Consolidated Financial Statements

31 December 2018

Kvika banki hf. • Borgartún 25 • 105 Reykjavík • Iceland • Reg. no. 540502-2930

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Endorsement and Statement
by the Board of Directors and the CEO

The Consolidated Financial Statements of Kvika banki hf. ("Kvika" or the "Bank") for the year 2018 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, and additional requirements in the Icelandic Financial Statement Act. The Consolidated Financial Statements comprise Kvika and its subsidiaries (together the "Group").

Kvika is a specialized bank focusing on asset management and investment services. The Bank operates four business segments, Asset Management, Corporate Finance, Corporate Banking and Capital Markets. Kvika provides businesses, investors and individuals with comprehensive investment banking and asset management services, as well as selected banking services. Kvika’s Asset Management has an established reputation and offers solutions covering all major asset classes, including fixed-income securities, equities, and alternative investments in both domestic and international markets.

Kvika's shares were admitted to trading on the First North market of Nasdaq Iceland hf. in March 2018. The Bank has announced its intention of listing its shares at Nasdaq OMX Iceland's main market and expects the listing to be finalised before the end of March 2019.

2018: Robust performance, realisation of synergies and further external growth in asset management

In November 2018 Kvika acquired all issued shares of GAMMA Capital Management hf. ("GAMMA"), a licenced fund management company focusing on asset- and fund management with ISK 135 billion of assets under management and 22 employees. The acquisition of GAMMA is subject to approval from competition authorities and thus the financials of GAMMA are not reflected in these financial statements. At the end of December 2018 Kvika had ISK 291 billion of assets under management, excluding the assets managed by GAMMA, compared to ISK 263 billion at year end 2017.

According to the Consolidated Statement of Financial Position, equity at the end of the year amounted to ISK 12,970 million (31.12.2017: ISK 10,982 million) and total assets amounted to ISK 88,274 million (31.12.2017: ISK 75,597 million).

The Group's net operating income during 2018 was ISK 5,705 million (2017: ISK 5,009 million). Net interest income remains strong and amounted to ISK 1,701 million (2017: ISK 1,563 million). Net fee income increased significantly between years, mainly as a result of the acquisitions of Virding hf. and Alda Sjodir hf. in the latter half of 2017, and amounted to ISK 3,698 million (2017: ISK 2,812 million). Other operating income amounted to ISK 306 million (2017: ISK 635 million). Administrative expenses during the year amounted to ISK 4,009 million (2017: ISK 3,670 million).

Profit for the year amounted to ISK 1,752 million (2017: ISK 1,591 million), corresponding to an annualised 15.7% return on equity based on the equity position at the beginning of the year adjusted for changes in share capital and transactions with treasury shares during the period. All business segments performed well during the year and contributed to the Group's profit. The contribution from Asset Management more than doubled between years demonstrating successful execution of the mergers with Virding hf. and Alda Sjodir hf.

The Group's total capital ratio year end 2018 is 25.1% (31.12.2017: 21.1%). The Bank's minimum regulatory capital requirement based on Financial Supervisory Authority's Supervisory Review and Evaluation Process (SREP) is 14.5%. The minimum regulatory capital requirement including the additional capital requirements imposed following the implementation of CRD IV is 20.25% as at 31 December 2018.

The Bank maintains a strong liquidity position. The Bank's assets are liquid and its access to funding is good, reflected in ample liquidity position. At year end 2018 the Group's 30 day liquidity coverage ratio (LCR) was 277%, well above the minimum level of 100%.

The Bank's Board of Directors propose that a dividend of ISK 0.240 per share, equal to ca. ISK 443 million, will be paid in the year 2019 on 2018 operations.

Share capital and shareholders

The Bank's issued share capital amounted to ISK 1,845 million as at 31 December 2018 (31.12.2017: ISK 1,815 million). At the end of the year the Bank held treasury shares with a nominal value of ISK 0 million (31.12.2017: ISK 10 million). The Bank's share capital was increased by a nominal value of ISK 30 million during the year.

The Bank had 733 shareholders at year-end 2018 (2017: 118), none of which held more than 10% of shares in the Bank (2017: 1). The ten largest shareholders are as follows:

Shareholder	31.12.2018	31.12.2017
Lífeyrissjóður verzlunarmanna	9.49%	8.96%
RES II ehf.	9.17%	9.32%
Vátryggingafélag Íslands hf.	8.66%	23.57%
K2B fjárfestingar ehf.	7.70%	7.52%
Arion banki hf.	4.91%	-
Íslandsbanki hf.	4.26%	-
Lífsverk lífeyrissjóður	3.58%	2.19%
Sindrandi ehf.	2.48%	2.52%
Mízar ehf.	2.09%	6.20%
Breiðahvarf ehf.	1.90%	1.93%
	54.24%	62.21%

Further information about the shareholders of the Bank is provided in note 70.

Risk management

The Bank is exposed to various types of risk in its operations. The Bank enforces a risk management framework which is further structured and outlined in the Bank's risk policy guide and rules on risk management. Refer to notes 46-58 on analysis of exposure to various types of risk.

Endorsement and Statement

by the Board of Directors and the CEO

Corporate governance

In the year 2018 the Bank completed a corporate governance assessment process resulting in an award from the Centre for Corporate Governance in Iceland for exemplary corporate governance in 2018-2019. The award is valid for three years as long as there are no material changes in ownership or the Board of Directors of the Bank. The Board of Directors intends to have such an assessment carried out on a regular basis and maintain the aforementioned award.

The Board of Directors emphasizes good corporate governance and adherence to accepted guidelines on corporate governance. The Board has laid down comprehensive rules in which the authority of the Board is defined and its scope of work in conjunction with the CEO. They address e.g. competence of Board members to participate in individual decisions, confidentiality and information disclosure between the CEO and the Board. The majority of Board members are independent of the Bank and there are no executive directors on the Board. The Bank aims to promote gender equality and three out of five board members are women.

The Board determines compensation for the CEO. The Board of Directors has delegated certain tasks to three separate subcommittees, the Risk Committee, Audit Committee and Remuneration Committee. In accordance with the Bank's articles of association, three members have been appointed to each committee, thereof at least two Board members. It is not permitted to appoint employees of the Bank to any committee. Members shall have the necessary experience and knowledge for each committee's tasks according to applicable laws and rules. Each committee has incorporated procedural rules which have been confirmed by the Board of Directors.

More information about the Bank's corporate governance can be found in an appendix to these financial statements which contains a corporate governance statement. A signed copy of the statement is available on the Bank's website, www.kvika.is.

Non-financial information

Kvika is a specialised bank focusing on asset management and investment services. Kvika surpasses the legal threshold of being considered a large company and a public interest entity, as defined in the Icelandic Financial Statement Act no. 3/2006. According to the Act, such companies shall include certain non-financial information in its financial statements, mostly concerning environmental, social and human resources issues in the context of the company's activities. This information is included in an appendix to these financial statements.

Statement by the Board of Directors and the CEO

To the best of our knowledge the Consolidated Financial Statements of Kvika banki hf. for the year 2018 comply with International Financial Reporting Standards as adopted by the EU and additional requirements in the Icelandic Financial Statement Act, and give a true and fair view of the Group's assets, liabilities and financial position as at 31 December 2018 and the financial performance of the Group and changes of cash flows for the year 2018.

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

The Board of Directors and the CEO of the Bank have today discussed the Consolidated Financial Statements for the year 2018, and confirm them by the means of their signatures.

Reykjavík, 28 February 2019.

