,318	19,632	19,417	331,139	329,735
Other loans	33,629	30,600	368,312	361,784	401,941	392,384
Loans to customers	370,738	365,287	407,845	399,814	778,583	765,101

The total book value of pledged loans that were pledged against amounts borrowed was ISK 203 billion at the end of the year (31.12.2017: ISK 183 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk Management Disclosures.

22. Financial instruments

	2018	2017
Bonds and debt instruments	71,451	51,755
Shares and equity instruments with variable income	20,265	36,190
Derivatives	6,241	7,624
Securities used for economic hedging	16,600	13,881
Financial instruments	114,557	109,450

Arion Bank Consolidated Financial Statements 2018 34 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

23. Financial assets and financial liabilities

2018			Manda-torily at	
Financial assets	Amortized cost	Fair value through OCI	fair value thr. P/L	Total
Loans				
Cash and balances with Central Bank	83,139	-	-	83,139
Loans to credit institutions	56,322	-	-	56,322
Loans to customers	829,014	-	4,812	833,826
Loans	968,475	-	4,812	973,287
Bonds and debt instruments				
Listed	-	51,329	17,274	68,603
Unlisted	-	2,459	389	2,848
Bonds and debt instruments	-	53,788	17,663	71,451
Shares and equity instruments with variable income				
Listed	-	-	7,270	7,270
Unlisted	-	-	9,867	9,867
Bond funds with variable income, unlisted	-	-	3,128	3,128
Shares and equity instruments with variable income	-	-	20,265	20,265
Derivatives				
OTC derivatives	-	-	5,020	5,020
Derivatives used for hedge accounting	-	-	1,221	1,221
Derivatives	-	-	6,241	6,241
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	10,010	10,010
Shares and equity instruments with variable income, listed	-	-	6,587	6,587
Shares and equity instruments with variable income, unlisted	-	-	3	3
Securities used for economic hedging	-	-	16,600	16,600
Accounts receivable	3,751	-	-	3,751
Other financial assets	2,056	-	-	2,056
Financial assets	970,531	53,788	65,581	1,089,900
Financial liabilities				
Due to credit institutions and Central Bank	9,204	-	-	9,204
Deposits	466,067	-	-	466,067
Borrowings	417,782	-	-	417,782
Subordinated liabilities	6,532	-	-	6,532
Short position in bonds	-	-	488	488
Short position in equity	-	-	37	37
Derivatives	-	-	1,795	1,795
Other financial liabilities	6,130	-	-	6,130
Financial liabilities	905,715	-	2,320	908,035

For further information on the IFRS 9 transition, reclassification and measurements on 1 January 2018, see Note 2.

Arion Bank Consolidated Financial Statements 2018 35 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

23. Financial assets and financial liabilities, continued

2017 *

Financial assets	Amortized cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	139,819	-	-	139,819
Loans to credit institutions	86,609	-	-	86,609
Loans to customers	765,101	-	-	765,101
Loans	991,529	-	-	991,529
Bonds and debt instruments				
Listed	-	2,452	46,638	49,090
Unlisted	-	23	2,642	2,665
Bonds and debt instruments	-	2,475	49,280	51,755
Shares and equity instruments with variable income				
Listed	-	1,677	5,380	7,057
Unlisted	-	1,303	10,397	11,700
Bond funds with variable income, unlisted	-	1,782	15,651	17,433
Shares and equity instruments with variable income	-	4,762	31,428	36,190
Derivatives				
OTC derivatives	-	7,544	-	7,544
Derivatives used for hedge accounting	-	80	-	80
Derivatives	-	7,624	-	7,624
Securities used for economic hedging				
Bonds and debt instruments, listed	-	6,024	-	6,024
Shares and equity instruments with variable income, listed	-	7,846	-	7,846
Shares and equity instruments with variable income, unlisted	-	11	-	11
Securities used for economic hedging	-	13,881	-	13,881
Accounts receivable	6,531	-	-	6,531
Other financial assets	2,417	-	-	2,417
Financial assets	1,000,477	28,742	80,708	1,109,927
Financial liabilities				
Due to credit institutions and Central Bank	7,370	-	-	7,370
Deposits	462,161	-	-	462,161
Borrowings	384,998	-	-	384,998
Short position in bonds	-	1,467	-	1,467
Short position in equity	-	67	-	67
Derivatives	-	1,722	-	1,722
Derivatives used for hedge accounting	-	345	-	345
Other financial liabilities	34,705	-	-	34,705
Financial liabilities	889,234	3,601	-	892,835

* Comparative figures were not restated when adopting IFRS 9.

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Notes to the Consolidated Financial Statements

23. Financial assets and financial liabilities, continued

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

2018	FVOCI	Mandatorily FVPL	Total
Financial and insurance activities	2,962	7,364	10,326
Public sector	44,084	8,724	52,808
Corporates	6,742	1,575	8,317
Bonds and debt instruments at fair value	53,788	17,663	71,451

2017*	Trading	Designated at fair value	Total
Financial and insurance activities	1,575	4,415	5,990
Public sector	823	38,389	39,212
Corporates	77	6,476	6,553
Bonds and debt instruments designated at fair value	2,475	49,280	51,755

* Comparative figures were not restated when adopting IFRS 9.

The total amount of pledged bonds was ISK 5.9 billion at the end of the year (31.12.2017: ISK 13.4 billion). Pledged bonds comprised Icelandic and foreign Government Bonds and corporate 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. On 1 January 2018 the Group implemented IFRS 9 and as a result of the implementation assets previously measured at amortized cost were reclassified to mandatorily measured at fair value through profit and loss. The reclassified assets are measured as Level 2 assets.

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

2018

Assets at fair value	Level 1	Level 2	Level 3	Total
Loans to customers	-	4,812	-	4,812
Bonds and debt instruments	61,909	9,500	42	71,451
Shares and equity instruments with variable income	3,980	14,956	1,329	20,265
Derivatives	-	5,020	-	5,020
Derivatives used for hedge accounting	-	1,221	-	1,221
Securities used for economic hedging	16,597	3	-	16,600
Investment property	-	-	7,092	7,092
Assets at fair value	82,486	35,512	8,463	126,461

Liabilities at fair value	Level 1	Level 2	Level 3	Total
Short position in bonds	488	-	-	488
Derivatives	37	-	-	37
Derivatives used for hedge accounting	-	1,795	-	1,795
Liabilities at fair value	525	1,795	-	2,320

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Notes to the Consolidated Financial Statements

24. Fair value hierarchy, continued

2017

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	32,452	19,264	39	51,755
Shares and equity instruments with variable income	4,140	30,920	1,130	36,190
Derivatives	-	7,544	-	7,544
Derivatives used for hedge accounting	-	80	-	80
Securities used for economic hedging	13,713	168	-	13,881
Investment property	-	-	6,613	6,613
Assets at fair value	50,305	57,976	7,782	116,063

Liabilities at fair value				
Short position in bonds	1,467	-	-	1,467
Short position in equity	67	-	-	67
Derivatives	-	1,722	-	1,722
Derivatives used for hedge accounting	-	345	-	345
Liabilities at fair value	1,534	2,067	-	3,601

Transfers from Level 2 to Level 1 amounted to ISK 496 million during the year due to listing of a company on Nasdaq Iceland (2017: no transfers).

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.

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24. Fair value hierarchy, continued

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

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

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international 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		
2018	property	Bonds	Shares	Total
Balance at the beginning of the year	6,613	39	1,130	7,782
Net fair value changes	471	10	56	537
Additions	284	-	210	494
Disposals	(276)	(7)	(1)	(284)
Transfers out of Level 3	-	-	(66)	(66)
Balance at the end of the year	7,092	42	1,329	8,463
2017				
Balance at the beginning of the year	5,358	89	18	5,465
Net fair value changes	1,036	(617)	23	442
Net gain from disposal	15	-	-	15
Additions	767	-	234	1,001
Disposal	(563)	(147)	(15)	(725)
Transfers into Level 3 *	-	714	870	1,584
Balance at the end of the year	6,613	39	1,130	7,782

* In a routine review of the portfolio the Bank reclassified a number of unlisted shares and bonds from Level 2 to Level 3. Presumptions for classification to Level 2 were no longer considered available.

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

	Investment	Financial assets		
2018	property	Bonds	Shares	Total
Net financial income	-	10	56	66
Other operating income	471	-	-	471
Effects recognized in the Income Statement	471	10	56	537
2017				
Net interest income	-	27	-	27
Net financial income	-	(644)	23	(621)
Other operating income	1,051	-	-	1,051
Effects recognized in the Income Statement	1,051	(617)	23	457

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24. Fair value hierarchy, continued

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

2018	Carrying value	Fair value	Unrealized gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	83,139	83,139	-
Loans to credit institutions	56,322	56,322	-
Loans to customers	833,826	837,153	3,327
Other financial assets	5,807	5,807	-
Financial assets not carried at fair value	979,094	982,421	3,327
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	9,204	9,204	-
Deposits	466,067	466,067	-
Borrowings	417,782	426,390	(8,608)
Subordinated liabilities	6,532	6,454	78
Other financial liabilities	6,130	6,130	-
Financial liabilities not carried at fair value	905,715	914,245	(8,530)

2017	Carrying value	Fair value	Unrealized gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	139,819	139,819	-
Loans to credit institutions	86,609	86,609	-
Loans to customers	765,101	772,185	7,084
Other financial assets	8,948	8,948	-
Financial assets not carried at fair value	1,000,477	1,007,561	7,084
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,370	7,370	-
Deposits	462,161	462,161	-
Borrowings	384,998	402,355	(17,357)
Other financial liabilities	34,705	34,705	-
Financial liabilities not carried at fair value	889,234	906,591	(17,357)

Loans to customers are largely with variable interest rate. Those loans, including corporate loans, are presented at book value as they have generally short duration and very limited interest rate risk. Loans with fixed interest rate, 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.

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24. Fair value hierarchy, continued

Derivatives	Notional	Fair value	
2018	value	Assets	Liabilities
Forward exchange rate agreements	60,940	901	406
Fair value hedge of interest rate swap	146,520	1,221	-
Interest rate and exchange rate agreements	109,698	2,749	1,252
Bond swap agreements	7,526	18	45
Share swap agreements	7,455	1,340	84
Options - purchased agreements	834	12	8
Derivatives	332,973	6,241	1,795
2017			
Forward exchange rate agreements	52,914	563	251
Fair value hedge of interest rate swap	99,613	80	345
Interest rate and exchange rate agreements	199,723	6,265	1,392
Bond swap agreements	1,818	1	15
Share swap agreements	8,270	701	64
Options - purchased agreements	1,219	14	-
Derivatives	363,557	7,624	2,067

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 58.

	Notional	Maturity	Fair value		Gain/loss on FV
2018	Value	date	Assets	Liabilities	changes
Interest rates swaps - EUR	146,520	1-5 years	1,221	-	1,182
2017					
Interest rates swaps - EUR	99,613	1-5 years	80	345	(400)

	Book	Accumulated Fair value		Gain/loss on FV
2018	value	Assets	Liabilities	changes
EUR 500 million - issued 2016/18 - 5 years	65,845	640	-	(161)
EUR 300 million - issued 2017 - 3 years	40,034	1	-	(19)
EUR 300 million - issued 2018 - 3 years	40,328	-	343	(329)
Hedged borrowings	146,207	641	343	(509)
2017				
EUR 500 million - issued 2016/17 - 5 years	61,341	746	-	718
EUR 300 million - issued 2017 - 3 years	37,356	18	-	18
Hedged borrowings	98,697	764	-	736

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 93-105%.

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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				
2018	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	12,026	(50)	11,976	(10,387)	-	1,589	-	11,976
Derivatives	4,082	-	4,082	(840)	-	3,242	2,159	6,241
Total assets	16,108	(50)	16,058	(11,227)	-	4,831	2,159	18,217
2017								
Reverse repurchase agreements	15,197	-	15,197	(82)	-	15,115	-	15,197
Derivatives	6,350	-	6,350	(1,210)	-	5,140	1,274	7,624
Total assets	21,547	-	21,547	(1,292)	-	20,255	1,274	22,821

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the Balance Sheet				
2018	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	10,437	(50)	10,387	(10,387)	-	-	-	10,387
Derivatives	878	-	878	(840)	-	38	917	1,795
Total liabilities	11,315	(50)	11,265	(11,227)	-	38	917	12,182
2017								
Repurchase agreements	82	-	82	(82)	-	-	-	82
Derivatives	1,299	-	1,299	(1,210)	-	89	768	2,067
Total liabilities	1,381	-	1,381	(1,292)	-	89	768	2,149

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

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26. Investments in associates

The Group's interest in its principal associates	2018	2017
Audkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	25.4%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	35.8%	35.8%
JCC ehf., Borgartúni 19, Reykjavík, Iceland	33.3%	-
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	20.0%	23.0%
220 Fjördur ehf., Fjardargötu 13-15, Hafnarfjördur, Iceland	37.4%	35.3%

Investments in associates		
Carrying amount at the beginning of the year	760	839
Acquisitions	85	961
Dividend received	-	(41)
Transfers to assets and disposal groups held for sale	(55)	-
Disposals	-	(74)
Share of profit (loss) of associates and net impairment	27	(925)
Investment in associates	818	760

Arion Bank holds 38.4% of share capital in Farice ehf., but holds 35.8% of voting rights, based on different classes of share capital of Farice ehf.

The entity JCC ehf. was founded by the three largest Icelandic banks, with the purpose of operating cash center in Iceland. Arion Bank's shareholding in JCC ehf. is 33.3%.

27. Intangible assets

Intangible assets comprise 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 either acquired (i.e. software licenses).

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 building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as described below.

Customer relationships and related agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries and agreements bought. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationship related to individual customers through Retail Banking. When deciding on the lifetime of those agreements it was based on experience of the Bank and the industry. As a result, those 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 them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

Policies applied to the Group's intangible assets	Goodwill and infrastructure	Customer relationship and related agreements	Software
Useful lives	Undefined	Finite 5-15 years and undefined	Finite 3-10 years
Amortization method	Impairment test	Straight-line basis over 5-15 years and impairment test	Straight-line basis over 3-10 years
Internally generated or acquired	Acquired	Acquired	Acquired

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27. Intangible assets, continued

2018	Goodwill	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	4,315	3,705	1,492	4,336	13,848
Additions	-	-	-	1,372	1,372
Transfers to assets and disposal groups held for sale	(3,646)	(1,322)	(445)	(2,645)	(8,058)
Amortization	-	-	(260)	(505)	(765)
Intangible assets	669	2,383	787	2,558	6,397

2017	Goodwill	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	2,202	3,705	1,608	3,542	11,057
Acquisition through business combination	1,773	-	297	107	2,177
Additions and transfers	174	-	(125)	1,310	1,359
Additions, internally developed	-	-	-	347	347
Exchange difference	166	-	20	41	227
Impairment	-	-	(3)	-	(3)
Amortization	-	-	(305)	(1,011)	(1,316)
Intangible assets	4,315	3,705	1,492	4,336	13,848

Goodwill is recognized in the segment Subsidiaries and other divisions, see Note 5.

Impairment testing

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

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis no impairment was recognized in 2018 (2017: ISK 3 million) and is recognized in the line item Net impairment in the Income Statement.

Discount and growth rates	2018 Discount rates	2018 Growth rates	2017 Discount rates	2017 Growth rates
Asset Management operation	13.0%	2.5%	15.2%	2.5%
Payment solution and Credit card operation	-	-	13.7%	2.5%
Insurance operation	16.0%	2.5%	13-13.9%	2.5%

28. Tax assets and tax liabilities

	2018 Assets	2018 Liabilities	2017 Assets	2017 Liabilities
Current tax	-	4,650	-	6,329
Deferred tax	90	469	450	499
Tax assets and tax liabilities	90	5,119	450	6,828

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

	2018 Assets	2018 Liabilities	2017 Assets	2017 Liabilities
Foreign currency denominated assets and liabilities	-	(305)	293	-
Investment property and property and equipment	-	(221)	68	(1,050)
Financial assets	567	-	468	-
Other assets and liabilities	157	(375)	124	(383)
Deferred tax related to foreign exchange gain	-	(302)	-	(9)
Tax loss carry forward	100	-	440	-
	824	(1,203)	1,393	(1,442)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(734)	734	(943)	943
Deferred tax assets and tax liabilities	90	(469)	450	(499)

Deferred tax assets are recognized for unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilized. Significant management judgement is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and the level of future taxable profits, together with future tax planning strategies.

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28. Tax assets and tax liabilities, continued

The Group has ISK 2,347 million (31.12.2017: ISK 2,465 million) of tax losses carried forward. These losses relate to subsidiaries that have a history of losses, do not expire, and may not be used to offset taxable income elsewhere in the Group. The subsidiaries neither have any taxable temporary difference nor any tax planning opportunities available that could partly support the recognition of these losses as deferred tax assets. On this basis, the Group has determined that it cannot recognize deferred tax assets on the tax losses carried forward. If the Group was able to recognize all unrecognized deferred tax assets, profit and equity would have increased by ISK 469 million (31.12.2017: ISK 493 million).

Changes in deferred tax assets and tax liabilities

2018	At 1 Jan.	Changes due to Valitor	Recognized through equity	Recognized in profit or loss	At 31 Dec.
Foreign currency denominated assets and liabilities	293	-	-	(598)	(305)
Investment property and property and equipment	(982)	465	-	296	(221)
Financial assets	468	-	-	99	567
Other assets and liabilities	(259)	60	(222)	203	(218)
Deferred foreign exchange differences	(9)	-	-	(293)	(302)
Tax loss carry forward	440	(303)	-	(37)	100
Change in deferred tax assets and tax liabilities	(49)	222	(222)	(330)	(379)
2017					
Foreign currency denominated assets and liabilities	(224)	-	-	517	293
Investment property and property and equipment	(649)	-	-	(333)	(982)
Financial assets	475	-	-	(7)	468
Other assets and liabilities	(141)	-	-	(118)	(259)
Deferred foreign exchange differences	(103)	-	-	94	(9)
Tax loss carry forward	267	-	-	173	440
Change in deferred tax assets and tax liabilities	(375)	-	-	326	(49)

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

Assets and disposal groups held for sale	2018	2017
Valitor Holding hf.	40,003	-
Eignabjarg ehf., a holding company of Stakksberg ehf.	6,516	5,219
Disposal groups held for sale	46,519	5,219
Real estate	2,021	2,879
Other assets	44	40
Assets and disposal groups held for sale	48,584	8,138
Liabilities associated with disposal groups		
Valitor Holding hf.	26,337	-
Liabilities associated with disposal groups	26,337	-

For further information about Valitor Holding hf. see Note 4.

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

Stakksberg ehf., a subsidiary of Eignabjarg ehf.

On 22 January 2018 United Silicon was declared bankrupt following serious operational problems which resulted it its operating license being temporarily suspended, as well as a failed attempt at reaching a composition 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. Disputes with other creditors regarding the validity of the collateral and assurances provided by the Bank in relation thereto are disclosed in Note 37. 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, successfully worked to reduce uncertainties surrounding the recommissioning of the silicon plant, amongst other things by securing 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 concluding a new environmental impact assessment for the plant which is currently well under way, as well as preparations for changes to local planning, which will be carried out in cooperation with Reykjanesbær community in due course. The outcome of the latter is uncertain at this point. The Bank's objective is to divest Stakksberg ehf. on the basis of this preparatory work. Consequently Stakksberg ehf. is classified as disposal group held for sale in accordance with IFRS 5.