Board of Directors

CEO

Independent Auditors' Report

To the Board of Directors and Shareholders of Kvika banki hf.

Opinion

We have audited the consolidated financial statements of Kvika banki hf. for the year ended December 31, 2018 which comprise, the consolidated income statement and statement of comprehensive income, the consolidated statement of financial position, the 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 Kvika banki hf. as at December 31, 2018, and 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 Kvika banki hf. in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) as well as the Icelandic Institute of State Authorized Public Accountants, Code of Ethics (FLE Code) 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 our audit**
Impairment charges for loans	
Loans to customers are ISK 29,444 million, 33.4% of the balance sheet. In total, the group held impairment provisions of ISK 238.4 million against loans at amortized cost, unused credit facilities and guarantees 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 3. Measurement of loan impairment charges for loans is deemed a key audit matter as the determination of assumptions for expected credit losses is highly subjective due to the level of judgement applied by management. The most significant judgements are: • Assumptions used in the expected credit loss models to incorporate future looking information. • Timely identification of exposures with significant increase in credit risk and credit impaired exposures. • Valuation of collateral and assumptions of future cash flows on manually assessed credit-impaired exposures. • Management overlays for particular exposures, which are not appropriately captured in the expected credit loss model. Management has provided further information about the loan impairment charges and provisions for guarantees in notes 23, 47 and 85 to the consolidated financial statements.	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. During our audit we have evaluated whether the groups expected credit loss models are compliant to IFRS 9. Our examination included the following elements: • Testing of key controls over assumptions used in the expected credit loss models. • Substantively testing the valuation of collateral with particular focus on management overlays applied to collateral value. • Substantively testing the PD model from Credit Info and how it has been calibrated to represent the banks portfolio. • Testing the appropriateness of forward looking information and how they have been applied in the expected credit loss models. • We have reviewed the disclosures to the financial statements to confirm compliance with IFRS.

Independent Auditors' Report

Other information

The Board of Directors and CEO are responsible for the other information. Other information comprises the endorsement and statement by the Board of Directors and the CEO, the Statement on the Corporate Governance of Kvika banki hf. and non- financial information.

Our opinion on the financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon, except from our confirmation related to the endorsement and statement by the Board of Directors and the CEO as described below.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information identified above 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 on the other information, 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 endorsement and statement by the Board of Directors and the CEO contains 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 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 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 CEO are responsible for assessing Kvika banki 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.

The Board of Directors and Audit Committee are responsible for overseeing the Kvika banki hf.’s consolidated financial reporting process.

Auditors' 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 the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism 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 Kvika banki 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 Kvika banki hf. 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 Kvika banki hf. 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.

Independent Auditors' Report

We communicate with the Board of Directors and 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 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 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, 28 February 2019.

Deloitte ehf.

Pálína Árnadóttir
State Authorized Public Accountant

Guðmundur Ingólfsson
State Authorized Public Accountant

Kvika Amounts are in ISK thousands

Consolidated Income Statement
For the year 2018

	Notes	2018	2017
Interest income		4,717,873	4,657,949
Interest expense		(3,017,016)	(3,095,419)
Net interest income	6	1,700,857	1,562,530
Fee and commission income		3,863,083	3,033,265
Fee and commission expense		(165,404)	(221,118)
Net fee and commission income	7	3,697,680	2,812,146
Net financial income	8	521,609	547,234
Share in profit of discontinued operations		0	8,403
Share in (loss) profit of associates, net of income tax	26	(302,949)	63,912
Other operating income		87,305	15,005
Other operating income		305,965	634,554
Net operating income		5,704,502	5,009,230
Administrative expenses	10-13	(4,008,788)	(3,669,687)
Net impairment	14	(15,395)	(14,228)
Revaluation on investment properties	27	114,582	92,258
Profit before taxes		1,794,900	1,417,573
Income tax	15	110,028	248,658
Special tax on financial activity	16	(62,436)	(23,047)
Special tax on financial institutions	17	(90,818)	(52,289)
Profit for the year		1,751,674	1,590,896

	Notes	2018	2017
Attributable to the shareholders of Kvika banki hf.		1,741,803	1,592,976
Attributable to non-controlling interest	25	9,871	(2,080)
Profit for the year		1,751,674	1,590,896
Earnings per share	18		
Basic earnings per share (ISK per share)		0.95	1.07
Diluted earnings per share (ISK per share)		0.86	1.03

The notes on pages 13 to 68 are an integral part of these Consolidated Financial Statements.

Kvika Amounts are in ISK thousands

Consolidated Statement of Comprehensive Income

For the year 2018

	Notes	2018	2017
Profit for the year		1,751,674	1,590,896
Translation of foreign operations			
Exchange difference on translation of foreign operations		9,698	(4,668)
Items that may be reclassified subsequently to profit and loss, net of tax		9,698	(4,668)
Total comprehensive income for the year		1,761,372	1,586,228

	Notes	2018	2017
Attributable to the shareholders of Kvika banki hf.		1,751,501	1,588,309
Attributable to non-controlling interest		9,871	(2,080)
Total comprehensive income for the year		1,761,372	1,586,228

The notes on pages 13 to 68 are an integral part of these Consolidated Financial Statements.

Kvika Amounts are in ISK thousands

Consolidated Statement of Financial Position

As at 31 December 2018

Assets	Notes	31.12.2018	31.12.2017
Cash and balances with Central Bank	19	21,339,185	20,493,739
Fixed income securities	20	5,127,335	5,598,409
Shares and other variable income securities	21	2,926,675	2,837,375
Securities used for hedging	22	21,526,794	14,026,433
Loans to customers	23	29,443,573	25,338,250
Derivatives	24	1,213,266	1,052,652
Investment in associates	26	774,832	676,610
Investment properties	27	950,000	953,874
Intangible assets	29	2,379,281	2,284,340
Property and equipment	30	42,894	57,251
Deferred tax assets	31	608,858	464,414
Other assets	32	1,941,070	1,797,913
Assets classified as held for sale		0	15,260
Total assets		88,273,762	75,596,519

Liabilities	Notes	31.12.2018	31.12.2017
Deposits from customers	33	47,893,959	41,749,497
Borrowings	34	15,634,648	13,731,375
Issued bills	35	3,577,718	3,934,757
Issued bonds	36	3,160,215	1,401,879
Subordinated liabilities	37	1,947,511	1,058,741
Short positions held for trading	38	805,334	370,163
Derivatives	24	593,934	364,692
Current tax liabilities	31	3,140	789
Deferred tax liabilities	31	76,980	65,658
Other liabilities	39	1,610,323	1,936,693
Total liabilities		75,303,763	64,614,243

Equity	Notes	31.12.2018	31.12.2017
Share capital	40	1,844,996	1,805,060
Share premium		2,881,165	2,722,583
Option reserve		4,297	903
Warrants reserve	41	202,527	207,048
Deficit reduction reserve		3,103,697	3,103,697
Other reserves		(12,023)	(21,722)
Restricted retained earnings		506,896	254,844
Retained earnings		4,376,900	2,858,439
Total equity attributable to the shareholders of Kvika banki hf.		12,908,455	10,930,854
Non-controlling interest		61,544	51,423
Total equity		12,969,999	10,982,276
Total liabilities and equity		88,273,762	75,596,519

The notes on pages 13 to 68 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK thousands

Consolidated Statement of Changes in Equity

For the year 2018

1 January 2018 to 31 December 2018	Notes	Share capital	Share premium	Option reserve	Warrants reserve	Deficit reduction reserve	Trans-lation reserve	Restricted retained earnings	Retained earnings	Total share-holders' equity	Non-controlling interest	Total equity
Equity as at 1 January 2018		1,805,060	2,722,583	903	207,048	3,103,697	(21,722)	254,844	2,858,439	10,930,854	51,423	10,982,277
Impact of adopting IFRS 9									28,709	28,709		28,709
Restated opening balance under IFRS 9		1,805,060	2,722,583	903	207,048	3,103,697	(21,722)	254,844	2,887,149	10,959,563	51,423	11,010,986
Profit for the year									1,741,803	1,741,803	9,871	1,751,674
Translation of foreign operations												
Exchange difference on translation of foreign operations							9,698			9,698		9,698
Total comprehensive income for the year		0	0	0	0	0	9,698	0	1,741,803	1,751,501	9,871	1,761,372
Restricted retained earnings								252,051	(252,051)	0		0
Transactions with owners of the Bank												
Capital increase		29,936	98,339		(4,521)					123,754		123,754
Transactions with own shares		10,000	60,242							70,242		70,242
Stock options				3,394						3,394		3,394
Other transactions												
Acquisition of a subsidiary with a non-controlling interest										0	250	250
Equity as at 31 December 2018		1,844,996	2,881,165	4,297	202,527	3,103,697	(12,023)	506,896	4,376,900	12,908,455	61,544	12,969,999

The notes on pages 13 to 68 are an integral part of these Consolidated Financial Statements.

Kvika Amounts are in ISK thousands

Consolidated Statement of Changes in Equity

For the year 2017

1 January 2017 to 31 December 2017	Notes	Share capital	Share premium	Option reserve	Warrants reserve	Deficit reduction reserve	Trans-lation reserve	Restricted retained earnings	Retained earnings	Total share-holders' equity	Non-controlling interest	Total equity
Equity as at 1 January 2017		1,375,819	912,768	4,771	40,300	3,103,697	(17,054)	403,553	1,524,392	7,348,246	48,630	7,396,876
Profit for the year									1,592,976	1,592,976	(2,080)	1,590,896
Translation of foreign operations												
Exchange difference on translation of foreign operations							(4,668)			(4,668)		(4,668)
Total comprehensive income for the year		0	0	0	0	0	(4,668)	0	1,592,976	1,588,309	(2,080)	1,586,228
Restricted retained earnings								(148,709)	148,709	0		0
Transactions with owners of the Bank												
Capital increase		300,000	1,368,000							1,668,000		1,668,000
Transactions with own shares		17,812	78,374							96,187		96,187
Dividend paid to shareholders									(407,638)	(407,638)		(407,638)
Stock options				(3,868)						(3,868)		(3,868)
Warrants sold					189,218					189,218		189,218
Warrants exercised		111,429	363,441		(22,470)					452,400		452,400
Other transactions												
Acquisition of non-controlling interest via purchase											188,422	188,422
Acquisition of non-controlling interest via merger											53,502	53,502
Sale of shares in subsidiaries											(237,052)	(237,052)
Equity as at 31 December 2017		1,805,060	2,722,583	903	207,048	3,103,697	(21,722)	254,844	2,858,439	10,930,854	51,423	10,982,276

The notes on pages 13 to 68 are an integral part of these Consolidated Financial Statements.

Kvika Amounts are in ISK thousands

Consolidated Statement of Cash Flows

For the year 2018

Cash flows from operating activities	Notes	2018	2017
Profit for the year		1,751,674	1,590,896
Adjustments for:			
Indexation and exchange rate difference		509,563	168,401
Share in loss (profit) of associates, net of income tax	26	302,949	(63,912)
Depreciation and amortisation		25,342	78,183
Net interest income	6	(1,700,857)	(1,562,530)
Net impairment		15,395	14,228
Income tax		(110,028)	(225,611)
Investment properties, fair value change		(114,582)	(92,258)
Other adjustments		1,500	(156,955)
		680,957	(249,559)
Changes in:			
Fixed income securities		216,074	(1,527,834)
Shares and other variable income securities		(89,300)	944,659
Securities used for hedging		(7,500,360)	(1,637,041)
Loans to customers		(4,114,031)	1,001,054
Derivatives - assets		(160,614)	(500,160)
Other assets		98,145	(886,249)
Deposits from customers		5,995,525	9,196,963
Short positions		435,171	289,977
Derivatives - liabilities		229,242	(134,077)
Other liabilities		(363,414)	935,976
		(5,253,563)	7,683,269
Interest received		4,561,814	4,395,424
Interest paid		(2,740,780)	(2,956,732)
Net cash (to) from operating activities		(2,751,573)	8,872,401
Cash flows from investing activities			
Net proceeds from the sale of Investment properties		128,456	0
Acquisition of intangible assets	29	(104,304)	(48,680)
Net proceeds from the sale of property and equipment		2,394	(2,499)
Acquisition of subsidiary, net of cash		0	(2,839,819)
Net investment in associates		7,750	(595,444)
Proceeds from the sale of assets classified as held for sale		11,700	72,460
Net cash from (to) investing activities		45,996	(3,413,982)
Cash flows from financing activities			
Borrowings		3,623,081	702,392
Issued bills		(357,039)	11,839
Subordinated liabilities		800,000	427,615
(Increase) decrease in warrants		(4,521)	166,748
Dividend paid to shareholders		0	(407,638)
Treasury share transactions		70,242	96,187
Increase (reduction) of share capital		128,275	2,142,870
Net cash from financing activities		4,260,039	3,140,013
Net increase in cash and balances with Central Bank		1,554,462	8,598,433
Cash and balances with Central Bank at the beginning of the year	19	20,493,739	12,032,879
Change in cash and cash equivalents due to sale of subsidiary		0	57,931
Effects of exchange rate fluctuations on cash and balances with Central Bank held		(709,016)	(195,503)
Cash and balances with Central Bank at the end of the year	19	21,339,185	20,493,739

The notes on pages 13 to 68 are an integral part of these Consolidated Financial Statements.

Notes to the Consolidated Financial Statements

Notes to the Consolidated Financial Statements

General information

1. Reporting entity

Kvika banki hf. ("Kvika" or the "Bank") is a limited liability company incorporated and domiciled in Iceland, with its registered office at Borgartún 25, Reykjavík. The Bank operates as a bank based on Act No. 161/2002, on Financial Undertakings, and is supervised by the Financial Supervisory Authority of Iceland.

The Consolidated Financial Statements for the year ended 31 December 2018 comprise Kvika banki hf. and its subsidiaries (together referred to as the Group). Kvika is a specialized bank focusing on asset management and investment services. The Bank operates four business segments, Asset Management, Corporate Finance, Corporate Banking and Capital Markets. Kvika provides businesses, investors and individuals with comprehensive investment banking and asset management services as well as selected banking services.

The Consolidated Financial Statements were approved and authorised for issue by the Board of Directors and the CEO on 28 February 2019.

2. Basis of preparation

a. 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 Statement Act. The Consolidated Financial Statements are also prepared in accordance with Icelandic laws on financial statements.

b. Basis of measurement

The Consolidated Financial Statements have been prepared using the historical cost basis except for the following:
- fixed income securities are measured at fair value;
- shares and other variable income securities are measured at fair value;
- securities used for hedging are measured at fair value;
- loans to customers which are measured at fair value;
- derivatives are measured at fair value;
- investment properties are measured at fair value;
- short positions are measured at fair value; and
- assets classified as held for sale are measured at the lower of cost or fair value less cost to sell.

c. Functional and presentation currency

The Consolidated Financial Statements are prepared in Icelandic Krona (ISK), which is the Bank's functional currency. All financial information has been rounded to the nearest thousand, unless otherwise stated.
The Group's assets and liabilities which are denominated in other currency than ISK are translated to ISK using the exchange rate as at the end of day 31 December 2018.

d. Going concern

The Bank's management and Board of Directors has assessed the Group's ability to continue as a going concern and are satisfied that the Group has the resources to continue its operations.

e. Estimates and judgements

The preparation of financial statements in accordance with IFRSs requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

The estimates and underlying assumptions are based on historical result and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying amounts of assets and liabilities that are not readily apparent from other sources.