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30. Other assets

	2018	2017
Property and equipment	5,797	6,561
Accounts receivable	3,751	6,531
Unsettled securities trading	92	481
Investment for life assurance policyholders where risk is held by policyholder	833	869
Sundry assets	3,029	2,524
Other assets	13,502	16,966

Property and equipment

	Real estate	Equip-ment	Total 2018	Total 2017
Gross carrying amount at the beginning of the year	5,980	8,091	14,071	13,701
Additions	91	283	374	776
Acquisition through business combination	-	-	-	21
Disposals	-	(231)	(231)	(433)
Translation difference	-	-	-	5
Transfer to Assets and disposal groups held for sale	(13)	(1,736)	(1,749)	-
Gross carrying amount at the end of the year	6,058	6,407	12,465	14,070
Accumulated depreciation at the beginning of the year	(1,841)	(5,669)	(7,510)	(6,978)
Depreciation	(141)	(415)	(556)	(816)
Disposals	-	198	198	285
Transfer to Assets and disposal groups held for sale	7	1,193	1,200	-
Accumulated depreciation at the end of the year	(1,975)	(4,693)	(6,668)	(7,509)
Property and equipment	4,083	1,714	5,797	6,561

The official real estate value (Registers Iceland) amounted to ISK 6,241 million at the end of the year (31.12.2017: ISK 5,677 million) and the insurance value amounts to ISK 10,715 million (31.12.2017: ISK 10,066 million).

31. Other liabilities

	2018	2017
Accounts payable *	633	26,394
Unsettled securities trading	34	527
Depositors' and Investors' Guarantee Fund	226	218
Technical provision	13,324	12,129
Technical provision for life assurance policyholders were investment risk is held by policyholder	833	869
Withholding tax	1,590	1,414
Bank levy	3,386	3,172
Accrued expenses	3,018	4,259
Prepaid income	1,599	1,740
Impairment of off balance items	717	-
Sundry liabilities	4,747	6,340
Other liabilities	30,107	57,062

Technical provision

	Technical provision	Reinsurers' share	Total 2018	Technical provision	Reinsurers' share	Total 2017
Claims reported and loss adjustment expenses	6,871	(192)	6,679	5,587	(121)	5,466
Claims incurred but not reported	1,193	(113)	1,080	1,664	(99)	1,565
Claims outstanding	8,064	(305)	7,759	7,251	(220)	7,031
Provision for unearned premiums	5,260	(3)	5,257	4,878	(19)	4,859
Own technical provision	13,324	(308)	13,016	12,129	(239)	11,890

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.

* Decrease is mainly due to reclassification of Valitor Holding hf. as discontinued operation held for sale at year end 2018.

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32. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	2018	2017
ARION CBI 19, ISK 4,500 million	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,743	4,586
ARION CB 19, ISK 2,740 million	2016	2019	At maturity	Fixed, 5.50%	1,746	1,789
ARION CBI 21, ISK 10,220 million ...	2014	2021	At maturity	Fixed, CPI linked, 3.50%	9,950	9,729
ARION CB 22, ISK 28,720 million	2015	2022	At maturity	Fixed, 6.50%	28,503	23,339
ARION CBI 25, ISK 37,940 million ...	2017	2025	At maturity	Fixed, CPI linked, 3.00%	39,333	22,875
ARION CBI 29, ISK 25,220 million ...	2014	2029	At maturity	Fixed, CPI linked, 3.50%	27,029	26,243
ARION CBI 34, ISK 2,500 million	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	-	2,152
ARION CBI 48 ISK 11,680 million	2018	2048	Amortizing	Fixed, CPI linked, 2.50%	10,606	-
Statutory covered bonds					121,910	90,713
ARION CB 2, ISK 51,125 million	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	79,399	78,267
Structured Covered bonds					79,399	78,267
Total Covered bonds					201,309	168,980
EUR 21 million	2009	2018	Amortizing	Floating, EURIBOR +1.00%	-	348
ISK 3,835 million	2010	2018	Amortizing	Floating, REIBOR +1.00%	-	531
EUR 300 million	2015	2018	At maturity	Fixed, 3.125%	-	25,461
SEK 500 million	2016	2018	At maturity	Floating, 3 month STIBOR +1.09%	-	6,348
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	19,376	37,957
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	1,037	966
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	3,601	3,485
SEK 100 million	2017	2019	At maturity	Fixed, 0.29%	1,310	1,268
NOK 800 million	2015	2020	At maturity	Floating, NIBOR +2.95%	10,846	10,236
NOK 320 million	2016	2020	At maturity	Floating, NIBOR +1.95%	4,326	4,087
EUR 300 million *	2017	2020	At maturity	Fixed, 0.75%	40,034	37,356
SEK 300 million	2017	2020	At maturity	Floating, 3 month STIBOR +1.35%	3,936	3,811
SEK 250 million	2017	2020	At maturity	Floating, 3 month STIBOR +0.75%	3,276	3,173
EUR 500 million *	2016	2021	At maturity	Fixed, 1.625%	65,845	61,341
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,423	3,231
EUR 300 million *	2018	2023	At maturity	Fixed, 1.00%	40,328	-
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,432	3,240
Senior unsecured bonds					200,770	202,839
Bills issued					15,505	10,794
Other borrowings					198	2,385
Other loans / bills					15,703	13,179
Borrowings					417,782	384,998

* 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 interest rate swaps are hedging the exposure of the Group's changes in the fair value of these fixed-rate foreign currency denominated bonds arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. The total carrying amount of the bond issuances is ISK 146,207 million and included in the amount are negative fair value changes amounting to ISK 298 million, see Note 24.

The book value of listed bonds was ISK 402 billion at the end of the year (31.12.2017: ISK 371 billion). The market value of those bonds was ISK 411 billion (31.12.2017: ISK 388 billion). The Group repurchased own debts during the year for the amount of ISK 22 billion (2017: ISK 20 billion) with minor effects on the Consolidated Income Statement.

33. Subordinated liabilities

Currency, original nominal value	Issued	Maturity	Maturity type	Terms of interest	2018	2017
Tier II capital SEK 500 million	2018	2028	At maturity	Floating, 3 month STIBOR +3.10% .	6,532	-
Subordinated liabilities					6,532	-

The notes are eligible as Tier 2 capital under the Icelandic Financial Undertakings Act No. 161/2002. The notes are callable by the issuer on 22 November 2023 and on every interest payment date thereafter.

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34. Pledged assets

Pledged assets against liabilities	2018	2017
Assets, pledged as collateral against borrowings	239,164	202,381
Assets, pledged as collateral against loans from credit institutions and short positions	5,927	13,364
Pledged assets against liabilities	245,091	215,745

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 239 billion at the end of the year (31.12.2017: ISK 202 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 201 billion at the end of the year (31.12.2017: ISK 169 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 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Share capital	Share premium	2018	Share capital	Share premium	2017
Issued share capital	2,000	73,861	75,861	2,000	73,861	75,861
Purchase of treasury stock	(190)	(16,949)	(17,139)	-	-	-
Employees stock grant	4	284	288	-	-	-
Shares outstanding	1,814	57,196	59,010	2,000	73,861	75,861
Own shares at year-end	186	16,665	16,851	-	-	-
- as proportion of issud share capital	9.3%	22.6%	22.2%			

Share premium represents excess of payment above nominal value that shareholders have paid for shares issued by Arion Bank hf.

Other reserves	2018	2017
Statutory reserve	1,637	1,637
Foreign currency translation reserve	308	186
Other reserves	1,945	1,823

In 2018 Arion Bank acquired own shares in relation to the decision to accept an offer from Kaupskil ehf., a subsidiary of Kaupthing ehf., to buy back 9.5% of issued share capital in Arion Bank, or 190 million shares. The decision to accept the offer from Kaupskil ehf. is in line with the decision taken at a shareholders' meeting on 12 February 2018 to amend the Bank's articles of association with a temporary authorization for the Board of Directors to buy back shares issued by the Bank. Arion Bank paid ISK 90.087 a share, a total of ISK 17,139 million.

According to 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 close to 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.

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Other information

36. Shareholders of Arion Bank

	2018	2017
Kaupskil ehf. (subsidiary of Kaupthing hf.)	32.67%	57.41%
Taconic Capital (through TCA New Sidecar s.á.r.l.)	9.99%	9.99%
Arion banki hf.	9.31%	-
Attestor Capital	7.35%	10.44%
Och Ziff Capital management	6.58%	6.58%
Goldman Sachs funds	3.47%	2.57%
Eaton Vance funds	3.35%	-
Lansdowne funds	2.95%	-
Gildi pension fund	2.52%	-
Miton Asset Management funds	1.37%	-
MainFirst Bank AG	1.00%	-
Icelandic State Financial Investments	-	13.00%
Other shareholders with less than 1% shareholding	19.44%	-
Issued share capital	100.00%	100.00%

37. Legal matters

The Group has in place formal controls and policies 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

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 Court of Appeal. In June 2018 the Court of Appeal 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 have appealed the judgment to the Court of Appeal. The second case awaits the result of this case. The Bank believes that it will be acquitted of the plaintiffs' claims in both cases and has therefore not made any provision.

In January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed a suit against Valitor hf. (a subsidiary of Valitor Holding hf.) for compensatory damages amounting to approximately ISK 8.1 billion relating to Valitor hf.'s termination of Datacell's vendor agreement. The Icelandic Supreme Court ruled on 24 April 2013 in case no. 612/2012 that Valitor hf. did not have the authority to terminate the agreement. The plaintiffs had court-appointed appraisers evaluate the plaintiffs' alleged losses and they returned their report in March 2016. Valitor hf. disagreed with the assessment stated in the report and filed a motion to appoint three court appraisers to re-evaluate the plaintiffs' alleged losses. The District Court agreed to Valitor hf.'s demand. The reassessment has been completed but it was not filed with the court. Valitor hf. requested a new assessment, which would examine particular aspects which have not yet been assessed. The District Court and the Court of Appeal have rejected the request. In February 2018 Datacell and Sunshine Press Production applied for the freezing of Valitor's assets on the basis of the aforementioned claim of compensatory damages but the district magistrate declined the application. The plaintiffs subsequently filed a complaint with the District Court to re-evaluate the decision by the Magistrate to decline the freezing of assets. The District Court of Reykjavík confirmed the magistrate's decision with a judgment on 7 June 2018. Datacell and Sunshine Press Production again applied for the freezing of Valitor's assets which the district magistrate again rejected on 6 July 2018. Datacell and Sunshine Press Productions appealed the decision to the District Court but the court dismissed the case. This verdict has been appealed to the Court of Appeal. A trial for the damages claim will likely be scheduled in the first quarter of 2019. When Arion Bank acquired a 38.62% shareholding in Valitor Holding hf. in 2014, the Bank signed agreements with the seller (Landsbankinn) concerning losses which Valitor may potentially sustain in relation to the compensatory damages described above. Thus the Group may lodge a claim against the seller for their share in the potential loss should Valitor lose the case. The Group has not made any provision in this case.

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37. Legal matters, continued

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 Court of Appeal 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 Bank has demanded the case be dismissed again. Should the defendants be ordered liable for damages, they would be jointly responsible. Therefore the Bank has not made any provision.

Other legal matters

Mortgage documents

Cases have been lodged against the Bank, where claims are made for the invalidation of mortgaging of parts of a property. The claims are made on the basis that the signatures of the mortgagor on the respective mortgage documents were incorrect. In 2017, the Supreme Court ruled on the issue in several cases which did not involve the Bank. In the majority of those cases, the Supreme Court invalidated the disputed mortgage. At the district court level, several court cases involving the Bank regarding the aforementioned issue have been ruled upon. In the majority of those, the district court invalidated the disputed mortgage. The overall legal situation has become clearer and the Bank is assessing how to treat those loan documents to which the above precedent may apply.

United Silicon

The company United Silicon was granted a moratorium on payments on 14 August 2017 and filed for bankruptcy on 22 January 2018. The Bank had collateral in the company's assets and the estate has transferred the assets to the Bank. The trustee in the estate has approved the Bank's secured claims but two unsecured creditors have lodged a protest against the Bank's lien on the assets of United Silicon. The trustee in the bankruptcy has referred the disagreement to the District Court of Reykjanes. The Bank has examined these protests and rejects them all. A hearing is expected in the autumn. It should be noted that in the agreement between the Bank and the estate, it is stated that should the Bank's collateral be judicially deemed to be invalid, the Bank will refund the estate the amount of the invalidated bond.

Penalty interest during extension of payments

The Supreme Court ruled on 8 March 2018, in case no. 159/2017, that the Bank was not permitted to calculate penalty interest on a customer's debt during the period in which the said customer had been granted an extension of payments under the law on debt mitigation. Since the judgment was handed out the Bank has examined how many customers have paid penalty interest on their debts to the Bank during this extension period. The Bank is in the final process of correcting loans of those customers, either by means of repayment or debt reduction. The financial impact will be minimal.

38. Events after the reporting period

No event has arisen after the reporting period and up to the approval of these Consolidated Financial Statements that require additional disclosures.

Notes to the Consolidated Financial Statements

Off balance sheet information

39. Commitments

Financial guarantees, unused credit facilities and undrawn loan commitments

	2018	2017
Financial guarantees	15,124	13,224
Unused overdrafts	48,320	45,897
Undrawn loan commitments	79,130	87,942
Financial guarantees, unused credit facilities and undrawn loan commitments	142,574	147,063

40. Operating lease commitments

Group as a lessee

The Group has concluded lease agreements on some of the real estate it uses for its operations. These lease agreements are for a period of up to 9 years. The majority of the contracts include renewal options for various periods of time.

	2018	2017
Less than one year	360	547
Over 1 year and up to 5 years	705	1,481
Over 5 years	225	341
Future minimum lease payments under non-cancellable leases	1,290	2,369

Group as a lessor

The Group has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 10 years.

	2018	2017
Less than one year	80	69
Over 1 year and up to 5 years	248	233
Over 5 years	228	103
Future minimum lease payments under non-cancellable leases	556	405

41. Assets under management and under custody

Assets under management	970,633	984,653
Assets under custody	1,422,327	1,620,355

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.

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Related party

42. Related party

The Group has a related party relationship with entities with influence over the Group as the largest shareholders of Arion Bank, which are on 31 December 2018 Kaupskil ehf. (32.67%) and Taconic Capital (9.99%), the Board of Directors of Kaupskil ehf. and Kaupthing ehf., being the parent company of Kaupskil ehf. and legal entities controlled by them.

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.

At year end 2017 Kaupskil ehf. (57.41%) was defined as shareholder with control over the Group, the Board of Directors of Kaupskil ehf. and Kaupthing ehf. as well as Taconic Capital Advisors UK LLP (9.99%) and Och Ziff Capital management (6.58%) as their shareholdings were managed by Kaupskil ehf. At year end 2017 Attestor Capital LLP (10.44%), Goldman Sachs International (2.57%) and the Icelandic State Financial Investments (13.00%) were defined as related parties with influence over the Group.

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

2018	Assets	Liabilities	Net balance
Shareholders with influence over the Group	70	(1,022)	(952)
Board of Directors and key Management personnel	246	(257)	(11)
Associates and other related parties	21	(71)	(50)
Balances with related parties	337	(1,350)	(1,013)

2017	Assets	Liabilities	Net balance
Shareholders with control over the Group	57	(4,785)	(4,728)
Shareholders with influence over the Group	423	(151)	272
Board of Directors and key Management personnel	183	(101)	82
Associates and other related parties	-	(83)	(83)
Balances with related parties	663	(5,121)	(4,457)

Transactions with related parties

2018	Interest income	Interest expense	Other income	Other expense
Shareholders with influence over the Group	47	(94)	112	-
Board of Directors and key Management personnel	12	(16)	7	(347)
Associates and other related parties	-	-	21	(1,110)
Transactions with related parties	59	(110)	140	(1,457)

2017	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(480)	-	-
Shareholders with influence over the Group	81	-	7	-
Board of Directors and key Management personnel	13	(5)	10	(184)
Associates and other related parties	-	(3)	-	(1,260)
Transactions with related parties	94	(488)	17	(1,444)

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Notes to the Consolidated Financial Statements

Risk management disclosures

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

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

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

The Bank operates several committees to manage risk. The Board Risk Committee (BRIC) is responsible for supervising the Bank's risk management framework, risk appetite and the internal capital and liquidity adequacy assessment processes (ICAAP/ILAAP). The Asset and Liability Committee (ALCO), is responsible for managing the asset-liability mismatch, liquidity risk, market risk, and interest rate risk and capital allocation. The Underwriting and Investment Committee (UIC) decides on underwriting and principal investments. The Data Committee (DC) is responsible for ensuring that data is managed properly; and the Security Committee (SC) is responsible for security matters, both information security and physical security. The Bank operates four credit committees: The Board Credit Committee (BCC) which decides on all major credit risk exposures, the Arion Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's own funds, and the Corporate Credit Committee (CCC) and Retail Branch Committees (RBC) which operate within tighter credit granting limits.

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

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralized and reports directly to the CEO. The division is divided into three units: Credit Control, which monitors credit exposures on a customer-by-customer basis; Balance Sheet Risk, which oversees all risks related to asset and liability mismatch, including capital and is responsible for the Bank's ICAAP and ILAAP; and Operational Risk which monitors risks associated with the daily operation of the Bank. The Bank's Data Officer is part of the Risk Management division.

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

The Group's operations are subject to interest rate risk associated with mismatches in the fixing of interest rates between assets and liabilities. Prepayment risk has been considerable in the past years due to favorable refinancing conditions. The Group is exposed to indexation risk as index-linked assets exceed index-linked liabilities.

Liquidity risk is a large risk factor in the Group's operation due to maturity mismatch between assets and liabilities. The maturity of loans exceeds the maturity of deposits, of which 77% is on-demand or with less than 30 day term.

The Bank and its subsidiaries face various legal and business risks arising from its operations as well as risks to its reputation.

Further information on risk management and capital adequacy is provided in the annual Financial Statements for 2018 and in the Pillar 3 Risk Disclosures for 2018. The Pillar 3 Risk Disclosures 2018 will be published in conjunction with the Financial Statements and be available on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not subject to external audit.

43. 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.

43. Credit risk, continued

Exposure to credit risk

The table below 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. Comparative figures have not been updated.