The estimates and underlying assumptions are reviewed on an on-going basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period and future periods if the revision affects both current and future periods.

Information about areas of estimation uncertainty and critical judgements made by management in applying accounting policies that can have a significant effect on the amounts recognised in the Consolidated Financial Statements is provided in note 110.

f. Relevance and importance of notes to the reader

In order to enhance the informational value of the Financial Statements, the notes are evaluated based on relevance and importance for the reader. This can result in information, that has been evaluated as neither important or relevant for the reader, not being presented in the notes.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

3. Changes in accounting policies

The Group has initially adopted IFRS 9 and IFRS 15 from 1 January 2018. Except for these changes, the Group has not changed its significant accounting policies from those applied in the 2017 financial statements. The adoption of IFRS 15 did not affect the timing or amount of fee and commission income from contracts with customers and the related assets and liabilities recognized by the Group. Due to the transition method chosen by the Group in applying IFRS 9 and IFRS 15, comparative information throughout these financial statements have not generally been restated to reflect its requirements.

The adoption of these two standards also led to additional disclosures being included in these consolidated financial statements. Further, the Group has adopted consequential amendments to IFRS 7 Financial Instruments: Disclosures that are applied to disclosures regarding 2018, but have not been applied to the comparative information. Except for these changes, the Group has consistently applied the accounting policies as set out in the notes section in these consolidated financial statements.

IFRS 9 sets out requirements for recognizing and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. This standard replaces IAS 39 Financial Instruments: Recognition and Measurement. The requirements of IFRS 9 represent a significant change from IAS 39. The new standard brings fundamental changes to the accounting for financial assets and to certain aspects of the accounting for financial liabilities.

The effect of initially applying IFRS 9 is mainly attributed to a change in the impairment loss account as at 1 January 2018 as well as a change in the classification and measurement of certain financial assets, refer to notes 4 and 5 for further information.

At 1 January 2018, the Group implemented the three-stage expected credit loss impairment model in IFRS 9. The impairment charge for expected credit losses depends on whether the credit risk has increased significantly since initial recognition. If the credit risk has not increased significantly, the impairment charge equals the expected credit losses resulting from default events that are possible within the next 12 months (stage 1). If the credit risk has increased significantly, the loan is more than 30 days past due, or the loan is in default or otherwise impaired, the impairment charge equals the lifetime expected credit losses (stages 2 and 3).

The expected credit loss is calculated for all individual facilities as a function of probability of default (PD), exposure at default (EAD) and loss given default (LGD) and incorporates forward-looking information. The estimation of expected credit losses involves forecasting future economic conditions.

The incorporation of forward-looking elements reflects the expectations of the Group's senior management and involves the creation of scenarios (base-case, upside and downside scenarios), including an assessment of the probability for each scenario. The purpose of using multiple scenarios is to model the non-linear impact of assumptions about macroeconomic factors on the expected credit losses.

The key changes to the Group's accounting policies resulting from its adoption of IFRS 9 are summarised in notes 82 and 85.

4. Reconciliation of Consolidated Statement of Financial Position

The table below shows a reconciliation of the Consolidated Statement of Financial Position carrying amounts in accordance with IAS 39 to the Consolidated Statement of Financial Position carrying amounts in accordance with IFRS 9 on 1 January 2018.

	IAS 39 31.12.2017	Impact of Impairment	Total impact	IFRS 9 1.1.2018
Assets:				
Cash and balances with Central Bank	20,493,739	-	-	20,493,739
Fixed income securities	5,598,409	-	-	5,598,409
Shares and other variable income securities	2,837,375	-	-	2,837,375
Securities used for hedging	14,026,433	-	-	14,026,433
Loans to customers	25,338,250	28,709	28,709	25,366,959
Derivatives	1,052,652	-	-	1,052,652
Investment in associates	676,610	-	-	676,610
Investment properties	953,874	-	-	953,874
Intangible assets	2,284,340	-	-	2,284,340
Property and equipment	57,251	-	-	57,251
Deferred tax assets	464,414	-	-	464,414
Other assets	1,797,913	-	-	1,797,913
Assets classified as held for sale	15,260	-	-	15,260
Total assets	75,596,519	28,709	28,709	75,625,229
Liabilities:				
Deposits from customers	41,749,497	-	-	41,749,497
Borrowings	13,731,375	-	-	13,731,375
Issued bills	3,934,757	-	-	3,934,757
Issued bonds	1,401,879	-	-	1,401,879
Subordinated liabilities	1,058,741	-	-	1,058,741
Short positions held for trading	370,163	-	-	370,163
Derivatives	364,692	-	-	364,692
Current tax liabilities	789	-	-	789
Deferred tax liabilities	65,658	-	-	65,658
Other liabilities	1,936,693	-	-	1,936,693
Total liabilities	64,614,243	0	0	64,614,243

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

4. Reconciliation of Consolidated Statement of Financial Position (cont.)

Equity:				
Share capital	1,805,060	-	-	1,805,060
Share premium	2,722,583	-	-	2,722,583
Option reserve	903	-	-	903
Warrants reserve	207,048	-	-	207,048
Deficit reduction reserve	3,103,697	-	-	3,103,697
Other reserves	(21,722)	-	-	(21,722)
Restricted retained earnings	254,844	-	-	254,844
Retained earnings	2,858,439	28,709	28,709	2,887,148
Total equity attributable to the shareholders	10,930,854	28,709	28,709	10,959,563
Non-controlling interest	51,423	-	-	51,423
Total equity	10,982,276	28,709	28,709	11,010,986
Total liabilities and equity	75,596,519	28,709	28,709	75,625,229

5. Financial assets and financial liabilities classification transition from IAS 39 to IFRS 9

The table below shows the original measurement categories in accordance with IAS 39 and the new measurement categories in accordance with IFRS 9 for the Group's financial assets and financial liabilities as at 1 January 2018