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

		Collateral				
2018	Maximum exposure	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	83,139	-	-	-	-	-
Loans to credit institutions	56,322	-	-	-	-	-
Loans to customers at amortized cost	829,014	18,324	590,513	59,143	83,469	751,449
Individuals	*400,483*	*837*	*363,615*	*18*	*11,027*	*375,497*
Corporates	*428,531*	*17,487*	*226,898*	*59,125*	*72,442*	*375,952*
Real estate activities and construction	*140,955*	*1,280*	*136,935*	*22*	*2,484*	*140,721*
Fishing industry	*84,128*	*11*	*9,452*	*57,978*	*10,771*	*78,212*
Information and communication technology	*20,635*	*550*	*3,562*	*-*	*6,618*	*10,730*
Wholesale and retail trade	*65,824*	*349*	*29,196*	*15*	*29,257*	*58,817*
Financial and insurance activities	*38,806*	*15,152*	*6,470*	*685*	*9,001*	*31,308*
Industry, energy and manufacturing	*35,406*	*61*	*23,801*	*-*	*7,520*	*31,382*
Transportation	*11,958*	*17*	*1,055*	*307*	*1,673*	*3,052*
Services	*16,531*	*64*	*7,407*	*118*	*4,535*	*12,124*
Public sector	*6,829*	*3*	*2,031*	*-*	*315*	*2,349*
Agriculture and forestry	*7,459*	*-*	*6,989*	*-*	*268*	*7,257*
Other assets with credit risk	5,807	-	-	-	-	-
Financial guarantees	15,124	1,574	4,408	1,949	4,652	12,583
Undrawn loan commitments and unused overdrafts	127,450	-	-	-	-	-
Fair value through OCI	53,788	-	-	-	-	-
Government bonds	*44,084*	-	-	-	-	-
Corporate and finance bonds	*9,704*	-	-	-	-	-
Balance at the end of the year	1,170,644	19,898	594,921	61,092	88,121	764,032

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Notes to the Consolidated Financial Statements

43. Credit risk, continued

Maximum exposure to credit risk and collateral held against different types of financial instruments under IAS 39

2017	Maximum exposure	Collateral: Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	139,819	-	-	-	-	-
Loans to credit institutions	86,609	-	-	-	-	-
Loans to customers	765,101	15,571	525,401	53,986	55,790	650,748
Individuals	*365,287*	*195*	*326,456*	*16*	*8,413*	*335,080*
Corporates	*399,814*	*15,376*	*198,945*	*53,970*	*47,377*	*315,668*
Real estate activities and construction	*128,153*	*371*	*115,467*	*208*	*1,928*	*117,974*
Fishing industry	*78,937*	*24*	*8,569*	*52,693*	*10,580*	*71,866*
Information and communication technology	*22,020*	*541*	*1,103*	*-*	*2,035*	*3,679*
Wholesale and retail trade	*57,432*	*208*	*32,294*	*12*	*16,131*	*48,645*
Financial and insurance activities	*34,138*	*13,440*	*4,184*	*681*	*6,174*	*24,479*
Industry, energy and manufacturing	*29,452*	*660*	*19,367*	*-*	*5,747*	*25,774*
Transportation	*17,111*	*3*	*973*	*278*	*1,395*	*2,649*
Services	*18,157*	*15*	*7,365*	*98*	*3,047*	*10,525*
Public sector	*7,824*	*114*	*3,657*	*-*	*92*	*3,863*
Agriculture and forestry	*6,590*	*-*	*5,966*	*-*	*248*	*6,214*
Financial instruments	78,784	5,948	-	-	-	5,948
Other assets with credit risk	8,948	-	-	-	-	-
Financial guarantees	13,224	871	3,343	1,598	3,343	9,155
Undrawn loan commitments and unused overdrafts	133,839					-
Balance at the end of the year	1,226,324	22,390	528,744	55,584	59,133	665,851

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.

2018	Gross carrying amount	Thereof credit impaired
Less than 50%	148,995	1,516
50-70%	132,893	2,499
70-90%	58,422	1,209
90-100%	12,773	482
100%-110%	3,904	97
More than 110%	9,543	656
Not classified	6	-
Balance at the end of the year	366,536	6,459

At the end of the year the gross carrying amount of assets in stage 3 are ISK 18,175 million with ISK 12,881 million in collateral, there of ISK 11,045 million in real estate.

Collateral repossessed

During the year the Group took possession of assets due to foreclosures. The total amounts of real estates the Group took possession of during the year and still holds at the end of the year amount to ISK 827 million (31.12.2017: ISK 833 million) and other assets ISK 31 million (31.12.2017: ISK 2 million). The assets are held for sale, see note 29.

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43. Credit risk, continued

Credit quality

The Bank uses internal credit rating models and external credit ratings if available to monitor credit risk. The internal credit rating models rate customers with one of four 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 judgement for large corporate exposures. Two models rate individuals' exposures – one for prime mortgages and another for other exposures. 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. External ratings are used for marketable securities, cash and balances, and loans to credit institutions. For further information on the rating scales used, see note 57.

The tables below 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. Comparative figures have not been restated.

Credit quality profile by rating class

2018	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI
Loans to credit institutions, securities and cash			
Investment grade	83,141	55,954	53,795
Non-investment grade	-	403	-
Gross carrying amount	83,141	56,357	53,795
Loss allowance	(2)	(35)	(7)
Book value	83,139	56,322	53,788

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 1 - (Grades A+ to BBB-)	370,832	78	-	-	370,910
Risk class 2 - (Grades BB+ to BB-)	265,361	18,521	-	41	283,923
Risk class 3 - (Grades B+ to B-)	107,897	24,582	-	87	132,566
Risk class 4 - (Grades CCC+ to CCC-)	15,287	11,318	-	48	26,653
Risk class 5 - (DD)	-	-	18,175	3,640	21,815
Unrated	1,977	1,061	-	-	3,038
Gross carrying amount	761,354	55,560	18,175	3,816	838,905
Loss allowance	(1,415)	(931)	(6,301)	(1,244)	(9,891)
Book value	759,939	54,629	11,874	2,572	829,014

Loans to customers - Individuals	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 1 - (Grades A+ to BBB-)	222,003	-	-	-	222,003
Risk class 2 - (Grades BB+ to BB-)	118,271	4,831	-	41	123,143
Risk class 3 - (Grades B+ to B-)	32,562	3,255	-	87	35,904
Risk class 4 - (Grades CCC+ to CCC-)	8,368	5,390	-	48	13,806
Risk class 5 - (DD)	-	-	8,467	815	9,282
Unrated	32	3	-	-	35
Gross carrying amount	381,236	13,479	8,467	991	404,173
Loss allowance	(739)	(311)	(2,408)	(233)	(3,691)
Book value	380,497	13,168	6,059	758	400,482

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Notes to the Consolidated Financial Statements

43. Credit risk, continued

Loans to customers - Companies and sovereign	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 1 - (Grades A+ to BBB-)	148,829	78	-	-	148,907
Risk class 2 - (Grades BB+ to BB-)	147,090	13,690	-	-	160,780
Risk class 3 - (Grades B+ to B-)	75,335	21,327	-	-	96,662
Risk class 4 - (Grades CCC+ to CCC-)	6,919	5,928	-	-	12,847
Risk class 5 - (DD)	-	-	9,708	2,825	12,533
Unrated	1,945	1,058	-	-	3,003
Gross carrying amount	380,118	42,081	9,708	2,825	434,732
Loss allowance	(676)	(620)	(3,893)	(1,011)	(6,200)
Book value	379,442	41,461	5,815	1,814	428,532

Loans to customers - mortgage loans	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 1 - (Grades A+ to BBB-)	204,698	-	-	-	204,698
Risk class 2 - (Grades BB+ to BB-)	103,547	3,464	-	41	107,052
Risk class 3 - (Grades B+ to B-)	30,021	4,400	-	79	34,500
Risk class 4 - (Grades CCC+ to CCC-)	7,397	6,197	-	48	13,642
Risk class 5 - (DD)	-	-	5,911	548	6,459
Unrated	71	114	-	-	185
Gross carrying amount	345,734	14,175	5,911	716	366,536
Loss allowance	(156)	(85)	(409)	(66)	(716)
Book value	345,578	14,090	5,502	650	365,820

Loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Risk class 1 - (Grades A+ to BBB-)	78,151	1	-	78,152
Risk class 2 to 4 - (Grades BB+ to CCC-)	368	38	-	406
Unrated	55,751	6,589	1,676	64,016
Gross carrying amount	134,270	6,628	1,676	142,574
Loss Allowance	(147)	(485)	(57)	(689)
Book value	134,123	6,143	1,619	141,885

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Notes to the Consolidated Financial Statements

43. Credit risk, continued

2017

Credit quality by class of financial assets	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Cash and balances with Central Bank	139,819	-	-	139,819
Loans to credit institutions	86,609	-	-	86,609
Loans to customers				
Loans to corporates	*385,197*	*13,655*	*962*	*399,814*
Loans to individuals	*344,829*	*18,929*	*1,529*	*365,287*
Financial instruments	78,784	-	-	78,784
Other assets with credit risk	8,948	-	-	8,948
Credit quality by class of financial assets	1,044,186	32,584	2,491	1,079,261

The following table shows loans to customers that are neither past due nor impaired, broken down by the Bank's classification scale as under IAS 39, where 5 denotes the highest risk. The disclosure has not been restated after the implementation of IFRS 9.

Neither past due nor impaired loans	Risk classification						
	1	2	3	4	5	Unrated	Total
Individuals	176,980	116,296	36,507	9,953	2,238	2,855	344,829
Real estate activities and construction	28,508	51,363	40,327	3,013	83	479	123,773
Fishing industry	37,742	28,908	9,129	1,498	653	-	77,930
Information and communication technology	17,691	1,162	2,958	21	-	3	21,835
Wholesale and retail trade	19,996	20,822	9,368	2,117	563	141	53,007
Financial and insurance activities	14,638	3,708	15,103	105	-	10	33,564
Industry, energy and manufacturing	17,236	6,394	4,233	794	187	-	28,844
Transportation	10,644	3,713	2,201	48	-	65	16,671
Services	2,392	6,227	5,224	432	2,443	3	16,721
Public sector	1,730	4,938	862	108	47	-	7,685
Agriculture and forestry	863	1,740	1,816	585	163	-	5,167
Neither past due nor impaired loans	328,420	245,271	127,728	18,674	6,377	3,556	730,026

Past due but not impaired loans by class of loans	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	4,361	4,221	1,774	1,339	1,960	13,655
Loans to individuals	3,065	8,149	4,387	350	2,978	18,929
Past due but not impaired loans	7,426	12,370	6,161	1,689	4,938	32,584

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

Impaired loans to customers specified by sector	Impairment amount	Gross carrying amount
Individuals	4,010	5,539
Real estate activities and construction	467	762
Fishing industry	658	861
Information and communication technology	111	112
Wholesale and retail trade	490	702
Financial and insurance activities	297	314
Industry, energy and manufacturing	473	581
Transportation	1	1
Services	3,570	3,617
Public sector	45	45
Agriculture and forestry	165	244
Impaired loans to customers specified by sector	10,287	12,778

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Notes to the Consolidated Financial Statements

43. Credit risk, continued

The following tables reconciles the opening and closing allowance balance for debt securities at amortized cost and FVOCI 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, imapirment 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 year.

• Derecognitions and maturities, reflect the allowance related to assets derecognized during the year 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 year.

• Foreign exchange: the effects of foreign exchange on the loss allowance between year.

During the first quarter there were no significant changes to the models used to estimate expected credit loss.

2018

*Impairment loss allowance total **	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	3,189	-	10,352	-	13,541
Net effect of assets and disposal groups held for sale	(175)	-	-	-	(175)
Net remeasurement due to adoption of IFRS 9	(1,309)	621	(363)	363	(688)
Opening balance at 1.1.2018	1,705	621	9,989	363	12,678
Transfers of financial assets:					
Transfers to Stage 1 - (12-month ECL)	1,241	(650)	(591)	-	-
Transfers to Stage 2 - (lifetime ECL)	(289)	485	(196)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(189)	(272)	461	-	-
Net remeasurement of loss allowance	(1,222)	1,341	4,352	50	4,521
New financial assets, originated or purchased	715	71	735	5,065	6,586
Derecognitions and maturities	(347)	(164)	(5,034)	(41)	(5,586)
Write-offs **	(20)	(42)	(3,607)	(4,384)	(8,053)
Foreign exchange difference	13	26	249	191	479
Impairment loss allowance	1,607	1,416	6,358	1,244	10,625

* These amounts are a combination of all impairments, including an allowance for loan commitments and guarantees presented as a liability in the financial statements.

** During the reporting period an amount of ISK 7.248 million was written off but is still subject to enforcement activities subject to Icelandic law.

Impairment loss allowance for credit institutions, securities and cash	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI	Total
ECL balance at 31.12.2017	-	-	-	-
Net remeasurement due to adoption of IFRS 9	7	3	3	13
Opening balance at 1.1.2018	7	3	3	13
Net remeasurement of loss allowance	(2)	33	(4)	27
Net effects of trading	(3)	(1)	9	5
Impairment loss allowance for assets only carrying 12-month ECL	2	35	8	45

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Notes to the Consolidated Financial Statements

43. Credit risk, continued

2018

Impairment loss allowance for loans to customers

	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	3,189	-	10,294	-	13,483
Net effect of assets and disposal groups held for sale	(175)	-	-	-	(175)
Net remeasurement due to adoption of IFRS 9	(1,502)	572	(363)	363	(930)
Opening balance at 1.1.2018	1,512	572	9,931	363	12,378
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	1,159	(603)	(556)	-	-
Transfers to Stage 2 - (lifetime ECL)	(269)	465	(196)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(166)	(268)	434	-	-
Net remeasurement of loss allowance	(1,147)	866	2,410	50	2,179
New financial assets, originated or purchased	515	61	713	5,065	6,354
Derecognitions and maturities	(180)	(136)	(2,902)	(41)	(3,259)
Write-offs	(20)	(42)	(3,607)	(4,384)	(8,053)
Foreign exchange	11	16	74	191	292
Impairment loss allowance for loans to customers	1,415	931	6,301	1,244	9,891

Impairment loss allowance for loans to customers - Individuals

	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	1,435	-	4,023	-	5,458
Net effect of assets and disposal groups held for sale	(175)	-	-	-	(175)
Net remeasurement due to adoption of IFRS 9	(538)	309	(365)	357	(237)
Opening balance at 1.1.2018	722	309	3,658	357	5,046
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	833	(396)	(437)	-	-
Transfers to Stage 2 - (lifetime ECL)	(133)	327	(194)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(103)	(159)	262	-	-
Net remeasurement of loss allowance	(712)	287	474	75	124
New financial assets, originated or purchased	264	38	249	-	551
Derecognitions and maturities	(119)	(74)	(378)	(36)	(607)
Write-offs	(12)	(19)	(1,260)	(166)	(1,457)
Foreign exchange	-	-	32	2	34
Impairment loss allowance for loans to customers - Individuals	740	313	2,406	232	3,691

Impairment loss allowance for loans to customers - Companies and sovereign

	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	1,754	-	6,271	-	8,025
Net remeasurement due to adoption of IFRS 9	(964)	263	2	6	(693)
Opening balance at 1.1.2018	790	263	6,273	6	7,332
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	326	(207)	(119)	-	-
Transfers to Stage 2 - (lifetime ECL)	(136)	138	(2)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(63)	(109)	172	-	-
Net remeasurement of loss allowance	(435)	579	1,936	(25)	2,055
New financial assets, originated or purchased	251	23	464	5,065	5,803
Derecognitions and maturities	(61)	(62)	(2,524)	(5)	(2,652)
Write-offs	(8)	(23)	(2,347)	(4,218)	(6,596)
Foreign exchange	11	16	42	189	258
Impairment loss allowance for loans to customers - Companies and sovereign	675	618	3,895	1,012	6,200

Arion Bank Consolidated Financial Statements 2018 60 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

43. Credit risk, continued

Impairment loss allowance for loans to customers - mortgage loans

	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	538	-	797	-	1,335
Net remeasurement due to adoption of IFRS 9	(345)	70	(128)	127	(276)
Opening balance at 1.1.2018	193	70	669	127	1,059
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	195	(66)	(129)	-	-
Transfers to Stage 2 - (lifetime ECL)	(38)	50	(12)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(5)	(28)	33	-	-
Net remeasurement of loss allowance	(250)	70	32	(46)	(194)
New financial assets, originated or purchased	79	5	7	-	91
Derecognitions and maturities	(14)	(10)	(89)	(10)	(123)
Write-offs	(4)	(6)	(102)	(5)	(117)
Impairment loss allowance for loans to customers - mortgage loans	156	85	409	66	716

Impairment loss allowance for loan commitments, guarantees and unused credit facilities

	Stage 1	Stage 2	Stage 3	Total
ECL balance at 31.12.2017	-	-	58	58
Net remeasurement due to adoption of IFRS 9	180	49	-	229
Opening balance at 1.1.2018	180	49	58	287
Transfers of financial assets				
Transfers to 12-month ECL	82	(47)	(35)	-
Transfers to lifetime ECL	(20)	20	-	-
Transfers to credit impaired financial assets	(23)	(4)	27	-
Net remeasurement of loss allowance	(102)	475	1,942	2,315
New financial assets, originated or purchased	195	10	22	227
Derecognitions and maturities	(167)	(28)	(2,132)	(2,327)
Foreign exchange	2	10	175	187
Impairment loss allowance for loan commitments, guarantees and unused credit facilities	147	485	57	689

The following table reconciles the opening and closing loss allowance balance as measured under IAS 39. The comparative amounts have not been restated after the implementation of IFRS 9.

2017	Specific	Collective	Total
Balance at the beginning of the year	18,281	4,557	22,838
Provision for losses	3,029	(1,362)	1,667
Effects due to acquisition of subsidiary*	(8,723)	-	(8,723)
Write-offs	(2,421)	-	(2,421)
Foreign exchange difference	3	-	3
Payment of loans previously written-off	118	-	118
Balance at the end of the year	10,287	3,195	13,482

* At the end of September 2017 Arion Bank became majority owner of United Silicon, see Note 29. Arion Bank had made provision for losses on loans to United Silicon which was eliminated on Group level when United Silicon became a subsidiary of Arion Bank.

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 had no large exposure at the end of the year before taking account of eligible credit risk mitigation (31.12.2017: no large exposure).

Arion Bank Consolidated Financial Statements 2018 61 Amounts are in ISK millions

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

Interest rate risk

Interest rate risk arises from the possibility that changes in 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 repricing 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 has applied cash flow hedging for its foreign denominated fixed rate borrowings. For domestic rates, longer fixing periods are more common, and this especially applies to indexed mortgages issued between 2004 and 2006. The fixing profile of indexed mortgages is however largely matched by that of the Group's structured covered bonds issue, which serves as a hedge against repricing risk. The Group has been able to manage relatively small interest fixing gaps.

Due to favorable refinancing spreads, prepayments and/or refinancing of loans have been considerable over the past few years. 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.

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 Consolidated 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 at 31. December 2018 as they are classified as held for sale. The average duration of fixed rates has reduced between years for the Bank's assets and reduction in loans to credit institutions and balances with Central Bank results in considerable change for shorter fixing periods.

2018	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	83,139	-	-	-	-	83,139
Loans to credit institutions	56,322	-	-	-	-	56,322
Loans to customers	498,065	88,553	148,853	7,794	93,888	837,153
Financial instruments	9,543	10,941	30,847	664	2,015	54,010
Assets	647,069	99,494	179,700	8,458	95,903	1,030,624
Liabilities						
Due to credit institutions and Central Bank	9,204	-	-	-	-	9,204
Deposits	430,260	20,277	13,156	1,383	991	466,067
Borrowings	37,497	33,242	190,111	44,425	121,115	426,390
Subordinated loans	6,532	-	-	-	-	6,532
Liabilities	483,493	53,519	203,267	45,808	122,106	908,193
Derivatives and other off-balance sheet items (net position)	(185,255)	40,259	150,397	(2,484)	-	2,917
Net interest gap	(21,679)	86,234	126,830	(39,834)	(26,203)	125,348

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Notes to the Consolidated Financial Statements

44. Market risk, continued

2017 *Assets*	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	129,864	-	-	-	-	129,864
Loans to credit institutions	86,609	-	-	-	-	86,609
Loans to customers	440,161	77,099	141,944	5,867	107,114	772,185
Financial instruments	27,342	3,033	8,186	-	1,866	40,427
Assets	683,976	80,132	150,130	5,867	108,980	1,029,085
Liabilities						
Due to credit institutions and Central Bank	7,370	-	-	-	-	7,370
Deposits	427,393	19,453	13,083	1,343	889	462,161
Borrowings	64,533	6,637	187,946	31,293	111,946	402,355
Liabilities	499,296	26,090	201,029	32,636	112,835	871,886
Derivatives and other off-balance sheet items (net position)	(99,372)	114	102,038	1,548	-	4,328
Net interest gap	85,308	54,156	51,139	(25,221)	(3,855)	161,527

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 purely based on contractual interest rate adjustments where it is simplistically assumed that all rates are equally sensitive to the presumed change in market rates.

Interest rates for foreign currencies are predominantly short term for the Group and hedging is applied for fixed rate borrowings. As a result the Group's effective interest income is marginally sensitive to changes to foreign currency interest rates.

	2018		2017	
NPV change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(4,544)	4,872	(1,465)	2,411
ISK, Non index-linked	624	(139)	(76)	742
Foreign currencies	700	(708)	88	(113)

	2018		2017	
NII change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(828)	828	(693)	693
ISK, Non index-linked	(90)	90	(429)	429
Foreign currencies	232	(232)	353	(353)

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.

	2018		2017	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	123	(111)	99	(95)
ISK, Non index-linked	62	(54)	19	(14)
Foreign currencies	13	(13)	27	(27)

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44. Market risk, continued

Indexation risk

A significant part of the Group's balance sheet is linked to the Icelandic Consumer Price Index (CPI). Index-linked loans and borrowings are typically annuities, where the principal and monthly payments change in the same proportion as 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

2018	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	30,455	79,761	246,605	356,821
Financial instruments	12,791	-	-	12,791
Off-balance sheet position	532	(995)	-	(463)
Assets, CPI index-linked	43,778	78,766	246,605	369,149
Liabilities, CPI index-linked				
Deposits	72,766	12,735	2,367	87,868
Borrowings	6,482	17,567	147,209	171,258
Other	875	208	1,420	2,503
Off-balance sheet position	895	4,999	1,082	6,976
Liabilities, CPI index-linked	81,018	35,509	152,078	268,605
Net on-balance sheet position	(36,877)	49,251	95,609	107,983
Net off-balance sheet position	(363)	(5,994)	(1,082)	(7,439)
CPI Balance	(37,240)	43,257	94,527	100,544

2017	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	16,928	100,149	233,292	350,369
Financial instruments	6,659	-	-	6,659
Off-balance sheet position	4,667	2,096	-	6,763
Assets, CPI index-linked	28,254	102,245	233,292	363,791
Liabilities, CPI index-linked				
Deposits	68,667	12,499	2,201	83,367
Borrowings	1,832	20,867	121,692	144,391
Other	982	203	1,369	2,554
Off-balance sheet position	-	539	-	539
Liabilities, CPI indexed linked	71,481	34,108	125,262	230,851
Net on-balance sheet position	(47,894)	66,580	108,030	126,716
Net off-balance sheet position	4,667	1,557	-	6,224
CPI Balance	(43,227)	68,137	108,030	132,940

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Notes to the Consolidated Financial Statements

44. 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

2018

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	81,245	833	222	168	179	59	433	83,139
Loans to credit institutions	3,158	16,418	14,055	1,484	1,191	15,722	4,294	56,322
Loans to customers	680,413	103,775	33,473	3,290	6,912	692	5,271	833,826
Financial instruments	53,852	30,915	26,930	771	189	1,649	251	114,557
Other financial assets	5,381	318	54	-	48	4	2	5,807
Assets	824,049	152,259	74,734	5,713	8,519	18,126	10,251	1,093,651
Liabilities								
Due to credit inst. and Central Bank	7,144	945	1,109	4	-	1	1	9,204
Deposits	398,789	35,773	22,615	2,110	1,632	1,954	3,194	466,067
Financial liabilities at fair value	1,281	494	383	54	-	39	69	2,320
Other financial liabilities	3,599	353	1,458	148	333	41	198	6,130
Borrowings	218,049	165,583	-	-	-	22,027	12,123	417,782
Subordinated liabilities	-	-	-	-	-	-	6,532	6,532
Liabilities	628,862	203,148	25,565	2,316	1,965	24,062	22,117	908,035
Net on-balance sheet position	195,187	(50,889)	49,169	3,397	6,554	(5,936)	(11,866)	
Net off-balance sheet position	5,071	44,881	(48,840)	(7,403)	(10,536)	5,963	10,864	
Net position	200,258	(6,008)	329	(4,006)	(3,982)	27	(1,002)	

Addition, for management reporting

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Investment property	7,092	-	-	-	-	-	-	7,092
Investments in associates	810	8	-	-	-	-	-	818
Intangible assets	6,397	-	-	-	-	-	-	6,397
Tax assets	90	-	-	-	-	-	-	90
Assets and disposal groups held for sale	23,959	9,849	1,010	7,603	4,003	532	1,628	48,584
Other non financial assets	7,536	107	19	8	2	23	-	7,695
Assets	45,884	9,964	1,029	7,611	4,005	555	1,628	70,676
Liabilities and equity								
Tax liabilities	5,119	-	-	-	-	-	-	5,119
Liabilities associated with disposal groups held for sale	19,843	1,254	793	3,378	577	400	92	26,337
Other non-financial liabilities	23,883	70	20	-	1	-	3	23,977
Shareholders' equity	200,729	-	-	-	-	-	-	200,729
Non-controlling interest	130	-	-	-	-	-	-	130
Liabilities and equity	249,704	1,324	813	3,378	578	400	95	256,292
Management reporting of currency risk *	(3,562)	2,632	545	227	(555)	182	531	

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Notes to the Consolidated Financial Statements

44. Market risk, continued

2017

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	137,399	943	293	266	265	117	536	139,819
Loans to credit institutions	17,678	15,033	27,117	8,518	1,910	10,621	5,732	86,609
Loans to customers	624,192	97,687	27,879	3,283	7,245	646	4,169	765,101
Financial instruments	56,240	39,891	11,309	102	9	1,691	208	109,450
Other financial assets	6,023	965	613	1,102	171	24	50	8,948
Assets	841,532	154,519	67,211	13,271	9,600	13,099	10,695	1,109,927
Liabilities								
Due to credit inst. and Central Bank .	6,989	292	38	3	-	1	47	7,370
Deposits	412,981	23,792	15,382	3,309	1,349	3,692	1,656	462,161
Financial liabilities at fair value	2,253	1,183	34	27	32	35	37	3,601
Other financial liabilities	20,150	3,870	2,183	5,505	1,393	565	1,039	34,705
Borrowings	181,787	162,486	1,832	14	-	20,794	18,085	384,998
Liabilities	624,160	191,623	19,469	8,858	2,774	25,087	20,864	892,835
Net on-balance sheet position	217,372	(37,104)	47,742	4,413	6,826	(11,988)	(10,169)	
Net off-balance sheet position	(536)	34,743	(46,994)	(1,557)	(9,142)	12,331	11,155	
Net position	216,836	(2,361)	748	2,856	(2,316)	343	986	

Addition, for management reporting

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Investment property	6,613	-	-	-	-	-	-	6,613
Investments in associates	752	8	-	-	-	-	-	760
Intangible assets	13,848	-	-	-	-	-	-	13,848
Tax assets	450	-	-	-	-	-	-	450
Assets and disposal groups held for sale	8,138	-	-	-	-	-	-	8,138
Other non-financial assets	7,844	61	34	36	2	19	22	8,018
Assets	37,645	69	34	36	2	19	22	37,827
Liabilities and equity								
Tax liabilities	6,828	-	-	-	-	-	-	6,828
Other non-financial liabilities	22,105	99	30	122	1	-	-	22,357
Shareholders' equity	225,606	-	-	-	-	-	-	225,606
Non-controlling interest	128	-	-	-	-	-	-	128
Liabilities and equity	254,667	99	30	122	1	-	-	254,919
Management reporting of currency risk *	(186)	(2,391)	752	2,770	(2,315)	362	1,008	

* 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.

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44. Market risk, continued

Sensitivity analysis on currency risk

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

	2018		2017	
Currency	-10%	+10%	-10%	+10%
EUR	(263)	263	239	(239)
USD	(55)	55	(75)	75
GBP	(23)	23	(277)	277
DKK	56	(56)	232	(232)
NOK	(18)	18	(36)	36
Other	(53)	53	(101)	101

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 of equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices that affect the Consolidated Financial Statement. 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.

	2018		2017	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(231)	231	(166)	166
Banking book - listed	(487)	487	(540)	540
Banking book - unlisted	(617)	617	(1,170)	1,170

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 reduce market risk on its balance sheet. Note 24 shows a breakdown of the Group's derivative positions by type.

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45. 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 72% 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.

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

Contractual cash flow of assets and liabilities

2018	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Assets								
Cash and balances with CB	-	77,854	5,373	-	-	-	83,227	83,139
Loans to credit institutions	34,635	20,714	585	403	-	-	56,337	56,322
Loans to customers	2,937	116,527	126,990	332,488	655,349	-	1,234,291	829,014
Financial instruments	17,081	7,375	15,674	44,436	8,768	26,856	120,190	114,557
Derivatives - assets leg	-	*41,746*	*23,340*	*45,303*	*3,184*	-	*113,573*	*113,573*
Derivatives - liabilities leg	-	*(41,110)*	*(21,143)*	*(39,681)*	*(3,039)*	-	*(104,973)*	*(104,973)*
Other financial assets	393	1,921	2,592	896	5	-	5,807	5,807
Assets	55,046	224,391	151,214	378,223	664,122	26,856	1,499,852	1,088,839
Liabilities								
Due to credit inst. and Central Bank ..	9,230	-	27	-	-	-	9,257	9,204
Deposits	335,644	83,059	32,413	13,316	2,527	-	466,959	466,067
Financial liabilities at fair value	-	1,133	1,036	3,256	270	-	5,695	2,320
Derivatives - assets leg	-	*(22,574)*	*(2,823)*	*(19,861)*	*(6,733)*	-	*(51,991)*	*(51,991)*
Derivatives - liabilities leg	-	*23,182*	*3,859*	*23,117*	*7,003*	-	*57,161*	*57,161*
Short position bonds and derivatives ..	-	*487*	-	-	-	-	*487*	*487*
Short position securities used for economic hedging	-	*36*	-	-	-	-	*36*	*38*
Other financial liabilities	45	3,680	1,652	753	-	-	6,130	6,130
Borrowings	-	19,568	42,677	248,808	198,821	-	509,874	417,782
Subordinated liabilities	-	44	146	782	7,509	-	8,481	6,532
Liabilities	344,919	107,484	77,951	266,915	209,127	-	1,006,396	908,035
Net position for assets and liab.	(289,873)	116,907	73,263	111,308	454,995	26,856	493,456	180,804
Off-balance sheet items								
Financial guarantees	4,130	1,712	4,288	3,204	1,790	-	15,124	15,124
Unused overdraft	-	48,320	-	-	-	-	48,320	48,320
Undrawn loan commitments	95	53,531	21,333	4,171	-	-	79,130	79,130
Off-balance sheet items	4,225	103,563	25,621	7,375	1,790	-	142,574	142,574
Net contractual cash flow	(294,098)	13,344	47,642	103,933	453,205	26,856	350,882	38,230

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Notes to the Consolidated Financial Statements

45. Liquidity and Funding risk, continued

2017 *Assets*	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Cash and balances with CB	31,281	99,340	9,362	-	-	-	139,983	139,819
Loans to credit institutions	52,320	34,294	-	-	-	-	86,614	86,609
Loans to customers	2,908	107,790	90,076	336,545	568,833	-	1,106,152	765,101
Financial instruments	8,512	15,082	14,641	20,028	5,926	44,047	108,236	109,450
Derivatives - assets leg	*1,436*	*38,718*	*18,153*	*71,627*	*678*	-	*130,612*	*126,111*
Derivatives - liabilities leg	*(1,423)*	*(37,084)*	*(18,084)*	*(68,879)*	*(585)*	-	*(126,055)*	*(118,487)*
Other financial assets	1,535	5,103	2,224	86	-	-	8,948	8,948
Assets	96,556	261,609	116,303	356,659	574,759	44,047	1,449,933	1,109,927
Liabilities								
Due to credit inst. and Central Bank	7,658	-	26	-	-	-	7,684	7,370
Deposits	331,796	86,524	30,244	13,071	2,246	-	463,881	462,161
Financial liabilities at fair value	-	2,182	(102)	593	(273)	-	2,400	3,601
Derivatives - assets leg	-	*(20,039)*	*(11,449)*	*(14,407)*	*(1,557)*	-	*(47,452)*	*(40,931)*
Derivatives - liabilities leg	-	*20,688*	*11,347*	*15,000*	*1,284*	-	*48,319*	*42,998*
Short position bonds and derivatives	-	*410*	-	-	-	-	*410*	*410*
Short position securities used for economic hedging	-	*1,124*	-	-	-	-	*1,124*	*1,124*
Other financial liabilities	25,538	7,296	28	1,843	-	-	34,705	34,705
Borrowings	-	37,110	23,066	239,210	175,845	-	475,231	384,998
Liabilities	364,992	133,112	53,262	254,717	177,818	-	983,901	892,835
Net position for assets and liab.	(268,436)	128,497	63,041	101,942	396,941	44,047	466,032	217,092
Off-balance sheet items								
Financial guarantees	2,918	2,852	3,164	2,827	1,463	-	13,224	13,224
Unused overdraft	-	45,897	-	-	-	-	45,897	45,897
Undrawn loan commitments	2,966	45,788	17,751	9,559	11,878	-	87,942	87,942
Off-balance sheet items	5,884	94,537	20,915	12,386	13,341	-	147,063	147,063
Net contractual cash flow	(274,320)	33,960	42,126	89,556	383,600	44,047	318,969	70,029

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%.

Calculations of the NSFR are based on consolidated figures for the Bank and Arion Bank Mortgages Institutional Investor Fund. 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 that of this Consolidated Financial Statement due to the sub-consolidation applied.

2018	ISK	Foreign currency	Total
Available stable funding	681,074	215,434	896,508
Required stable funding	615,717	134,082	749,799
Foreign currency balance		(7,102)	
Net stable funding ratio	111%	155%	120%

2017	ISK	Foreign currency	Total
Available stable funding	663,850	199,770	863,620
Required stable funding	577,761	110,473	688,234
Foreign currency balance		7	
Net stable funding ratio	115%	181%	125%

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45. Liquidity and Funding risk, continued

Liquidity coverage ratio

The Liquidity Coverage Ratio (LCR) is part 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 accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, assets must be non-pledged, liquid and easily priced on the market, repo-able at the Central Bank 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 broken down by currencies. All amounts are weighted by their respective LCR weights. The calculations are based on consolidated figures for the Bank, the Arion Bank Mortgages Institutional Investor Fund and Valitor Holding hf.

2018	ISK	Foreign currency	Total
Liquid assets level 1 *	75,340	48,806	124,146
Liquid assets level 2	-	-	-
Liquid Assets	75,340	48,806	124,146
Deposits	91,008	33,983	124,991
Borrowing	4,413	109	4,522
Other cash outflows	9,229	10,347	19,576
Cash outflows	104,650	44,439	149,089
Short-term deposits with other banks **	4,011	56,527	60,538
Other cash inflows	10,719	2,314	13,033
Cash inflows	14,730	58,841	73,571
Liquidity coverage ratio (LCR) ***	84%	439%	164%

2017	ISK	Foreign currency	Total
Liquid assets level 1 *	131,197	27,716	158,913
Liquid assets level 2	-	-	-
Liquid Assets	131,197	27,716	158,913
Deposits	108,442	24,738	133,180
Borrowing	2,426	96	2,522
Other cash outflows	6,067	9,500	15,567
Cash outflows	116,935	34,334	151,269
Short-term deposits with other banks **	1,048	59,528	60,576
Other cash inflows	12,232	6,540	18,772
Cash inflows	13,280	66,068	79,348
Liquidity coverage ratio (LCR) ***	127%	323%	221%

* 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 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.

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Notes to the Consolidated Financial Statements

45. Liquidity and Funding risk, continued

Composition of liquid assets

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

2018	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	88,687	222	833	838	90,580
Short-term deposits in other banks	4,012	14,141	16,265	26,120	60,538
Domestic bonds eligible as collateral at the Central Bank	4,844	-	-	-	4,844
Foreign government bonds	-	21,152	21,961	757	43,870
Covered bonds with a minimum rating of AA-	-	-	1,340	1,625	2,965
Liquidity reserve	97,543	35,515	40,399	29,340	202,797
2017					
Cash and balances with Central Bank	137,399	293	943	1,184	139,819
Short-term deposits in other banks	1,048	24,796	15,334	19,398	60,576
Domestic bonds eligible as collateral at the Central Bank	3,022	-	-	-	3,022
Foreign government bonds	-	6,401	16,291	-	22,692
Covered bonds with a minimum rating of AA-	-	-	1,262	1,538	2,800
Liquidity reserve	141,469	31,490	33,830	22,120	228,909

LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. The table contains deposits at the Bank and at banking subsidiaries. Thus, amounts due to Central Bank and amounts due to credit institutions at non-banking subsidiaries are excluded.

LCR categorization - amounts and LCR outflow weights

	Deposits maturing within 30 days					
2018	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Individuals	126,196	11%	51,232	5%	69,000	246,428
Small and medium enterprises	48,961	11%	4,836	5%	5,417	59,214
Corporations	48,033	40%	852	20%	7,605	56,490
Sovereigns, central banks and PSE	14,052	40%	-	-	5,067	19,119
Pension funds	45,671	100%	-	-	10,038	55,709
Domestic financial entities	22,494	100%	-	-	12,630	35,124
Foreign financial entities	3,187	100%	-	-	-	3,187
Total	308,594		56,920		109,757	475,271
2017						
Individuals	117,789	11%	47,943	5%	64,419	230,151
Small and medium enterprises	45,753	11%	4,458	5%	4,322	54,533
Corporations	51,968	40%	811	20%	5,757	58,536
Sovereigns, central banks and PSE	14,583	40%	-	-	1,383	15,966
Pension funds	53,116	100%	-	-	15,391	68,507
Domestic financial entities	23,175	100%	-	-	15,949	39,124
Foreign financial entities	2,714	100%	-	-	-	2,714
Total	309,098		53,212		107,221	469,531

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

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Notes to the Consolidated Financial Statements

46. 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 Act No. 161/2002 on Financial Undertakings and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR), but has temporarily excluded Article 501 on capital requirements relief for small and medium enterprises. The Group uses 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 Vörður tryggingar hf. should be viewed independently from capital adequacy for the Group's consolidated situation.