Financial assets:	Measurement category under IAS 39	Measurement category under IFRS 9	Carrying amount IAS 39	Reclassifi-cation	Remeasure-ment	Carrying amount IFRS 9
Cash and balances with Central Bank	Amortised cost	Amortised cost	20,493,739	-	-	20,493,739
Fixed income securities:			5,598,409	-	-	5,598,409
Fixed income securities	FVTPL *	FVTPL ***	*5,598,409*	-	-	*5,598,409*
Fixed income securities	FVTPL**	FVTPL ***	-	-	-	*0*
Shares and other variable income sec.:			2,837,375	-	-	2,837,375
Shares and other variable income sec.	FVTPL *	FVTPL ***	*2,833,752*	-	-	*2,833,752*
Shares and other variable income sec.	FVTPL**	FVTPL ***	*3,623*	-	-	*3,623*
Securities used for hedging	FVTPL *	FVTPL ***	14,026,433	-	-	14,026,433
Loans to customers:	Amortised cost	Amortised cost	25,338,250	-	28,709	25,366,959
Loans to customers	Amortised cost	Amortised cost	*25,338,250*	*(1,749,637)*	*28,709*	*23,617,322*
Loans to customers	Amortised cost	FVTPL ***	*0*	*1,749,637*	-	*1,749,637*
Derivatives	FVTPL *	FVTPL ***	1,052,652	-	-	1,052,652
Other assets	Amortised cost	Amortised cost	1,797,913	-	-	1,797,913
Total financial assets			71,144,771	0	28,709	71,173,480
Financial liabilities:						
Deposits from customers	Amortised cost	Amortised cost	41,749,497	-	-	41,749,497
Borrowings	Amortised cost	Amortised cost	13,731,375	-	-	13,731,375
Issued bills	Amortised cost	Amortised cost	3,934,757	-	-	3,934,757
Issued bonds	Amortised cost	Amortised cost	1,401,879	-	-	1,401,879
Subordinated liabilities	Amortised cost	Amortised cost	1,058,741	-	-	1,058,741
Short positions held for trading	FVTPL *	FVTPL ***	370,163	-	-	370,163
Derivatives	FVTPL *	FVTPL ***	364,692	-	-	364,692
Other liabilities	Amortised cost	Amortised cost	1,936,693	-	-	1,936,693
Total financial liabilities			64,547,796	0	0	64,547,796

FVTPL * - Held for trading
FVTPL ** - Designated at fair value through profit or loss
FVTPL *** - Mandatorily measured at fair value through profit or loss

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

Income statement

6. Net interest income

Interest income is specified as follows:

	2018	2017
Cash and balances with Central Bank	945,278	1,282,411
Derivatives	1,140,160	1,094,009
Loans to customers	2,528,746	2,238,875
Other interest income	103,689	42,654
Total	4,717,873	4,657,949

Interest expense is specified as follows:

	2018	2017
Deposits from customers	1,440,430	1,349,277
Borrowings	1,024,390	1,341,632
Issued bills	175,598	212,903
Issued bonds	148,942	25,259
Subordinated liabilities	141,488	64,629
Derivatives	10,181	28,309
Other interest expense	75,987	73,411
Total	3,017,016	3,095,419

Total interest income recognised in respect of financial assets not carried at fair value through profit or loss amounts to ISK 3,413 million (2017: ISK 3,569 million). Total interest expense recognised in respect of financial liabilities not carried at fair value through profit or loss amounts to ISK 3,007 million (2017: ISK 3,067 million).

7. Net fee and commission income

Fee income and expenses are presented on a net fee basis, as presented in internal reporting to management for decision making purposes, and broken down by business segments. The business segments are representative of the nature and types of activity from which the Group generates fee income from. A description of each business segment is provided in note 63. Reference is made to note 76 for information on how fee income and expense is recognised and reported.

Net fee and commission income by business segment	2018	2017
Corporate Banking	622,501	574,796
Corporate Finance	579,018	415,372
Capital Markets	671,971	649,487
Proprietary trading and Treasury	73,711	97,679
Asset Management	1,919,013	1,167,572
Support functions and eliminations	(168,534)	(92,760)
Total	3,697,680	2,812,146

8. Net financial income

Net financial income is specified as follows:

	2018
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	
Fixed income securities	332,386
Shares and other variable income securities	57,497
Derivatives	20,707
Loans to customers	113,090
Foreign currency exchange difference	(2,072)
Total	521,609

	2017
Financial assets held for trading	
Fixed income securities	262,264
Shares and other variable income securities	113,660
Derivatives	107,638
Financial assets designated at fair value through profit or loss	
Fixed income securities	1,748
Shares and other variable income securities	43,247
Foreign currency exchange difference	18,679
Total	547,234

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

9. Foreign currency exchange difference

Foreign currency exchange difference is specified as follows:

	2018	2017
Gain (loss) on financial instruments at fair value through profit and loss	491,349	(59,950)
(Loss) gain on other financial instruments	(493,421)	78,628
Total	(2,072)	18,679

Note 57 provides information about the development of foreign exchange rates against the Icelandic krona.

10. Administrative expenses

Administrative expenses are specified as follows:	2018	2017
Salaries and related expenses	2,737,663	2,396,227
Other operating expenses	1,150,699	1,099,111
Depositors' and Investors' Guarantee Fund contributions	95,085	96,166
Depreciation and amortisation	25,342	78,183
Total	4,008,788	3,669,687

11. Salaries and related expenses

Salaries and related expenses are specified as follows:	2018	2017
Salaries	2,072,620	1,863,502
Performance based payments excluding share-based payments	24,198	10,350
Share-based payment expenses	3,394	14,496
Pension fund contributions	337,122	249,321
Tax on financial activity	127,491	114,804
Other salary related expenses	172,838	143,754
Total	2,737,663	2,396,227
Average number of full time employees during the year	110	91
Total number of full time employees at year-end	109	107

According to Act No. 165/2011, passed in 2011, banks and other financial institutions providing VAT exempt services, must pay a tax based on salary payments, called tax on financial activity. The current tax rate is 5.50% (2017: 5.50%).

12. Employment terms of the Board of Directors and management

Salaries and benefits paid to the Board of Directors, the CEO and Managing Directors, including the Deputy CEO, of the Bank for their work for companies within the Group, and their shareholding in the Bank, are specified as follows:

			31.12.2018			31.12.2017
	Salaries and benefits	Number of shares	Warrants and options	Salaries and benefits	Number of shares	Warrants and options
Ármann Þorvaldsson, CEO	41,850	2,082	22,040	21,186	2,082	22,008
Sigurður Atli Jónsson, former CEO	0	0	0	80,743	0	9,979
Kristín Pétursdóttir, Chairman of the Board	9,656	7,900	0	0	0	0
Guðmundur Þórðarson, Deputy Chairman of the Board	5,278	152,304	0	3,974	136,463	0
Inga Björg Hjaltadóttir, Board member	5,375	0	0	5,024	0	0
Hrönn Sveinsdóttir, Board member	5,375	0	0	4,047	0	0
Guðjón Karl Reynisson, Board member	4,097	10,411	0	0	0	0
Kristín Guðmundsdóttir, alternate Board member	6,405	419	0	4,932	634	0
Pétur Guðmundarson, alternate Board member	867	0	0	2,512	0	0
Þorsteinn Pálsson, former Board member	2,324	0	0	9,892	0	0
Jónas Hagan Guðmundsson, former Board member	639	0	0	7,535	0	0
Anna Skúladóttir, former Board member	0	0	0	976	0	0
Finnur Reyr Stefánsson, former Board member	0	0	0	976	0	0
Ármann Fr. Ármannsson, former alternate Board member	0	0	0	479	0	0
Managing Directors (2018: 7 (on average: 6.9), 2017: 6*(on average: 4.0))	267,410	2,270	159,713	163,659	2,757	149,483
Former Managing Directors (2018: 0, 2017: 2)	0	0	0	74,516	0	38,529
Total	349,277	175,386	181,752	380,452	141,936	219,998

Notes to the Consolidated Financial Statements

12. Employment terms of the Board of Directors and management (cont.)

Salaries and benefits are substantially all short-term employee benefits. Salaries and benefits paid to members of the Board of Directors include compensation for their participation in Board committees. The CEO and the managing directors did not receive performance based payments in 2018. In 2017 the following changes were made to the senior management of the Bank: i) In June, Ármann Þorvaldsson took up the position of CEO, ii) In August, Marinó Örn Tryggvason took up the position of Deputy CEO, iii) in September Baldur Stefánsson took up the position of Managing Director of Corporate Finance and iv) in October Hannes Frímann Hrólfsson took up the position of Managing Director of Asset Management. When the Deputy CEO joined the Bank in 2017 the number of managing directors in the table above increased to six. Moreover, in February 2018, Lilja Rut Jensen, the Bank's General Counsel, joined the executive management, resulting in the number of managing directors in the table increasing to seven. Due to the aforementioned the salaries and benefits figures for managing directors for 2018 and 2017 are not directly comparable.