Valitor holding hf. has been classified as disposal group held for sale and discontinued operations in these Consolidated 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 22.0% to 23.8%. The sale of Valitor would result in reduction in the Group's regulatory own funds adjustments, with positive effect on capital adequacy.

Own funds	2018	2017
Total equity	200,859	225,734
Deductions related to the consolidated situation	(8,986)	(8,635)
Non-controlling interest not eligible for inclusion in CET 1 capital	(130)	(128)
Common Equity Tier 1 capital before regulatory adjustments	191,743	216,971
Intangible assets	(12,152)	(11,125)
Tax assets	(191)	(357)
Indirect holdings of own CET1 instruments	(190)	-
Cash flow hedges	(1,221)	265
Additional value adjustments	(126)	(119)
Foreseeable dividend *	(9,069)	(25,000)
Common equity Tier 1 capital	168,794	180,635
Non-controlling interest not eligible for inclusion in CET 1 capital	130	128
Tier 1 capital	168,924	180,763
Subordinated liabilities	6,532	-
General credit risk adjustments **	-	3,195
Tier 2 capital	6,532	3,195
Total own funds	175,456	183,958

Risk-weighted assets		
Credit risk, loans	639,788	605,058
Credit risk, securities and other	50,112	56,979
Counterparty credit risk	4,405	5,844
Market risk due to currency imbalance	4,280	4,895
Market risk other	8,928	5,473
Credit valuation adjustment	2,228	2,506
Operational risk	86,858	86,013
Total risk-weighted assets	796,599	766,768

Capital ratios		
CET 1 ratio	21.2%	23.6%
Tier 1 ratio	21.2%	23.6%
Capital adequacy ratio	22.0%	24.0%

* On 31 December 2018, the foreseeable dividend corresponds to the ISK 10 billion dividend payment approved by the Board of Directors on 13 February 2019. The amount is net of the Bank's own shares of 9.31% of total outstanding shares. At 31 December 2017 the amount is the equity reduction executed in the first quarter of 2018 through purchase of own shares and dividend distribution.

** Under IAS 39, the Bank's general provisions accounted as Tier 2 capital as stipulated in CRR. As per EBA's opinion, all provisions under IFRS 9 are considered specific credit risk adjustments (SCRA). FME has adopted this opinion - as a result the Group's own funds no longer include general credit risk adjustments and these are now treated as SCRA, effectively reducing risk-weighted assets.

Capital ratios of the parent company	2018	2017
CET 1 ratio	23.5%	26.0%
Tier 1 ratio	23.5%	26.0%
Capital adequacy ratio	24.3%	26.4%

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46. Capital management, continued

The following table outlines the implementation of the capital buffer requirements in accordance with the Financial Undertakings Act, as prescribed by the Financial Stability Council (FSC) and approved by the FME.

Capital buffer requirement, % of RWA	Current	15.5.2019	1.2.2019
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 *	1.25%	1.75%	2.00%
Combined capital buffer requirement	8.75%	9.25%	9.50%

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 FME 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 FME'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 RWA, current

31.12.2018	CET 1	Tier 1	Total
Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.6%	2.2%	2.9%
Combined buffer requirement *	8.5%	8.5%	8.5%
Regulatory capital requirement	14.6%	16.6%	19.4%
Available capital	21.2%	21.2%	22.0%

Capital requirement, % of RWA, 15.5.2019

Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.6%	2.2%	2.9%
Combined buffer requirement *	8.9%	8.9%	8.9%
Regulatory capital requirement	15.1%	17.1%	19.8%
Available capital	21.2%	21.2%	22.0%

* The effective capital buffers for systemic risk and countercyclical effects are determined by calculating the weighted average of the corresponding buffer levels of each country (if recognized by the FME), the weights being the total risk weighted exposures for credit risk against counterparties residing in those countries.

** The SREP result based on the Group's financial statement at 31.12.2017. The Pillar 2 requirement is 2.9% of risk-weighted assets based on the Group's prudential consolidation under CRR, which excludes Vörður 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 Act No. 161/2002 on Financial Undertakings.

	2018	2017
On-balance sheet exposures	1,106,368	1,074,207
Derivative exposures	8,239	10,957
Securities financing transaction exposures	8,194	8,925
Off-balance sheet exposures	68,316	83,058
Total exposure	1,191,117	1,177,147
Tier 1 capital	168,924	180,763
Leverage ratio	14.2%	15.4%

Solvency II

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vördur Group was ISK 3,860 million at 31 December 2018 (31.12.2017: ISK 3,503 million) and calculated solvency of Vördur Group was ISK 5,520 million (31.12.2017: ISK 4,949 million). The solvency ratio, which is the ratio of calculated solvency to the solvency requirements was 143% at 31 December 2018 (31.12.2017: 141%).

Arion Bank Consolidated Financial Statements 2018 73 Amounts are in ISK millions

47. Operational risk

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

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

The Group uses the standardized approach for the calculation of capital requirements for operational risk.

Notes to the Consolidated Financial Statements

Significant accounting policies

The accounting policies adopted in the preparation of these Consolidated Financial Statements are consistent with those followed in the preparation of the Annual Financial Statements for the year ended 31 December 2017 except for new and amended IFRS adopted by the European Union, that became effective as of 1 January 2018, see Note 2 and amendments to Icelandic Annual Accounts Act, Financial undertakings Act and Rules on Accounting for credit institutions.

48. 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 Consolidated Financial Statements are prepared on a going concern basis.

49. Principles underlying the consolidation

Subsidiaries

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

Business combinations

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. The Group controls an investee if, and only if, the Group has:

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

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

The Group measures goodwill at the acquisition date as:
- the fair value of the consideration transferred; plus
- the recognized amount of any non-controlling interests in the acquiree; less
- if the business combination is achieved in stages, the fair value of the pre-existing equity interest in the acquiree; less
- the net recognized amount (generally fair value) of the identifiable assets acquired and liabilities assumed.

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

Transaction costs incurred are expensed and included in administration expense.

Non-controlling interests

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

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:
- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

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

Notes to the Consolidated Financial Statements

49. Principles underlying the consolidation, continued

Loss of control

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

Transactions eliminated on consolidation

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Consolidated Financial Statements. This also applies to subsidiaries classified as disposal groups held for sale.

Funds management

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

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

50. Associates

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

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

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

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

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

Impairment on investments in associates

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

Notes to the Consolidated Financial Statements

51. Foreign currency

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

Foreign currency transactions

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

52. Interest

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

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

Interest income and expense presented in the Income Statement include Income and expenses of assets and liabilities carried at:

- amortized cost;
- fair value through profit and loss (FVTPL); and
- fair value through other comprehensive income (FVOCI).

53. Fee and commission

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

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

54. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and liabilities at fair value and Net foreign exchange gain.

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

ii) Net gain on financial assets and liabilities at fair value comprises all realized and unrealized fair value changes, except for interest (which is included in Interest income and Interest expense) and foreign exchange gain and losses (which are included in Net foreign exchange gains as described below).

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

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

55. Net insurance income

Premiums recognized as income comprise the premiums contracted during the fiscal year including premiums transferred from last years but excluding next periods premiums, which are recognized as provision for unearned premiums. Provision for unearned premiums is a part of the technical provision in the Statement of Financial Position.

Claims recognized in the Income Statement are the periods claims including increases or decreases due to claims from previous fiscal years. Outstanding claims included in technical provision in the Statement of Financial Position are the total amount of reported but unpaid claims as well as actuarial provision for claims occurred but unreported.

Notes to the Consolidated Financial Statements

56. Income tax expense

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

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years. Taxable profit may differ from earnings before tax as reported in the Income Statement as it may exclude income or expense that is deductible in other years and it excludes income or expense that are never taxable or deductible.

Current and deferred tax relating to items recognized directly in equity is recognized in equity and not in the statement of profit or loss.

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

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

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

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Such deferred tax assets and liabilities are not recognized if the temporary difference arises from the initial recognition (other than in a business combination) of assets and liabilities in transaction that affects neither the taxable profit nor the accounting profit. In addition, tax liabilities are not recognized if the temporary difference arises from the initial recognition of goodwill.

57. Financial assets and financial liabilities

Recognition and initial measurement

The Group initially recognizes financial assets and financial liabilities on the date that they are originated at the fair value of consideration paid. Regular-way purchases and sales of financial assets are recognized on the trade date at which the Group commits to purchase or sell assets. All other financial assets and liabilities are recognized on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

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

Derecognition

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

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

Debt instruments

Debt instruments, including loans and debt securities, are classified into one of the following measurement categories:

- amortized cost;
- fair value through profit and loss (FVTPL); or
- fair value through other comprehensive income (FVOCI).

A debt instrument is measured at amortized cost only if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to collect contractual cash flows; and
- its contractual cash flows are solely payments of principal and interest on the principal amount outstanding (here after SPPI).

A debt instrument is measured at FVOCI only if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to collect contractual cash flows and selling financial assets; and
- its contractual cash flows are SPPI.

All other debt instruments are carried at FVTPL.

57. Financial assets and financial liabilities, continued

Business model assessment

Business model assessment involves determining whether financial assets are managed in order to generate cash flows from collection of contractual cash flows, selling financial assets or both. The Group assesses the business model at a portfolio level reflective of how groups of assets are managed together to achieve a particular business objective. For the assessment of business models the Group takes into consideration the following factors:

- how the performance of assets in a portfolio is evaluated and reported to group heads and other key decision makers within the Group's business lines;
- the risks that affect the performance of assets held within a business model and how those risks are managed;
- whether the assets are held for trading purposes, i.e. assets that the Group acquires or incurs principally for the purpose of selling or repurchasing in the near term, or holds as part of a portfolio that is manage together for short-term profit or position taking;
- how compensation is determined for the Group's business lines' management that oversee the assets; and
- the frequency and volume of sales in prior periods and expectations about future sales activity.

Cash flow characteristics assessment

The contractual cash flow characteristics assessment involves assessing the contractual features of an instrument to determine if they give rise to cash flows that are consistent with a basic lending arrangement. Contractual cash flows that are consistent with a basic lending arrangement are considered SPPI.

Interest is defined as consideration for the time value of money, the banks funding costs, the credit risk associated with the principal amount outstanding and other costs (e.g liquidity risk and administrative costs), as well as a profit margin. Indexation of loans to the Consumer Price Index (CPI) are considered part of interest as CPI guarantees the time value of money of the original outstanding balance. Principal may change over the life of the instruments due to repayments. Indexation on principal accumulates over time.

In performing this assessment, the Group takes into consideration contractual features that could change the amount or timing of contractual cash flows, such that the cash flows are no longer consistent with a basic lending arrangement. If the Group identifies any contractual features that could modify the cash flows of the instruments such that they are no longer consistent with a basic lending arrangement, the related financial assets is classified at FVTPL.

Debt instruments measured at amortized cost

Debt instrument are measured at amortized cost if they are held within a business model whose objective is to hold for collection of contractual cash flows where those cash flows represent solely payments of principal and interest. After initial measurement, debt instruments in this category are carried at amortized cost using the effective interest rate method. The effective interest rate is the rate that discounts contractual cash payments or receipt through the contractual lifetime of the financial asset to the gross carrying amount of a financial asset. Amortized cost is calculated taking into account any discount or premium on acquisition, transaction cost and fees that are an integral part of the effective interest rate. Amortization is included in interest income in the Consolidated Income Statement.

Impairment on debt instruments measured at amortized cost is calculated using the expected credit loss (ECL) approach. Loans and debt securities measured at amortized cost are presented net of allowance for credit losses in the Consolidated Statement of Financial Position.

Debt instruments measured at FVOCI

Debt instrument are measured at FVOCI if they are held within a business model whose objective is to hold for collection of contractual cash flows and/or selling financial assets, where the assets' cash flows represent payments that are solely payments of principal and interest. Subsequent to initial recognition, unrealized gains and losses on debt instruments measured at FVOCI are recorded in Other Comprehensive Income (OCI). At realization the accumulated profit or loss recognized in OCI in previous periods is recycled to the Consolidated Income Statement. Foreign exchange gains and losses of the debt instrument are recognized in the Consolidated Income Statement. Interest income from received payments are recognized in interest income in the Consolidated Income Statement upon payment.

Impairment on debt instruments measured at FVOCI is calculated using the expected credit loss approach. The ECL on debt instruments measured at FVOCI does not reduce the carrying amount of the asset in the Statement of Financial Position, which remains at its fair value. Instead, an amount equal to the allowance that would arise if the assets were measured at amortized cost is recognized in OCI whit a corresponding charge to net impairment in the Consolidated Statement of Comprehensive Income. The accumulated allowance recognized in OCI is recycled to the Consolidated Statement of Comprehensive Income upon derecognition of the debt instrument.

57. Financial assets and financial liabilities, continued

Debt instruments measured at FVTPL

Debt instrument are measured at FVTPL if they are held for short term gain before maturity, held as part of a portfolio managed on a fair value basis or the cash flows do not represent payments that are solely payments of principal and interest. These instruments are measured at fair value in the Consolidated Statement of Financial Position. Realized and unrealized gains and losses are recognized as part of Net financial income in the Consolidated Income Statement.

Purchased loans

All purchased loans are initially measured at fair value on the date of acquisition. As a result no allowance for credit losses would be recorded in the Consolidated Statement of Financial Positions on the date of acquisition. Purchased loans may fit into either of the two categories: Performing loans or Purchased or Originated Credit Impaired (POCI) loans.

Purchased performing loans are reflected in Stage 1 and will follow the same accounting as other performing loans. They will be subject to a 12-month allowance for credit losses which is recorded as provision for credit losses in the Consolidated Income Statement. The fair value adjustments set up for these loans on the date of acquisition is amortized into interest income over the life of these loans.

POCI loans do not have allowance at initial recognition but subsequently the allowance will reflect the changes in the lifetime expected losses. At recognition the discount of each POCI loan is split up into two categories, impairment discount and interest discount or premium. Interest is calculated with a credit adjusted effective interest rate and is posted to interest income. Periodically the Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original credit adjusted effective interest rate, any changes in the expected cash flows since the date of acquisition are recorded as a charge/recovery in net impairment in the Consolidated Income Statement at the end of all reporting periods subsequent to the date of acquisition.

Equity instruments

Equity instruments are measured at FVTPL unless an election is made to designate them at FVOCI at initial recognition.

For equity instruments measured at FVTPL, changes in fair value are recognized as part of Financial income in the Consolidated Income Statement.

The Group can elect to classify non-trading equity instruments at FVOCI. This election will be used for certain equity instruments for strategic or longer term investment purposes. The FVOCI election is made upon initial recognition, on an instrument-by-instrument basis and once made is irrevocable. Gains and losses on these instruments including when derecognized/sold are recorded in OCI and are not subsequently reclassified to the Consolidated Income Statement. Dividends received are recorded in Financial income in the Consolidated Income Statement. Any transaction costs incurred upon purchase of the security are added to the cost basis of the security and are not reclassified to the Consolidated Income Statement of the security.

Offsetting

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

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

Notes to the Consolidated Financial Statements

57. Financial assets and financial liabilities, continued

Expected credit losses

Expected credit loss (ECL) is established for all financial assets, except for financial assets classified or designated as FVTPL and equity instruments designated as FVOCI, which are not subject to impairment assessment. Assets subject to impairment assessment are primarily debt instruments (including loans to customers) measured at amortized cost or FVOCI. ECL on financial assets is presented in Net impairment. Other financial assets carried at amortized cost are presented net of ECL in the Group's Consolidated Statement of Financial Position. Off-balance sheet items subject to impairment assessment include financial guarantees and undrawn loan commitments. ECL for Off-balance sheet items is separately calculated and included in Other Liabilities.

The Group measures the ECL on each balance sheet date according to a three-stage expected credit loss impairment model:

Stage	Criteria	Assessment of expected credit loss, and effective interest
1	Exposures not impaired and with no significant increase in credit risk	12 month expected credit loss is recorded. The expected credit loss is computed using a probability of default occurring over the next 12 months. For those instruments with a remaining maturity of less than 12 months, a probability of default corresponding to remaining term to maturity is used. The effective interest rate is calculated on the gross carrying amount.
2	Exposures not impaired with significant increase in credit risk subsequent to origination.	Lifetime expected credit loss is recorded, based on the probability of default over the remaining estimated life of the financial instrument. Effective interest rate is calculated on the gross carrying amount.
3	Exposures in default / Credit impaired	Lifetime expected credit loss is recorded. Effective interest rate is calculated on the book value.

The ECL is an unbiased discounted probability-weighted estimate of the cash shortfalls expected to result from defaults occurring in the next 12 months or, in cases where credit risk has significantly increased, in the expected lifetime of an exposure. For guarantees and loan commitments, credit loss estimates consider the portion of the commitment that is expected to be paid out or expected to be drawn over the relevant time period, contingent on significant financial difficulty.

Increases or decreases in the required ECL attributable to purchases and new originations, derecognitions or maturities, and remeasurements due to changes in loss expectations or state migrations are recorded in net impairment. Write-offs and recoveries of amounts previously written off are recorded against ECL.

The ECL represents an unbiased estimate of expected credit losses on our financial assets as at the balance sheet date. Judgement is required in making assumptions and estimations when calculating the ECL, including movements between the three stages and the application of forward looking scenarios. The underlying assumptions and estimates may results in changes to the provisions from period to period that significantly affect our results of operations.

Definition of default

The Group considers a financial assets to be in default when:

- the borrower is more than 90 days past due, or
- the borrower is considered to be unlikely to pay.

In assessing whether a borrower is unlikely to pay, the Group considers both qualitative and quantitative indicators, e.g. overdue status, debt and equity ratios, market circumstances and other data developed internally or obtained from external sources.

For corporate counterparties it is assumed that if one exposure is in default, all other exposures to that counterparty are also in default (cross-default). For individuals however, mortgages and other exposures are assessed separately, meaning that if an individual is in default on a mortgage, his other exposures are not assumed to be in default, and vice versa. A default event for a mortgage can however be an indicator on the likelihood of default for the borrower’s other exposures, and vice versa.

Frequent default events within a year are treated as a single default event. A defaulted exposure is considered to be cured if it has returned to non-default state, with no amount in arrears, within 12 months from default and without any incurred loss for the Group.

Probability of default and credit risk rating

The Group allocates to each exposure a credit risk rating (e.g. A+, A, A-, BBB+, etc.) based on the calculated 12 month probability of default ('the PD'). The PD is assessed through the Group's credit rating models or based on external ratings if available. The Group's credit rating models are 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 judgement for large corporate exposures. Factors vary depending on the nature of the exposure and the profile of the borrower. The PD estimates used for the purpose of calculating IFRS 9 impairments are point-in-time, i.e. dependent on the economic cycle. The Group's credit rating models are subject to annual performance tests and are recalibrated on a regular basis if needed.

Notes to the Consolidated Financial Statements

57. Financial assets and financial liabilities, continued

The Group's rating scale is shown below, including mapping of external ratings. The lower bounds are inclusive.

Risk class	Rating	Lower PD	Upper PD	S&P / Fitch	Moody's	Description
0	AAA	0.000%	0.006%	AAA	Aaa	Investment Grade
	AA+	0.006%	0.018%	AA+	Aa1	
	AA	0.018%	0.029%	AA	Aa2	
	AA-	0.029%	0.045%	AA-	Aa3	
1	A+	0.045%	0.070%	A+	A1	Investment Grade
	A	0.070%	0.110%	A	A2	
	A-	0.110%	0.170%	A-	A3	
	BBB+	0.170%	0.260%	BBB+	Baa1	
	BBB	0.260%	0.410%	BBB	Baa2	
	BBB-	0.410%	0.640%	BBB-	Baa3	
2	BB+	0.640%	0.990%	BB+	Ba1	Non-investment Grade
	BB	0.990%	1.540%	BB	Ba2	
	BB-	1.540%	2.400%	BB-	Ba3	
3	B+	2.400%	3.730%	B+	B1	Non-investment Grade
	B	3.730%	5.800%	B	B2	
	B-	5.800%	9.010%	B-	B3	
4	CCC+	9.010%	14.000%			Non-investment Grade
	CCC	14.000%	31.000%			
	CCC-	31.000%	99.990%			
5	DD	99.99%	100.00%	D	C	Default / Impaired

The Group uses external ratings for counterparties that receive such ratings from recognized rating agencies such as Moody's, Standard & Poor's and Fitch. The Group's internal rating scale was originally calibrated to match historical default rates shown in publications of the aforementioned rating agencies and using smoothing techniques. External ratings are primarily used to assess expected losses for counterparties of marketable securities, money market and deposit accounts positions which fall under the Impairment requirements of IFRS 9. The Bank's ECL is broken down by investment grade and non-investment grade classes for such exposures, as per the definition of the corresponding rating agency.

Each exposure is allocated a credit risk rating at initial recognition. The calculations are based on rules and available information at the time of origination. Exposures are continuously monitored and revaluated, which may result in transitions between risk ratings. The monitoring typically involves the use of credit history, audited financial statements, management accounts, budgets, KPI's, projections, quality of management, data from credit reference agencies, overdue status and other qualitative and quantitative information available.

PD term structures

In addition to calculating PD and allocating a credit risk rating to each exposure, the Group calculates the lifetime probability of default (LPD), which is an assessment of the probability that a default event occurs over the lifetime of the exposure. The LPD incorporates management's view of possible future macroeconomic developments and the likelihood of rating transitions over the lifetime of the exposure. For the determination of LPD, the Bank calculates PD term structures – which effectively provides the probability of default for any given time period, one for each rating grade, PD model and economic scenario. The annualized lifetime probability of default (ALPD) of an exposure is the fixed 12 month PD (without transitions) that corresponds to the exposure's LPD. The credit risk rating that corresponds to the ALPD is defined as the lifetime credit risk rating.

The assessed 12 months PDs are the basis for the determination of the term structure of PDs for exposures. The Group applies transition models, developed on the basis of historical data, to predict the development of risk grades for periods that exceed one year. The Group has separated transition behavior due to specific and general risk and applies its macro-economic forecasts to the latter. The analysis of credit rating transitions due to general risk includes the identification and calibration of relationships between changes in default rates and changes in key macro-economic factors. Unemployment rate is the predominant predictive variable. Among other indicators examined are GDP growth and benchmark interest rates.

Assumptions on key macro-economic indicators are on an ongoing basis estimated based on internal and external information available at each time. The Group formulates a 'base case' view of the future direction of relevant economic variables as well as a representative range of other possible forecast scenarios. The Group uses these forecasts to adjust its estimates of lifetime probability of default and other factors that affect the lifetime expected credit loss.

57. Financial assets and financial liabilities, continued

Significant increase in credit risk

The assessment of significant increase in credit risk requires significant judgment. In determining whether the risk of default for an exposure has increased significantly since initial recognition, the Group considers relevant, reasonable and supportable information on an ongoing basis. Assumptions are drawn based on the Group's historical experience and expert judgement including forward-looking expectations. If a debt investment security has low credit risk and is considered investment grade at the reporting date, the Group will determine that the credit risk on the asset has not increased significantly since initial recognition.

For a given exposure, the Group considers a significant increase in credit risk to have occurred if one of the following holds:

- the exposure's credit risk rating on reporting date is not in risk class 0 or 1 and has deteriorated by more than one risk rating compared to the credit risk rating at origination;
- the exposure's lifetime credit risk rating on reporting date is not in risk class 0 or 1 and has deteriorated by more than one risk grade (two or more) compared to the lifetime credit risk rating at origination. As the Group does not have the benefit of hindsight, this comparison is only used for exposures that originate on or after 1 January 2018;
- the number of days in arrears exceeds 30 days; or
- the exposure is on the Group's watch list.

The Group monitors the effectiveness of the criteria used to identify significant increases in credit risk by regular reviews to confirm that the criteria is capable of identifying significant increases in credit risk before an exposure is in default and there is no unwarranted volatility in loss allowance from transfers between 12-month ECL (stage 1) and lifetime ECL (stage 2).

Exposures in default

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

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, default or delinquency by a borrower, restructuring of a loan or advance by the Group on terms that the Group would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, the disappearance of an active market for a security, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group. When estimating impairments the following is considered:

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

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow. In some instances exposures do not require impairment due to collateral coverage.

Impairment losses are recognized in net impairment, see note 43. When an event occurring after the impairment was recognized causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through net impairment.

Expected credit loss measurement

The expected credit loss (ECL) calculations are based on three main components:

- probability of default (PD),
- loss given default (LGD); and
- exposure at default (EAD).

Each component is derived from internally generated models, apart from external credit ratings. The models are developed with statistical methods and/or expert judgement supported by historical data and adjusted for expected macro-economic effects.

The Group's PDs and PD term structures are based on both quantitative and qualitative factors and in some cases external ratings are used. PD's are re-assessed on a regular basis with different frequencies depending on the type of counterparty and/or exposure.

Each credit facility is assigned an LGD. The LGD is an assessment of loss conditional on a default occurrence. The Group splits LGD into three components; the probability of cure, the expected recovery from liquidation of collateral, and the recovery rate for the unsecured part of the exposure. The cure rate is modeled on the groups historical data of assets returning to performing status after being in default without loss. The expected recovery is the outcome of The Group’s collateral allocation algorithm which takes into account the seniority of debt and collateral type. Haircuts are applied to different types of collaterals based on expert judgment, supported by historical data, and takes into account costs and the time value of money. Different haircuts are applied for different macro-economic scenarios in the ECL calculations. In some instances assets are considered to be fully covered by collateral after haircut application and therefore carry no ECL. The recovery rate for the unsecured part of the exposure is based on expert judgment taking into account historical loss experience.

57. Financial assets and financial liabilities, continued

The EAD represents the expected exposure at the event of a default. For a given exposure, the Group derives the EAD from the contractual amortization schedule and taking into account the likelihood of pre-payments, drawdowns, rollovers, extensions and use of unused allowance in the period leading up to default. These behavioral estimates, which are based on historical observations and forward-looking forecasts, apply differently to each type of exposure.

The Group measures ECL considering the risk of default over the maximum contractual period (including any extension periods) over which it is exposed to credit risk. The maximum contractual period extends to the date at which the Group has the right to require repayment of an advance or terminate a loan commitment or guarantee. However, for overdrafts and credit card facilities that include both a loan and an undrawn commitment component, the Group measures ECL over a period longer than the maximum contractual period if the Group’s contractual ability to demand repayment and cancel the undrawn commitment does not limit the Group’s exposure to credit losses to the contractual notice period. These facilities do not have a fixed term or repayment structure. The Group can cancel them with immediate effect but this contractual right is not enforced in the normal day-to-day management, but only when the Group becomes aware of an increase in credit risk at the facility level. This longer period is estimated taking into account the credit risk management actions that the Group expects to take and that serve to mitigate ECL. These include a reduction in limits, cancellation of the facility and/or turning the outstanding balance into a loan with fixed repayment terms. The ECL calculations involve discounting using the exposures' effective interest rates.

Forward looking scenarios

The ECL for an exposure is the weighted average of the expected credit loss for different macro-economic scenarios provided by the Group's management. The Group currently considers three scenarios: 'base case', 'optimistic' and 'pessimistic' and assign its best estimate of likelihood of occurrence to each one. The development of macro-economic variables and the corresponding weights are based on expert judgement supported by historical data. The Group incorporates forward-looking macro-economic information into both its assessment of whether the credit risk of an instrument has increased significantly since its initial recognition (via the lifetime credit risk rating comparison) and its measurement of ECL as the PD term structures, LGD and EAD include macro-economic adjustments for each of the scenarios.

The predominant macro-economic variable used across all portfolios is the unemployment rate in Iceland, as measured by the Directorate of Labor. The default rate observed for the Group's exposures has been shown to be highly correlated with unemployment rate. Collateral haircuts are adjusted for different scenarios. Exit and pre-payment rates, which affects EAD, are dependent on refinancing spreads and due to the correlation between interest rates and unemployment rate they are adjusted for different scenarios.

Write-off of loans

Loans are written off, either partially or in full, when there is no realistic prospect of recovery i.e. the bankruptcy of the borrower or an ineffective attachment or distraint. Collateralized loans are generally written of when the realization of collateral have been received. After write-off, exposures continue to be subject to collection activities in accordance with Icelandic law.

Modifications

The original terms of a financial asset may be renegotiated or otherwise modified, resulting in changes to the contractual terms of the financial asset that affect the contractual cash flow. The treatment of such modifications is primarily based on the process undertaken to execute the renegotiation and the nature and extent of changes made. Modifications which are performed for credit reasons, primarily related to troubled debt restructurings, are generally treated as modifications of the original financial asset unless modifications are significant. Significant modifications are generally considered to be an expiry of the original cash flows; accordingly, such renegotiations are treated as a derecognition of the original financial asset and recognition of a new financial asset.

If a modification of terms does not result in derecognition of the financial asset, the carrying amount of the financial asset is recalculated as the present value of the renegotiated or modified contractual cash flows, discounted at the original effective interest rate and gain or loss is recognized. The financial asset continues to be subject to the same assessments for significant increase in credit risk relative to initial recognition and credit-impairment, as described above. A modified financial asset will migrate out of Stage 3 if the conditions that led to it being identified as credit-impaired are no longer present and relate objectively to an event occurring after the original credit-impairment was recognized. A modified financial asset will migrate out of Stage 2 when it no longer satisfies the relative thresholds set to identify significant increase in credit risk, which are based on changes in its PD, lifetime PD, days past due and other qualitative considerations.

If a modification of terms results in derecognition of the original financial asset and recognition of the new financial asset, the new financial asset will generally be recorded in Stage 1, unless it is determined to be credit-impaired at the time of renegotiation. For the purposes of assessing for significant increase in credit risk, the date of initial recognition for the new financial asset is the date of modification.

58. Hedge accounting

From the applying of IFRS 9 from 1 January 2018, the Group has choosed to continue to apply the hedge accounting requirements of IAS 39, in line with exemption from IFRS 9. However, the Group will provide the expanded disclosures on hedge accounting introduced by IFRS 9's amendments to IFRS 7, as the accounting policy election does not provide an exemption from the new disclosure requirements under IFRS 7.

The Group applies fair value hedge accounting with respect to designated hedging relationship of certain fixed-rate foreign currency denominated notes issued by the Bank as the hedged items and certain foreign currency denominated interest rate swaps as the hedging instruments. The Group recognizes the changes in fair value of the interest rate swaps together with changes in the fair value of bonds attributable to interest rate risk immediately in profit or loss in the line item of Note 9, Net gain on fair value hedge of interest rate swap. Calculated accrued interest on both swaps and bonds are included in the line item of Note 7, Interest expense.

Other derivatives, not designated in a qualifying hedge relationship, are used to manage its exposure to foreign currency, interest rate, equity market and credit risk. The financial instruments used include, but are not limited to, interest rate swaps, cross-currency swaps, forward contracts, futures, options, credit swaps and equity swaps.

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80–125%.

If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. Any adjustments, up to the point of discontinuation, to a hedged item for which the effective interest method is used, is amortized to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

59. Cash and cash equivalents

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

60. Loans

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

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

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

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

61. Derivatives

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

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

Notes to the Consolidated Financial Statements

62. Intangible assets

Goodwill

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

Infrastructure and customer relationship

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

Software

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

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

Amortization of intangible assets

Amortization of intangible assets is recognized in the Income Statement on a straight-line basis over the estimated useful life, from the date that it is available for use. The estimated useful life of intangible assets for the current and comparative periods is three to ten years.

63. Investment property

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

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

64. Impairment of non-financial assets

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

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

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

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

Notes to the Consolidated Financial Statements

65. Deposits

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

66. Borrowings

Borrowings are measured at amortized cost with any difference between cost and redemption amount being recognized in the Income Statement over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

67. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within Tier II, see Note 46. The Group may only retire subordinated liabilities with the permission of the Icelandic Financial Supervisory Authority.

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

68. Assets and disposal groups held for sale

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

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

69. Other assets and other liabilities

Property and equipment

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

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

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

Buildings	33 years
Equipment	3-7 years

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

Other assets and other liabilities

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

Insurance claim

Estimate is made in accordance with Solvency II rules. Data from the company's claim system are extrapolated to predict the final amount of the claims that will be paid at the end of the reporting period with corresponding expected payments from reporting date until the settlement of claims that occurred prior to the reporting date. In addition, estimation of settlement cost, risk and other factors is made in accordance with the instructions in Solvency II rules. This approach is consistent with the valuation of insurance liabilities in IFRS 4.

Notes to the Consolidated Financial Statements

70. Equity

Dividends

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

Reserve for investments in subsidiaries and associates

According to the Financial Statements Act No. 3/2006 the difference between share of profit of subsidiary or associate in excess of dividend payment or dividend payment pending, shall be transferred to a restricted shareholding equity reserve, net of tax, which is not subject to dividend payments. When shareholding in subsidiary or associate is sold or written off the shareholding equity reserve shall be released and the amount transferred to retained earnings.

Reserve for investments in securities

According to the Financial Statements Act No. 3/2006 fair value changes of financial assets from the initial reporting, shall be transferred from retained earnings to a fair value equity reserve, net of tax. The fair value equity reserve is not subject to dividend payments. The fair value equity reserve shall be released in accordance with fair value changes recognized when financial asset is sold or redeemed or the assumptions for the fair value change is no longer in force.

Financial assets at fair value through OCI

Unrealized fair value changes net of tax for assets held at fair value through other comprehensive income. The fair value reserve is released in correlation with realization of gains or losses of financial assets at derecognition.

Other reserves

Other reserves consist of statutory reserve and foreign currency translation reserve.

Statutory reserve

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

Foreign currency translation reserve

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

71. Earnings per share

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

72. Financial guarantees

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

Notes to the Consolidated Financial Statements

73. Fiduciary activities

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

74. Employee benefits

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

75. Standards issued but not yet effective

A number of new standards, amendments to standards and interpretations have been issued but are not yet effective for the year ended 31 December 2018, and have not been applied in preparing these Consolidated Financial Statements. Relevant to the Group's reporting are IFRS 16 Leases and IFRS 17 Insurance contracts.

IFRS 16 Leases

IFRS 16 requires lessees to account for all leases under a single on-balance sheet model. The standard does not significantly change the accounting for leases for lessors. The standard includes two recognition exemptions for lessees; leases of low-value assets and short-term leases. At the commencement date of a lease, a lessee will recognize a liability to make lease payments and an asset representing the right to use the underlying asset during the lease term. Lessees will be required to separately recognize the interest expense on the lease liability and the depreciation expense on the right-of-use asset.

The Group will elect to use the exemptions proposed by the standard on lease contracts for which the lease terms ends within 12 months as of the date of initial application, and lease contracts for which the underlying asset is of low value.

The Group has performed an impact assessment of IFRS 16 and will recognize a right-of-use asset of ISK 1 billion and a lease liability of the same amount, as at 1 January 2019. The adoption of IFRS 16 will not have impacts on the total equity nor the Income Statement as of 1 January 2019.

IFRS 17 Insurance Contracts

IFRS 17 Insurance Contracts, is comprehensive new accounting standard for insurance contracts covering recognition and measurement, presentation and disclosure. IFRS 17 applies to all types of insurance contracts (i.e., life, non-life, direct insurance and re-insurance). The overall objective of IFRS 17 is to provide an accounting model for insurance contracts that is more useful and consistent for insurers. IFRS 17 is effective for reporting periods beginning on or after 1 January 2021, with comparative figures required. This standard will be applicable to the Group‘s subsidiary Vördur, which is currently assessing the potential effect of the standard.

5-year overview

Income Statement

	2018	2017	2016	2015	2014
Net interest income	29,319	28,920	29,900	26,992	24,220
Net fee and commission income	10,350	10,211	13,978	14,484	13,309
Net financial income	2,302	4,045	5,162	12,844	7,290
Net insurance income	2,589	2,093	1,395	760	664
Share of profit of associates and net impairment	27	(927)	908	29,466	3,498
Other operating income	1,584	2,521	3,203	2,074	5,347
Operating income	46,171	46,863	54,546	86,620	54,328
Salaries and related expense	(14,278)	(13,602)	(16,659)	(14,892)	(13,979)
Other operating expense	(12,000)	(9,291)	(13,881)	(12,919)	(12,722)
Operating expenses	(26,278)	(22,893)	(30,540)	(27,811)	(26,701)
Bank levy	(3,386)	(3,172)	(2,872)	(2,818)	(2,643)
Net impairment	(3,525)	312	7,236	(3,087)	2,135
Earnings before income tax	12,982	21,110	28,370	52,904	27,119
Income tax expense	(4,046)	(5,966)	(6,631)	(3,225)	(4,815)
Net earnings from continuing operations	8,936	15,144	21,739	49,679	22,304
Discontinued operations, net of tax	(1,159)	(725)	-	-	6,290
Net earnings	7,777	14,419	21,739	49,679	28,594

Statement of Financial Position

Assets

	2018	2017	2016	2015	2014
Cash and balances with Central Bank	83,139	139,819	87,634	48,102	21,063
Loans to credit institutions	56,322	86,609	80,116	87,491	108,792
Loans to customers	833,826	765,101	712,422	680,350	647,508
Financial instruments	114,557	109,450	117,456	133,191	101,828
Investment property	7,092	6,613	5,358	7,542	6,842
Investments in associates	818	760	839	27,299	21,966
Intangible assets	6,397	13,848	11,057	9,285	9,596
Tax assets	90	450	288	205	655
Assets and disposal groups held for sale	48,584	8,138	4,418	5,082	3,958
Other assets	13,502	16,966	16,436	12,496	11,528
Total Assets	1,164,327	1,147,754	1,036,024	1,011,043	933,736

Liabilities and Equity

	2018	2017	2016	2015	2014
Due to credit institutions and Central Bank	9,204	7,370	7,987	11,387	22,876
Deposits	466,067	462,161	412,064	469,347	454,973
Financial liabilities at fair value	2,320	3,601	3,726	7,609	9,143
Tax liabilities	5,119	6,828	7,293	4,922	5,123
Liabilities associated with disposal groups held for sale	26,337	-	-	-	-
Other liabilities	30,107	57,062	54,094	49,461	47,190
Borrowings	417,782	384,998	339,476	256,058	200,580
Subordinated liabilities	6,532	-	-	10,365	31,639
Total liabilities	963,468	922,020	824,640	809,149	771,524
Shareholders' equity	200,729	225,606	211,212	192,786	160,711
Non-controlling interest	130	128	172	9,108	1,501
Total equity	200,859	225,734	211,384	201,894	162,212
Total Liabilities and Equity	1,164,327	1,147,754	1,036,024	1,011,043	933,736

Comparative figures for 2017 have been restated as Valitor Holding hf. has been classified as disposal group held for sale, see Note 4.