Figures for shares, share options and warrants are in thousands and include shares held by companies owned by or under the control of the respective parties as at 31 December 2018 and 31 December 2017. If the holdings are held indirectly through companies, then the pro rata ownership of the aforementioned persons has been included.

The Bank has defined the Deputy CEO and two Managing Directors as Key Employees, as defined in Act No. 161/2002 on Financial Undertakings. Furthermore the Bank has approved and published internal rules covering the qualification requirements, evaluation process and conduct of Key Employees, in accordance with requirements set forth by the Icelandic Financial Supervisory Authority.

The Bank has adopted a remuneration policy at the proposal of the Remuneration Committee. The policy covers three remuneration components, base pay, performance based incentive scheme and other benefits, including pension fund contributions. Further information about the remuneration policy is provided in notes 67-69.

* The salaries and benefits figure for managing directors for 2017 has been updated to include the salaries and benefits of one employee who joined the executive committee in 2017 as they were by mistake left out of the figures in the 2017 consolidated financial statements.

13. Auditor's fees

Remuneration to the Group's auditors is specified as follows:

	2018	2017
Audit of annual accounts	42,728	27,108
Review of interim accounts	7,854	6,194
Other audit related services	8,866	6,142
Total	59,448	39,444
Thereof to the auditors of the Bank	44,525	33,166

14. Net impairment

	2018
Net change in impairment of loans	(15,742)
Net change in impairment of other assets	13,698
Net change in impairment of loan commitments, guarantees and unused credit facilities	17,439
Net impairment	15,395

Net impairment under IAS 39	**2017**
Net change in specific impairment for the period	16,162
Net change in collective impairment for the period	(1,934)
Net impairment	14,228

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

15. Income tax

The Group will not pay income tax on its profit for 2018 due to the fact that it has a tax loss carry forward that offsets the calculated income tax. At year end 2018, the tax loss carry forward of the Group amounted to ISK 104 billion. A substantial part of the tax loss carry forward is utilisable until end of year 2019. Management is of the opinion that the Group's operations in the years to come will result in taxable results which will be offset with the tax loss carry forward. The Group has therefore recognised a part of the tax loss carry forward as a deferred tax asset in the consolidated statement of financial position. The deferred tax asset is recognised only to the extent that it is probable to be utilisable against future taxable profits. The deferred tax asset is reviewed at each reporting date. Refer to note 31 for more information on the deferred tax asset.

Income tax is recognised based on the tax rates and tax laws enacted during the current year, according to which the domestic corporate income tax rate was 20.0% (2017: 20.0%)

Reconciliation of effective tax rate:

		2018		2017
Profit before tax		1,794,900		1,417,573
Income tax using the domestic corporation tax rate	20.0%	(358,980)	20.0%	(283,515)
Non-deductible expenses	0.1%	(1,470)	0.3%	(4,218)
Non-taxable income	0.9%	(16,334)	4.0%	(56,221)
Recognition of tax losses	(28.1%)	505,203	(36.8%)	522,072
Other changes	1.0%	(18,391)	(5.0%)	70,540
Effective income tax	(6.1%)	110,028	(17.5%)	248,658

Profit before tax amounts to ISK 1,795 million. Income tax amounts to ISK 110 million, resulting in an effective tax rate of -6.1%. This is substantially different from the Icelandic corporate tax rate of 20%, mainly due to non-taxable income from shares and revaluation of the deferred tax asset.

16. Special tax on financial activity

The special tax on financial activity is an additional income tax which becomes effective when the income tax base exceeds ISK 1,000 million. It is levied on the same entities as the tax on financial activity according to Act No. 90/2003. The tax rate is set at 6.0% (2017: 6.0%) and the tax is not a deductible expense for income tax purposes. The tax is presented separately in the consolidated income statement.

17. Special tax on financial institutions

According to Act No. 155/2010 on Special Tax on Financial Institutions, certain types of financial institutions, including banks, must pay annually a tax based on the carrying amount of their liabilities as determined for tax purposes in excess of ISK 50 billion at year-end. The tax rate is set at 0.376% (2017: 0.376%) and the tax is not a deductible expense for income tax purposes. The tax is presented separately in the consolidated income statement.

18. Earnings per share

The calculation of basic earnings per share is based on earnings attributable to shareholders and a weighted average number of shares outstanding during the period. The diluted earnings per share is calculated by adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares. The Bank has issued warrants and stock options that have a dilutive effect.

	2018	2017
Net earnings attributable to equity holders of the Bank	1,741,803	1,592,976
Weighted average number of outstanding shares	1,835,482	1,491,905
Adjustments for warrants and stock options	194,798	59,674
Total	2,030,280	1,551,579
Basic earnings per share (ISK)	0.95	1.07
Diluted earnings per share (ISK)	0.86	1.03

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

Statement of Financial Position

19. Cash and balances with Central Bank

Cash and balances with Central Bank are specified as follows:

	31.12.2018	31.12.2017
Deposits with Central Bank	8,934,131	7,660,601
Cash on hand	9,114	24,813
Balances with banks	6,903,004	7,043,106
Foreign treasury bills	3,472,741	3,789,480
Included in cash and cash equivalents	19,318,990	18,517,999
Restricted balances with Central Bank - average maintenance level	708,656	1,467,824
Restricted balances with Central Bank - fixed reserve requirement	708,656	0
Receivables from Central Bank	602,882	507,916
Total	21,339,185	20,493,739

The Bank holds mandatory reserve deposit accounts with the Central Bank of Iceland in compliance with the Central Bank's new Rules on Minimum Reserve Requirements No. 585/2018. Under these rules the reserve requirement is divided into two parts: a fixed reserve requirement bearing no interest and an average maintenance level requirement bearing the same interest as that on deposit-taking institutions' current accounts with the Central Bank. The new rules came into effect for the reserve maintenance period starting 21 June 2018. The mandatory reserve deposit with the Central Bank and the receivables from the Central Bank are not available for the Group to use in its daily operations.

20. Fixed income securities

Fixed income securities are specified as follows:

Mandatorily measured at fair value through profit or loss	31.12.2018
Listed government bonds and bonds with government guarantees	1,841,982
Listed bonds	3,150,409
Unlisted bonds	134,944
Total	5,127,335

	31.12.2017
Held for trading	
Listed government bonds and bonds with government guarantees	1,767,992
Listed treasury bills	499,267
Listed bonds	3,110,155
Unlisted bonds	220,994
Total	5,598,409

21. Shares and other variable income securities

Shares and other variable income securities are specified as follows:

Mandatorily measured at fair value through profit or loss	31.12.2018
Listed shares	751,470
Unlisted shares	1,391,018
Unlisted unit shares	784,187
Total	2,926,675

	31.12.2017
Held for trading	
Listed shares	1,266,507
Unlisted shares	687,328
Unlisted unit shares	879,916
Designated at fair value through profit or loss	
Unlisted shares	3,623
Total	2,837,375

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

22. Securities used for hedging

Securities used for hedging are specified as follows:

	31.12.2018	31.12.2017
Listed government bonds and bonds with government guarantees	7,625,469	3,519,268
Listed bonds	4,487,698	1,740,609
Listed shares	9,395,761	8,681,677
Unlisted unit shares	17,866	84,880
Total	21,526,794	14,026,433