Arion Bank Consolidated Financial Statements 2018 90 Amounts are in ISK millions

Appendixes

Unaudited

Appendix to the Consolidated Financial Statements

Non-financial information

Society

Arion Bank shows its commitment to sustainable banking by making a difference to our customers and performing our role as a financial institution conscientiously and responsibly. Arion Bank takes an active role in our society and its development. Financial institutions are one of the pillars of society and our role is to help our customers, both individuals and companies, reach their goals. Arion Bank has played an important role in the regeneration of the Icelandic economy, not least in the rebuilding of the Icelandic stock market.

One of the Bank's main focuses is to provide convenient banking services anytime and anywhere, and the Bank has set itself the goal of being the leading digital bank in Iceland. The Bank also places great importance on being able to provide first-class advice at its branches and its employees also provide financial instruction to customers in order to help customers gain a better understanding of their own finances.

The key to understanding our customers' needs is to listen to what they say. We regularly perform surveys where we ask how likely or unlikely it is that our customers would recommend our services to others. Individual service components are also measured and the results are used to improve services. Lean management has been introduced across the Bank with the aim of improving service and eliminating waste. Constant improvements are integral to the Bank's culture. Improvements are recorded, targets set and then followed up on. In 2018 a new service strategy was brought in and special service training for employees was introduced to further enhance the customers' experience.

The Bank is dedicated to supporting the Icelandic business sector and has actively supported innovation and it has helped to set up two business accelerators, Startup Reykjavík and Startup Energy Reykjavík, where entrepreneurs are given the opportunity to develop their business ideas. Startup Reykjavík is fully owned by Arion Bank, while Startup Energy Reykjavík is a joint project with several leading players on the Icelandic energy market. The Bank has invested in the venture capital fund Eyrir Sprotar and supported innovation at primary and secondary level schools across Iceland.

In addition to providing strong backing to the Icelandic economy, innovation and financial literary, Arion Bank partners a number of organizations and companies and helps them make a positive impact. Arion Bank also organizes a whole range of seminars and other events on topics including the economy, pensions, art and design.

In late 2017 the Bank became a signatory to the United Nations Principles on Responsible Investment (UN PRI). In 2018, the Bank's credit rules were updated to the effect that sustainability must be taken into account as far as possible when evaluating loans to major companies and companies linked to the public interest.

Environment

In November 2015 Arion Bank was one of 104 signatories to the City of Reykjavík and Festa's Declaration on Climate Change. By signing the declaration the Bank pledged to reduce greenhouse gas emissions, reduce waste, measure what had been achieved and to regularly report on the status of the above factors. The Bank has comprehensively mapped the direct environmental impact of the Bank's activities. We have implemented environmental software from the innovation company Klappir, and since 2016 the Bank has reported the environmental impact of its operations in its Annual Report and will also do so in 2018.

Our environmental priorities are to:

- Optimize the sorting of waste produced by the Bank.
- Use energy sparingly.
- Use environmentally friendly solutions when printing by using new technology.
- Increase the number of paperless transactions.
- Encourage and motivate employees to prioritize environmental issues.
- Choose environmentally friendly goods and services whenever possible.

Digital solutions play a key role in reducing the ecological footprint of the Bank and our customers by reducing the number of trips made by customers to branches and cutting back on the use of paper. As digital services have become more widely used, the number of square metres used by the Bank's places of work has decreased and this has had a positive impact on greenhouse gas emissions from the Bank's operations.

Employees

The employees are the heart of Arion Bank's business and we do our utmost to take good care of our people. The Bank has a united team of employees and we strive to create a stimulating, positive and success-driven work environment. We seek to foster a working environment in which employees are able to grow and develop their skills and new employees receive training and education. Strong leadership and effective management is crucial and we work hard on developing our management's leadership skills.

The Bank has established policies on human resources, education, equal opportunities, remuneration and anti-bullying, harassment and violence and also has in place an equal opportunities action plan. Arion Bank has been a signatory to UN Women and UN Global Compact since 2014 and in 2015 became the first Icelandic bank to get equal pay certification from the labor union VR. Arion Bank was also the largest company in Iceland to gain equal pay certification. In 2018 Arion Bank was authorized to use the Ministry of Welfare's equal pay symbol, the first bank in Iceland to do so, after undergoing a rigorous appraisal by the standards agency BSI in Iceland.

Appendix to the Consolidated Financial Statements

Human rights

Arion Bank respects human rights and operates in accordance with Icelandic law and international obligations. Arion Bank has a clear policy to ensure equal opportunities and conditions for all employees, irrespective of their gender, sexuality, origin, nationality, race, age, disability or religion, or other factor. Employees are entitled to be treated with respect and all employees should be able to use their abilities to the full. Any kind of discrimination is contrary to the Bank's equal opportunities policy and equal opportunities legislation.

At the end of 2016 Arion Bank became a signatory to the UN Global Compact initiative on corporate sustainability. By doing this the Bank has committed itself to working in accordance with the UN's 10 principles on sustainability, including human rights.

Risk Management and measures to combat corruption

Managing risk and taking informed decisions is a crucial component of the Bank's activities and its responsibility towards society. Risk management is therefore a core activity within the Bank. The key to effective risk management is a process of ongoing identification of significant risk, quantification of risk exposure, action to limit risk and constant monitoring of risk. Simultaneous to the Annual Report the Bank publishes Pillar 3 Risk Disclosures which address the main risks and how to manage them.

We seek to prevent financial crime and the damaging impact it can have on our customers, our business and society. In order to be able do this the Bank provides its employees with the appropriate training and education, maintains effective monitoring and collaborates closely with the law enforcement authorities. The Bank is also aware of the risk of conflicts of interest which inevitably occur in our business and we have taken special measures to prevent conflicts of interest from negatively affecting our customers' interests.

We prioritize measures to prevent:

- Money laundering, terrorist financing and violations of trade sanctions.
- Conflicts of interest.
- Market manipulation and insider misconduct.
- Fraud and corruption.

Automatic monitoring is one of the measures employed by the Bank to prevent financial crimes. The aim is to identify suspicious transactions or customers who may fall into a risk category in terms of corruption, money laundering or terrorist financing. The Bank also has state-of-the-art equipment to combat cyber-attacks.

No form of monitoring is as effective as an alert and vigilant employee who receives regular training to learn to recognize suspicious behavior. Once a year employees take tests to ensure that their knowledge of anti-money laundering measures and the handling of confidential information is adequate. In addition numerous courses are held at the Bank, covering topics such as the Bank's competition policy, conflicts of interest and market misconduct.

Employees are urged to report any suspicions they may have of financial crime, whether on the part of a fellow employee, business partners or clients. Employees can send anonymous tip-offs and the Bank keeps the source of its tip-offs confidential unless otherwise dictated by law. All reports of potentially illegal conduct are investigated by the Bank's internal control units and referred to the relevant law enforcement authorities as required.

Further information on sustainability and non-financial reporting is available in the Bank's 2018 Annual Report.

Corporate Governance Statement of Arion Bank

for the year 2018

Good corporate governance helps to foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. Corporate governance also provides the foundations for responsible management and decision-making, with the objective of generating lasting value. The Board of Directors places great importance on good corporate governance and re-evaluates its governance practices regularly on the basis of recognized guidelines on corporate governance.

The Corporate Governance Statement of Arion Bank hf. (Arion Bank or the Bank) is based on the legislation, regulations and recognized guidelines that are in force at the time the Bank's financial statement is adopted by the Board of Directors.

Excellence in corporate governance

In December 2015, Arion Bank was recognized as a company that has achieved excellence in corporate governance following a formal assessment based on the Icelandic Guidelines on Corporate Governance issued by the Icelandic Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland. Arion Bank received this recognition following an in-depth survey of corporate governance at the Bank, including governance by the Board of Directors, sub-committees and management, performed by KPMG ehf. in the autumn of 2015. The recognition applies for three years.

Compliance with guidelines on good corporate governance

According to the Financial Undertakings Act No. 161/2002 Arion Bank is obliged to comply with recognized guidelines on good corporate governance. The Bank complies with the fifth edition of the Icelandic Guidelines on Corporate Governance issued by Iceland Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland, published in May 2015 and viewable on the website www.leidbeiningar.is. According to the guidelines, a company shall state whether it has deviated from the guidelines, if so, which parts and also explain why it has done so. The Bank complies with the guidelines with one deviation.

Article 5.1.2. states that the rules of procedure of sub-committees of the Board shall be posted on the Bank's website. The rules of the Board Credit Committee have not been published on the Bank's website due to their nature.

In order to promote good corporate governance within the Bank and to ensure that Board members of the Bank have wide and versatile qualifications and experience, a shareholders' meeting on 25 May 2018 approved rules of procedure for a Nomination Committee. The Committee has an advisory role regarding the election of Board members and makes a proposal on their remuneration. At a shareholders' meeting on 5 September 2018, two members of the Nomination Committee were elected, Christopher Felix Johannes Guth and Keith Magliana. The third

Nomination Committee member is appointed by the Board in accordance with the rules of procedure of the Nomination Committee. The third member is Eva Cederbalk, Chairman of the Board of Directors.

Legal framework for the Bank's operation

Arion Bank is a financial institution, which operates in accordance with the Financial Undertakings Act No. 161/2002. Acts of law that also apply to the Bank's operations include e.g. the Securities Transactions Act No. 108/2007, Act on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment Funds No. 128/2011, Act on Payment Services No. 120/2011, Act on Measures Against Money Laundering and Terrorist Financing No. 140/2018, Act on Consumer Mortgages No. 118/2016, Consumer Loans Act No. 33/2013, Competition Act No. 44/2005 and Public Limited Companies Act No. 2/1995.

The Bank is a universal bank that provides a comprehensive range of financial services relating to savings, loans, asset management, corporate finance and capital markets. The Bank's shares were listed on Nasdaq Iceland and Nasdaq Sweden on 15 June 2018 following a share offering of 28.8% of the Bank's shares. The Bank has issued financial instruments that have been admitted for trading on regulated securities markets in Iceland, Norway and Luxembourg. The Bank is therefore subject to the disclosure requirements of issuers pursuant to the Securities Transactions Act and the rules of the relevant stock exchanges.

The Financial Supervisory Authority (FME) supervises the operations of Arion Bank in accordance with the provisions of Act No. 87/1998 on the Official Supervision of Financial Operations. Further information on the FME and an overview of the legal and regulatory framework applicable to the Bank, and the FME's guidelines, can be seen on the FME's website, www.fme.is. Numerous other pieces of legislation apply to the operations of financial undertakings.

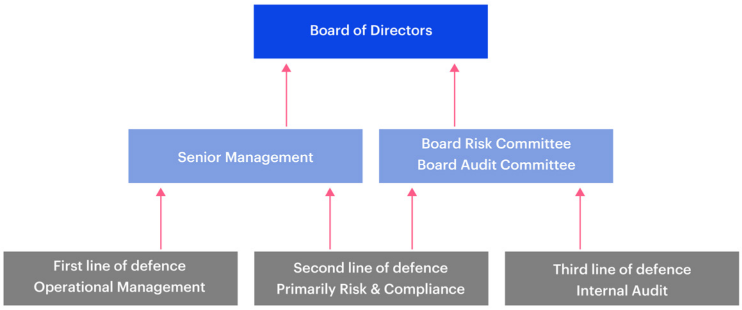
Internal controls, auditing and accounting

Internal control

Internal control at Arion Bank is organized into three lines of defence with the aim of ensuring effectiveness, defining responsibility and coordinating risk management. This structure is also designed to foster a sense of risk awareness and responsibility among all employees of the Bank.

The set-up distinguishes between the following roles:

- People who bear responsibility for risk and manage risk
- People who monitor and check internal controls
- People who perform independent surveys of the effectiveness of internal controls



The first line of defence is made up of people who have day-to-day supervision of operations and its organization. They are responsible for establishing and maintaining effective internal controls and managing risk in day-to-day operations. This involves identifying and evaluating risk and putting in place appropriate countermeasures to reduce risk. The first line of defence is responsible for supervising the implementation of internal rules and processes in compliance with the law, regulations and the Bank's strategy and it must ensure that all actions are in compliance with established procedures and that corrective action is taken if any deficiencies are detected.

The second line of defence is set up to ensure that the first line of defence has established adequate internal controls that work as intended. Risk Management and Compliance are the main participants in the second line of defence, although other units may also be assigned specific monitoring roles.

The third line of defence is Internal Audit, which keeps the Board and management informed of the quality of corporate governance, risk management and internal controls, including by performing independent and objective audits.

Compliance

The Compliance unit is an independent control function that reports directly to the CEO, in accordance with the Compliance Charter issued by the Board of Directors. The main role of Compliance is to ensure that the Bank has efficient measures in place to manage and mitigate compliance risk. The duties of Compliance are carried out under a risk-based compliance plan approved by the Board of Directors, including a training and monitoring schedule.

The goals of Compliance are:

- Ensuring that compliance risks and breaches are identified, assessed and mitigated with proactive measures;
- Fostering the Bank's values and culture;
- Ensuring customers are treated fairly;
- Ensuring that conflicts of interests are managed effectively;
- Promoting adequate transparency towards public authorities, investors and other stakeholders;
- Ensuring that the Bank's services are not used for illegal purposes;
- Ensuring accountability.

Risk management

A central feature of the activities of all financial companies is carefully calculated risk-taking according to a predetermined strategy. Arion Bank thus takes risk compatible with its risk appetite, which is regularly reviewed and approved by the Board of Directors. The Bank's risk appetite, set by the Board, is translated into exposure limits and targets that are monitored by Risk Management. The Board is responsible for Arion Bank's internal capital adequacy assessment process, the main objective of which is to ensure that Arion Bank understands its risk profile and has systems in place to assess, quantify and monitor its total risk exposure.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralized and reports directly to the CEO. Risk Management comprises three departments whose role is to analyze, monitor and regularly report to the CEO and Board of Directors on the risks faced by the Bank.

Further information on risk management and capital management is contained in the Bank's annual report and the Bank's risk report.

Internal audit

The Internal Auditor is appointed by the Board of Directors and reports directly to the Board. The Board sets the Internal Auditor a charter that lays out the responsibilities associated with the position and the scope of the work. The mission of the Internal Auditor is to provide independent and objective assurance and advice designed to add value and improve the Bank's operations. The scope of the audit is the Bank, its subsidiaries and pension funds serviced by Arion Bank.

The audit is governed by the audit charter, guidelines No. 3/2008 issued by the FME on the internal audit function in financial institutions and international standards on internal auditing. All audit work is completed by issuing an audit report with deadlines for the implementation of audit findings. Implementations are followed up by the Internal Audit every quarter.

Accounting and auditing

The Bank's Finance division is responsible for preparing the accounts and this is done in accordance with the International Financial Reporting Standards (IFRS). The Bank publishes its financial statement on a quarterly basis and management statements are generally submitted to the Board ten times a year. The Board Audit Committee examines the annual financial statement and interim financial statements, while the external auditors review and audit the accounts twice a year. The Board Audit Committee gives its opinion on the accounts to the Board of Directors, which then approves and endorses the accounts.

Customers' Ombudsman

The Customers' Ombudsman is appointed by, and responsible to, the CEO. The role of the Ombudsman is to ensure that the business of customers is handled fairly and objectively, prevent discrimination against customers and make certain that the process for handling cases is transparent and documented. The Customers' Ombudsman examined 126 cases in 2018, compared to 162 cases in 2017 and 160 cases in 2016.

Cornerstones and code of ethics

Arion Bank's cornerstones is the name used to describe the Bank's core values. The cornerstones are designed to provide guidance when making decisions and in everything else employees say and do. They refer to the Bank's role, attitude and conduct. Arion Bank's cornerstones are *we make a difference, we get things done* and *we say what we mean*.

The management and employees of Arion Bank are conscious of the fact that the Bank's activities affect different stakeholders and society at large. The Bank's code of ethics is designed to serve as a key to responsible decision-making at Arion Bank. The code of ethics is approved by the Board of Directors.

Sustainability

Arion Bank's sustainability policy bears the title *Together we make good things happen*. The policy title indicates that the Bank wants to act as a role model in responsible and profitable business practices, taking into account the environment, the economy and the society in which we live and work.

Arion Bank shows its commitment to sustainable banking by making a difference to our customers and performing our role as a financial institution conscientiously and responsibly. Arion Bank takes an active role in our society and its development. Financial institutions are one of the pillars of society and our role is to help our customers, both individuals and companies, reach their goals. We place great importance on doing things fairly with the interests of our customers, employees, shareholders and the community at heart.

Arion Bank has been a partner of Festa, the Icelandic Center for Corporate Social Responsibility, for several years and has been a signatory to the CEO Statement of Support for the Women's Empowerment Principles (UN Women and UN Global Compact) since 2014. Arion Bank has been a signatory to the UN Global Compact, the UN's initiative to encourage businesses to adopt sustainable and socially responsible practices, since the end of 2016. The Bank has also been a signatory to the UN's Principles for Responsible Banking (UN PRI) since the end of 2017.

Arion Bank's activities are governed by the provisions of the Annual Accounts Act on non-financial reporting, which, among other things, apply to the status and influence of the company in respect of environmental, social and human resources issues. The Bank bases its reporting on 33 criteria specified by Nasdaq in the Nordic and Baltic region concerning the reporting of non-financial information. The objective of the Nasdaq criteria is to fulfil certain requirements of the Global Reporting Initiative, an international standard that helps companies and institutions to report information on sustainability in a transparent manner.

Further information on sustainability at Arion Bank is contained in the Bank's 2018 Annual Report.

Data protection

Arion Bank cares about data protection and our customers' personal data rights. One of our cornerstone values is that we say what we mean, and we place great importance on ensuring that personal data is processed in a legal, fair and transparent manner. The Bank has established a data protection policy, which can be found on the Bank's website. The data protection policy specifies which personal data the Bank may collect, for what purpose, how long this data can be stored, who it may be passed on to and how the security of the data is guaranteed. Customers can request a copy of their personal data file from the Bank in the online bank.

The Bank has a Data Protection Officer, who reports directly to the CEO, and ensures that the Bank adheres to the Data Protection Act and responds to any questions that may arise regarding data protection.

Board of Directors and committees

The main duty of the Bank's Board of Directors is to manage the Bank between shareholders' meetings according to applicable laws, regulations and articles of association. The Board tends to those operations of the Bank that are not considered part of the day-to-day business, i.e. it makes decisions on issues that are unusual or of a significant nature. One of the Board's main duties is to supervise the Bank's activities. The Board's work, duties and role are defined in detail in the rules of procedure of the Board of Directors, which have been established on the basis of Article 54 of the Financial Undertakings Act, Article 70 of the Public Limited Companies Act No. 2/1995, FME Guidelines No. 1/2010, and the articles of association of the Bank. The rules of procedure of the Board of Directors can be found on the Bank's website.