23. Loans to customers

The breakdown of the loan portfolio by individuals and corporates is specified as follows:

31.12.2018	**Individuals** Gross carrying amount	Book value	**Corporates** Gross carrying amount	Book value	**Total** Gross carrying amount	Book value
Loans to customers at amortised cost	5,407,411	5,364,291	22,096,616	21,918,759	27,504,028	27,283,050
Loans to customers at fair value through profit or loss	0	0	2,160,522	2,160,522	2,160,522	2,160,522
Total	5,407,411	5,364,291	24,257,139	24,079,282	29,664,550	29,443,573

31.12.2017	
Loans to customers, gross amount	25,626,960
Specific allowance for impairment losses	(28,436)
Collective allowance for impairment losses	(260,274)
Total	25,338,250

24. Derivatives

Derivatives are specified as follows:

31.12.2018	**Notional** Assets	Liabilities	**Carrying value** Assets	Liabilities
Interest rate derivatives	4,803,789	4,607,104	196,684	0
Currency forwards	400,192	413,565		13,372
Bond and equity total return swaps	22,983,930	22,547,910	966,627	530,607
Equity options	7,900	7,900	49,955	49,955
	28,195,811	27,576,479	1,213,266	593,934

31.12.2017	**Notional** Assets	Liabilities	**Carrying value** Assets	Liabilities
Interest rate derivatives	3,596,957	3,503,988	92,969	0
Currency forwards	1,027,214	1,022,872	8,126	3,784
Bond and equity total return swaps	15,009,156	14,429,317	889,858	310,019
Equity options	245,967	0	61,699	50,889
	19,879,293	18,956,176	1,052,652	364,692

25. Group entities

The main subsidiaries held directly or indirectly by the Group are listed in the table below.

Entity	**Nature of operations**	**Domicile**	**Share 31.12.2018**	**Share 31.12.2017**
FÍ Fasteignafélag GP ehf.	Real estate fund management	Iceland	100%	100%
Júpíter rekstrarfélag hf.	Fund management	Iceland	100%	100%
M-Investments ehf.	Holding company	Iceland	100%	100%
Netgíró reikningar ehf.	Holding company	Iceland	100%	100%
Netgíró lán ehf.	Holding company	Iceland	100%	100%
Netgíró lán II ehf.	Holding company	Iceland	100%	-
Rafklettur ehf.	Holding company	Iceland	100%	100%
Rekstrarfélag Virðingar hf.	Fund management	Iceland	100%	100%
AC GP 3 ehf.	Fund management	Iceland	80%	80%
Kvika Securities ltd.	Business consultancy services	UK	100%	100%

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

26. Investment in associates

a. Investment in associates is accounted for using the equity method and is specified as follows:

Entity	Nature of operations	Domicile	Share 31.12.2018	Share 31.12.2017
Akta sjóðir hf.	Fund management	Iceland	49%	49%
Kjölfesta GP ehf.	Holding company	Iceland	50%	50%
Kortaþjónustan hf.	Payment Institution	Iceland	47%	42%

The Group does not consider its associates material, neither individually nor as a group.

b. Changes in investments in associates are specified as follows:

	31.12.2018	31.12.2017
Balance at the beginning of the year	676,610	127,262
Additions through a merger	0	8,558
Acquisition of shares in associates	408,671	611,216
Dividend paid	(7,500)	0
Disposal of shares in associates	0	(182,519)
Reclassification	0	48,181
Share in (loss) profit of associates, net of income tax	(302,949)	63,912
Total	774,832	676,610

27. Investment properties

Investment properties are specified as follows:	31.12.2018	31.12.2017
Balance as at 1 January 2018	953,874	0
Acquisitions	31,544	861,616
Disposal	(150,000)	0
Revaluation on investment properties	114,582	92,258
Total	950,000	953,874

In October 2017, the Group acquired investment properties through one of its subsidiaries, Rafklettur ehf. The intention is to either earn rental income or capital appreciation or both. The book value of investment properties is based on the most recent appraisal values by licensed real estate agents, current listing prices and/or recent transactions for comparable real estates or valuation models based on gross income multipliers. The Group received rental income amounting to ISK 92 million (2017:ISK 16 million) and incurred direct operating expenses of ISK 14 million (2017:ISK 2 million).

28. Unconsolidated structured entities

Where the Group acts as an agent for the investor, it does not consolidate the investment funds. When the Group holds investments in unconsolidated investment funds, they are in 2018 classified as mandatorily measured at fair value through profit or loss while in 2017 they were classified as either financial instruments designated at fair value through profit or loss or other financial instruments held for trading. The fair value of these instruments represents the Group's maximum exposure to loss from its investments in such unconsolidated investment funds.

The nature and purpose of Investment funds is to generate fees from managing assets on behalf of third party investors. These vehicles are financed through the issuance of units to investors.

	31.12.2018	31.12.2017
Investment funds	128,301,382	133,984,761

The following table shows an analysis of the carrying amounts of interests held by the Group in unconsolidated structured entities. The Group's maximum exposure to loss is the carrying amount of the assets held.

	Carrying amount	
	31.12.2018	31.12.2017
Investment funds	684,811	522,667

The Group received management fees during the year:	2018	2017
Investment funds	750,154	531,350

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

29. Intangible assets

a. Intangible assets are specified as follows:

31.12.2018	**Goodwill**	**Software**	**Other**	**Total**
Balance as at 1 January 2018	2,244,521	23,959	15,860	2,284,340
Acquisitions	0	98,952	5,352	104,304
Amortisation	0	(4,482)	(4,880)	(9,362)
Balance as at 31 December 2018	2,244,521	118,428	16,332	2,379,281
Gross carrying amount	2,244,521	144,394	48,800	2,437,715
Accumulated amortisation and impairment losses	0	(25,966)	(32,468)	(58,434)
Balance as at 31 December 2018	2,244,521	118,428	16,332	2,379,281
31.12.2017	**Goodwill**	**Software**	**Other**	**Total**
Balance as at 1 January 2017	0	20,790	20,740	41,530
Acquisitions	0	8,680	40,000	48,680
Additions through business combinations	2,244,521	0	0	2,244,521
Amortisation	0	(5,511)	(44,880)	(50,391)
Balance as at 31 December 2017	2,244,521	23,959	15,860	2,284,340
Gross carrying amount	0	45,442	48,800	94,242
Accumulated amortisation and impairment losses	0	(24,652)	(28,060)	(52,712)
Balance as at 1 January 2017	0	20,790	20,740	41,530
Gross carrying amount	2,244,521	38,924	48,800	87,724
Accumulated amortisation and impairment losses	0	(14,965)	(32,940)	(47,905)
Balance as at 31 December 2017	2,244,521	23,959	15,860	2,284,340

Acquisitions by the Group in 2017 as a part of business combinations resulted in the recognition of goodwill. Preliminary purchase price allocation ("PPA") was prepared at end of 2017 at which time the fair value of the assets was determined. The PPA was finalized in 2018 and resulted in no change being made.

b. Impairment testing

Assets with indefinite useful life, such as goodwill, are not amortised but are subject to annual inpairment testing as described in note 93. Goodwill is allocated to cash generating units ("CGUs") for the purpose of impairment testing. The allocation is made to those CGUs or groups of CGUs that are expected to benefit from the business combinations in which the goodwill arose. The goodwill was allocated to the Asset Management business segment as the acquistions in 2017 were made to strengthen those operations of the Group.