The Board of Directors appoints a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The Board of Directors and the Chief Executive Officer shall carry out their duties with integrity and ensure that the Bank is run in a sound and reasonable manner in the interests of the customers, the community, the shareholders and the Bank itself, cf. Article 1 (1) of the Financial Undertakings Act. The Chief Executive Officer shall ensure that the Board receives sufficient support to carry out its duties.

The Board of Directors is generally elected for a term of one year at the Bank's annual general meeting. At Arion Bank's annual general meeting on 15 March 2018 seven Directors were elected to the Board of Directors, four men and three women, and three Alternates. The Chairman is a woman. At the Bank's shareholders' meeting on 5 September 2018, Benedikt Gíslason was elected to replace Jakob M. Ásmundsson who resigned from the Board on 30 May 2018. On 5 September 2018, John P. Madden resigned from the Board and an Alternate will attend Board meetings until a new Board member has been elected.

The elected Board Directors have diverse backgrounds and extensive skills, experience and expertise. When electing the Board, care is taken to ensure at least 40% representation of each gender among directors and alternates. Information on the independence of Directors is published on the Bank's website before the annual general meeting or a shareholders' meeting where a Board member is to be elected. The minutes of the shareholders' meetings were sent to shareholders until the Bank's listing, except the minutes of the annual general meeting, which are published on the Bank's website. Following the Bank's listing, minutes from shareholders' meetings have been published on the Bank's website.

The Board of Directors meets at least ten times a year. In 2018, the Board met on 21 occasions. The Chairman of the Board is responsible for ensuring that the Board performs its role in an efficient and organized manner. The Chairman chairs Board meetings and ensures that there is enough time allocated to the discussion of important issues and that strategy issues are discussed thoroughly. The Chairman is not permitted to undertake any other work for the Bank unless part of the normal duties of the Chairman.

According to the Board's Rules of Procedure, the Board is permitted to establish committees to discuss particular areas of the Bank's operations. No later than one month following the annual general meeting the Board appoints members to each of its sub-committees and assesses whether it is necessary to appoint external members to certain committees in order to bring in a greater level of expertise. One of the committee members on the Board Remuneration Committee, Ólafur Ö. Svansson, is an Alternate Director. One of the committee members in the Board Audit Committee, Heimir Thorsteinsson, is not a Board member and is independent of the Bank and its shareholders. The Board sub-committees are as follows:

Board Audit Committee (BAC): Its main task is, inter alia, to guarantee the quality of the financial statement and other financial information from the Bank and ensure the independence of its auditors. The Committee also assists the Board in meeting its responsibility to ensure an effective system of internal controls and compliance and for meeting its external financial reporting obligations under applicable laws and regulations. The Committee met five times in 2018.

Board Risk Committee (BRIC): The Committee's main role is, inter alia, to evaluate the Bank's risk policy and risk appetite and to have a thorough knowledge of the risk assessments and methods used to manage risk employed by the Bank. Committee members should have the qualifications and experience necessary to be able to discharge their duties including forming the Bank's risk policy and risk appetite. The Committee met nine times in 2018.

Board Credit Committee (BCC): Its main task is to attend to credit issues which exceed the credit limits of its sub-committees. The Committee met 20 times in 2018.

Board Remuneration Committee (BRC): The Committee's main task is to annually prepare a remuneration policy for the Bank. Further to advise the Board on remuneration to the CEO, Managing Directors, the Compliance Officer and the Chief Internal Auditor, and on the Bank's incentive scheme and other work-related payments. The Committee met seven times in 2018.

Sub-committees regularly inform the Board of their activities. Furthermore, the Board has access to all material used by the sub-committees and their minutes.

Below is an overview of the attendance of individual Directors and committee members.

Director	Period	Board (21)	BAC (5)	BRIC (9)	BCC (20)	BRC (7)
Eva Cederbalk	1 Jan – 31 Dec	21	-	-	19	-
Brynjólfur Bjarnason	1 Jan - 31 Dec	21	4	-	20	-
Benedikt Gíslason[1]	5 Sep - 31 Dec	5	-	3	-	3
Herdís D. Fjeldsted[2]	15 March – 31 Dec	12	3	-	-	5
Jakob M. Ásmundsson[3]	1 Jan – 30 May	13	1	5	-	2
John P. Madden[4]	1 Jan - 5 Sep	13	-	4	-	2
Kirstín Th. Flygenring[5]	1 Jan – 15 March	8	2	-	-	2
Måns Höglund	1 Jan - 31 Dec	18	-	9	13	-
Steinunn Kr. Thórdardóttir[6]	1 Jan – 31 Dec	21	-	7	14	-
Thóra Hallgrímsdóttir[7]	1 Jan – 15 March	8	2	-	-	2
Ólafur Ö. Svansson[8]	1 Jan - 31 Dec	10	-	-	-	3
Sigurbjörg Á. Jónsdóttir	1 Jan - 31 Dec	1	-	-	-	-
Thórarinn Thorgeirsson	1 Jan - 31 Dec	-	-	-	-	-
Heimir Thorsteinsson	1 Jan – 31 Dec	-	5	-	-	-

[1]Benedikt Gíslason was elected to the Board at the Bank's shareholders' meeting on 5 September 2018 and appointed to the Board Risk Committee and the Board Remuneration Committee on 18 September 2018.

[2]Herdís D. Fjeldsted was elected to the Board at the Bank's annual general meeting on 15 March 2018. Herdís was appointed to the Board Audit Committee and the Board Remuneration Committee on 15 March 2018.

[3]Jakob M. Ásmundsson was appointed to the Board Audit Committee and the Board Remuneration Committee on 15 March 2018. Jakob resigned from the Board on 30 May 2018.

[4]John P. Madden resigned from the Board on 5 September 2018.

[5]Kirstín Th. Flygenring resigned from the Board on 15 March 2018.

[6]Steinunn Kr. Thórdardóttir was appointed to the Board Risk Committee and the Board Remuneration Committee on 15 March 2018.

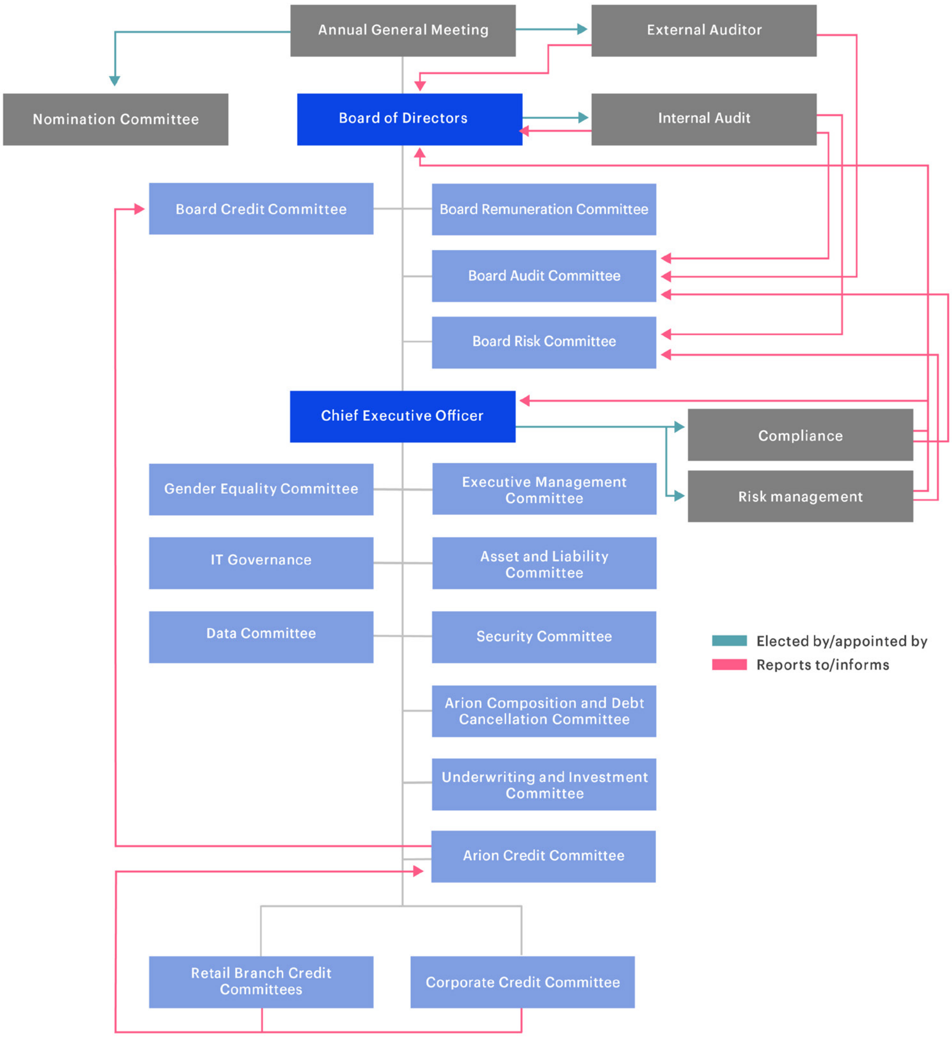
[7]Thóra Hallgrímsdóttir resigned from the Board on 15 March 2018.

[8]Ólafur Ö. Svansson was appointed to the Board Remuneration Committee on 2 August 2018.

The Board of Directors of Arion bank

Steinunn Kristín Thórdardóttir
Måns Höglund
Brynjólfur Bjarnason
Eva Cederbalk
Benedikt Gíslason
Herdís Dröfn Fjeldsted

Arion bank governance overview



Eva Cederbalk, Chairman

Eva was born in 1952. She was first elected as a Director at a shareholders' meeting on 23 June 2017. She is a shareholder of Arion Bank and is an independent Director. Eva is Chairman of the Board of Directors and the Chairman of the Board Credit Committee. Eva has an MSc in economics from the Stockholm School of Economics.

Eva is currently Chief Executive Officer of Cederbalk Consulting AB. She previously worked for Skandinaviska Enskilda Banken AB and If Skadeförsäkring AB. She was CEO of Netgiro Systems AB and SBAB Bank AB and managing director at Dial Försäkring AB. She has served on numerous boards of directors and was chairman of Klarna AB and was a director at Gimi AB and Íslandsbanki. Eva is currently a member of the board of directors of National Bank of Greece Group, Svolder and Ikano Group S.A.

Brynjólfur Bjarnason, Vice Chairman

Brynjólfur was born in 1946. He was first elected as a Director at a shareholders' meeting on 20 November 2014. He is not a shareholder of Arion Bank and is an independent Director. Brynjólfur is the Vice Chairman of the Board, Chairman of the Board Audit Committee and a member of the Board Credit Committee. Brynjólfur graduated with an MBA from the University of Minnesota in 1973 and a cand. oecon. degree in business studies from the University of Iceland in 1971.

Brynjólfur previously worked as the managing director of the Enterprise Investment Fund and as the CEO of Skipti, Síminn and Grandi hf. He has also worked as managing director of the publisher AB bókaútgáfa and was head of the economics department of VSÍ. Brynjólfur has broad experience as a director and has served on numerous boards and been chairman of several. Brynjólfur is an Alternate on the board of Fergusson ehf. and a board member of Marinvest ehf. and ISAL hf.

Benedikt Gíslason

Benedikt was born in 1974. He was first elected as a Director at a shareholders' meeting on 5 September 2018. He is not a shareholder in Arion Bank and is a dependent Director. Benedikt is a member of the Board Risk Committee and the Board Remuneration Committee. Benedikt gained a CSc in mechanical and industrial engineering from the University of Iceland in 1998.

Benedikt works as a senior consultant for Kaupthing ehf. He previously worked as a senior advisor for Iceland's Ministry of Finance and Economic Affairs, as managing director of Investment Banking at MP Bank and he has held a variety of managerial positions at Straumur–Burdarás, including managing director of securities and later CEO. Benedikt also worked as managing director of capital markets at FL Group and at proprietary trading and capital markets at Icelandic Investment Bank (FBA), later Íslandsbanki FBA. Benedikt was also a board member at Kaupthing and VÍS Insurance. Benedikt is on the board of Genís hf., EC Hugbúnadur ehf. and EC Software Sweden and an alternate board member of Brekkuás ehf.

Herdís Dröfn Fjeldsted

Herdís was born in 1971. She was first elected as a Director at Arion Bank's annual general meeting on 15 March 2018. She is not a shareholder in Arion Bank and is an independent Director. Herdís is a member of the Board Audit Committee and Chairman of the Board Remuneration Committee. Herdís graduated with a BSc in business administration with an emphasis on international marketing from the Technical University of Iceland in 2004 and a Master's degree in corporate finance from Reykjavik University in 2011. Herdís is also a certified stockbroker.

Herdís was the managing director of The Icelandic Enterprise Investment Fund (EIF) from 2014. Prior to that she worked as an investment manager at the fund. Before joining EIF, Herdís worked as a senior investment analyst at Thule Investments. Herdís has served on numerous boards of directors, e.g. as the chairman of Icelandic Group and VÍS hf., vice-chairman of Promens and as a board member of Icelandair Group, Invent Farma, Medicopack A/S and Copeinca AS. Today, Herdís is a board member at The Icelandic-Canadian Chamber of Commerce.

Måns Höglund

Måns was born in 1951. He was first elected as a Director at Arion Bank's annual general meeting on 24 March 2011. He is a shareholder of Arion Bank and is an independent Director. Måns is Chairman of the Board Risk Committee and a member of the Board Credit Committee. He graduated with a BSc in business and economics from the Stockholm School of Economics in 1975.

Måns previously worked for Swedish Export Credit Corporation (SEK) as executive director and head of corporate and structured finance and was a member of SEK's Executive Committee. He has worked for Unibank as head of the Sweden operation and Nordea as head of private banking in Sweden as well as Swedbank, where his roles included being head of the corporate division. Måns worked at Götabanken in London and Stockholm and held various positions at Hambros Bank in London. Måns has also worked as a lecturer and researcher at the Stockholm School of Economics.

Steinunn Kristín Thórdardóttir

Steinunn was born in 1972. She was first elected as a Director at a shareholders' meeting on 30 November 2017. She is not a shareholder of Arion Bank and is an independent Director. Steinunn has a Master's degree in international management from Thunderbird, Arizona and a BA in international business and politics from the University of South Carolina.

Steinunn was previously a partner and CEO of Beringer Finance Norway and global head of food and seafood. In 2010, she founded Akton AS, a management consulting company in Norway, where she worked as a managing director until 2015. Steinunn previously worked at Íslandsbanki (later Glitnir) as executive director of International Corporate Credit and later as managing director and head of the bank's UK operations. Steinunn was a board member of Silver Green AS and Silver Green TC AS in Norway, Versobank AS in Estonia, board member of the Icelandic State Financial Investment (ISFI) and an alternate board member at Kredittbanken, later Glitnir Norway. Today, Steinunn is the chairman of the board of Acton Capital AS and Akton AS and a board member of Cloud Insurance AS. She is also a board member of the British-Icelandic Chamber of Commerce, vice chairman of the Norwegian-Icelandic Chamber of Commerce and a member of Exedra. Steinunn is a member of the nomination committee of Síminn.

Alternate directors

Ólafur Örn Svansson, Supreme Court attorney, Sigurbjörg Ásta Jónsdóttir, lawyer and Thórarinn Thorgeirsson, attorney at law. Ólafur and Sigurbjörg are independent Alternate directors and Thórarinn is a dependent Alternate director.

More information on the Board of Directors can be found on the Bank's website.

Communication between shareholders and the Board of Directors and changes in the group ownership

The main venue at which the Board and the Bank report information to the shareholders and propose decisions to be made is at legally convened shareholders' meetings. The Bank provides an effective and accessible arrangement for communications between shareholders and the Board of Directors between those meetings. Any information defined by the Bank as inside information is published in the reporting system of the relevant stock exchange in accordance with the rules on MAR press releases. As part of the investor relations programme, Arion Bank has also arranged quarterly meetings where the CEO, CFO and Investor Relations present the interim financial results.

The Bank has a strong capital position despite substantial dividends and share buybacks totaling ISK 33 billion during the year. The Bank's listing on Nasdaq Iceland and Nasdaq Stockholm took place on 15 June following an initial public offering of 28.7% of shares in the Bank placed with investors in Iceland, Scandinavia, UK, Continental Europe and the US. This is the first listing of an Icelandic bank on the main market in Iceland since 2008. The IPO represents a significant step in the development of Arion Bank and the Bank welcomes the new shareholders. Following the IPO, there have been no major changes to the largest shareholdings. At the end of the year, Kaupthing ehf., is the largest shareholder with a 32.67% shareholding through Kaupskil ehf. The total number of shareholders at year-end 2018 was more than 6,000.

Chief Executive Officer

Höskuldur was born in 1959. He was appointed CEO of Arion Bank in June 2010. Höskuldur is a shareholder of Arion Bank but no stock option agreements have been entered into with him. Höskuldur joined the Bank from Valitor hf. where he had been CEO since 2006. Prior to that he worked at the Icelandic transportation company Eimskip hf. for 17 years and held a range of management positions, including that of deputy CEO. He has also served on the boards of directors of numerous companies and organizations in Iceland and abroad. Höskuldur graduated with a cand. oecon. degree in business administration from the University of Iceland in 1987. The CEO and the executive committee carry out the Bank's daily operations in accordance with a strategy set out by the Board. The CEO shall provide the Board with reports on the Bank's operations and financial position and all important issues that may affect the Bank's operations and finances. With respect to other duties responsibilities and duties of the CEO, please refer to Chapter VII of the Financial Undertakings Act and Chapter IX of the Public Limited Companies Act. The duties of the CEO and his responsibilities take into account the legal environment in which the Bank operates at any given time and the rules that the Board of Directors may establish.

Executive Committee

The Bank's Executive Committee consists of ten people, including the CEO. Memers are Höskuldur H. Ólafsson, CEO; Gísli S. Óttarsson, Chief Risk Officer; Ida Brá Benediktsdóttir, managing director of Retail Banking; Lýdur Thór Thorgeirsson, managing director of Investment Banking; Jónína S. Lárusdóttir, managing director of the Legal Division; Margrét Sveinsdóttir, managing director of Asset Management; Rakel Óttarsdóttir, managing director of IT; Rúnar Magni Jónsson, managing director of Corporate Banking; Stefán Pétursson, Chief Financial Officer; and Sture Stölen, head of Investor Relations.

More information on the Executive Committee can be found on the Bank's website.

Information on violations of laws and regulations.

Arion Bank has not been denied registration, authorization, membership or permission to conduct certain business, activity or operations. The Bank has not been subject to withdrawal, revocation or dismissal of registration, authorization, membership or permission. Information on the main legal cases relating to Arion Bank can be found in the notes to the annual financial statement.

The Board of Directors annually reviews and approves the Corporate Governance Statement.

This Corporate Governance Statement was examined and approved at a meeting of the Board of Directors on 13 February 2019.

Arion Bank
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