The purpose of impairment testing is to determine whether the recoverable amount exceeds the carrying amount of the above mentioned business segment. The recoverable amount of an operating segment is the higher of its value in use or fair value less costs to of sell. Value in use is determined as the present value of the future cash flows expected to be derived from a CGU, based on amongst others:

- the expected future cash flows from the GCU
- the time value of money, which is reflected by using a discount rate based on the current market risk-free rate of interest
- the price for the uncertainty inherent in the CGU

The estimated future cash flows are based on a budget for the CGU for the coming three years and a further four years using extrapolated figures based on estimated growth rates (3.5%) in assets under management. The time value of money and price of uncertainty, calculated as the weighted average cost of capital ("WACC"), are based on external market information about market risk, interest rates and CGU specific elements like country risk. The discount rate is calculated at CGU level and equals 12.5%.

The goodwill impairment test was performed at the end of 2018. Its results show that the recoverable value exceeds the carrying value of goodwill. In addition to the base case testing, additional scenarios were tested where some key inputs had been stressed. In all scenarios tested the results show that there is sufficient headroom and that there are no triggers indicating that impairment is necessary.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

30. Property and equipment

Property and equipment is specified as follows:

31.12.2018	Furniture and fixtures	Computer equipment	Other	Total
Balance as at 1 January 2018	15,615	9,608	32,028	57,251
Acquisitions	2,937	957	529	4,423
Disposals	0	0	(6,490)	(6,490)
Depreciation	(4,621)	(3,352)	(4,318)	(12,290)
Reclassified	663	(663)	0	0
Balance as at 31 December 2018	14,594	6,550	21,750	42,894
Gross carrying amount	41,832	40,415	197,507	279,753
Accumulated depreciation	(27,239)	(33,864)	(175,756)	(236,860)
Balance as at 31 December 2018	14,594	6,550	21,750	42,894

31.12.2017	Furniture and fixtures	Computer equipment	Other	Total
Balance as at 1 January 2017	14,569	10,425	34,141	59,135
Acquisitions	0	1,408	3,691	5,099
Additions through business combinations	4,490	4,605	377	9,472
Disposals	0	(2,184)	0	(2,184)
Depreciation	(3,444)	(4,646)	(6,180)	(14,270)
Balance as at 31 December 2017	15,615	9,608	32,028	57,251
Gross carrying amount	38,895	39,458	41,933	120,287
Accumulated depreciation	(24,326)	(29,033)	(7,792)	(61,152)
Balance as at 1 January 2017	14,569	10,425	34,141	59,135
Gross carrying amount	42,802	40,225	197,507	280,533
Accumulated depreciation	(27,187)	(30,617)	(165,478)	(223,282)
Balance as at 31 December 2017	15,615	9,608	32,028	57,251

31. Deferred tax assets and liabilities

	31.12.2018	31.12.2017
Deferred tax assets	608,858	464,414
Deferred tax liabilities	(76,980)	(65,658)
Net	531,878	398,756

The Group's deferred tax assets (liabilities) are attributable to the following items:

	31.12.2018	31.12.2017
Property and equipment	4,414	(1,970)
Intangible assets	0	6,800
Assets and liabilities denominated in foreign currencies	(3,795)	(9,340)
Other items	(73,367)	(61,386)
Tax losses carried forward	604,625	464,653
Total	531,878	398,756

At year end 2018, tax losses carried forward amount to ISK 104 billion, and are set to expire as follows:

	Tax losses
Tax losses 2009, expiring in 2019	96,929,489
Tax losses 2010, expiring in 2020	66,358
Tax losses 2011, expiring in 2021	764,208
Tax losses 2012, expiring in 2022	640,623
Tax losses 2013, expiring in 2023	1,511,014
Tax losses 2014, expiring in 2024	781,928
Tax losses 2015, expiring in 2025	3,041,144
Total	103,734,765

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

32. Other assets

Other assets are specified as follows:

	31.12.2018	31.12.2017
Unsettled transactions	120,563	290,598
Accounts receivable	1,283,215	1,147,904
Sundry assets	537,292	359,411
Total	1,941,070	1,797,913

33. Deposits from customers

Deposits from customers are specified as follows:

	31.12.2018	31.12.2017
Demand deposits	32,463,907	33,097,311
Time deposits	15,430,052	8,652,186
Total	47,893,959	41,749,497

34. Borrowings

Borrowings are specified as follows:

	31.12.2018	31.12.2017
Loans from credit institutions	1,215,343	609,897
Money market deposits	14,407,558	13,076,921
Other borrowings	11,747	44,557
Total	15,634,648	13,731,375

Money market deposits typically have a principal of ISK 5-500 million and maturity between 1 day and 6 months and pay fixed interest rates.

The Bank has not had any defaults of principal, interest or other breaches with respect to its debt issued and other borrowed funds.

35. Issued bills

Issued bills are specified as follows:

	31.12.2018	31.12.2017
Issued bills	3,577,718	3,934,757
Total	3,577,718	3,934,757

36. Issued bonds

Issued bonds are specified as follows:

Currency, nominal value	First issued	Maturity	Maturity type	Terms of interest	31.12.2018	31.12.2017
KVB 17 02, ISK 2,160 million	2017	2020	At maturity	Floating, 1 month REIBOR + 1.25%	1,963,336	1,031,433
Total					1,963,336	1,031,433
Unlisted senior unsecured bonds, total					1,196,879	370,446
Total					3,160,215	1,401,879

Unlisted senior unsecured bonds are composed of KVB 17 01, KVB 18 01, KVB 18 03 and KVB 18 04 which were issued in 2017 and 2018 and mature in 2019, 2020 and 2021 respectively. For further information on the bonds, refer to the issue descriptions which are available on Nasdaq CSD Iceland's website.

37. Subordinated liabilities

Subordinated liabilities:

Currency, nominal value	First issued	Maturity	Maturity type	Terms of interest	31.12.2018	31.12.2017
KVB 15 01, ISK 1,000 million	2015	2025	At maturity	CPI-Indexed, fixed 5.50%	1,093,162	1,058,741
KVB 18 02, ISK 800 million	2018	2028	At maturity	CPI-Indexed, fixed 7.50%	854,350	0
Total					1,947,511	1,058,741

At the interest payment date in the year 2020 for KVB 15 01, the annual interest rate increases from 5.50% p.a. to 7.50% p.a. At the same date, the Group has the right to repay the subordinated bond and on any subsequent interest payment dates until maturity.

At the interest payment date in the year 2023 for KVB 18 02, the Group has the right to repay the subordinated bond and on any subsequent interest payment dates until maturity.

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 2 and are a part of the equity base. The amount eligible for Tier 2 capital treatment is amortised on a straight-line basis over the final 5 years to maturity or up to 20% a year. The Group may only retire subordinated liabilities with the permission of the Icelandic Financial Supervisory Authority.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

38. Short positions held for trading

Short positions held for trading are specified as follows:

	31.12.2018	31.12.2017
Listed government bonds and bonds with government guarantees	569,471	305,041
Listed bonds	235,863	65,122
Total	805,334	370,163

Short positions held for trading are classified as mandatorily measured at fair value through profit or loss. Short positions held for trading were classified in 2017 as held for trading. Further discussion about the accounting classification of financial liabilites is provided in notes 60-62.

39. Other liabilities

Other liabilities are specified as follows:

	31.12.2018	31.12.2017
Unsettled transactions	186,794	556,716
Expected credit loss allowance for loan commitments, guarantees and unused credit facilities	17,439	0
Accounts payable and accrued expenses	250,522	219,834
Special taxes on financial institutions and financial activities	150,336	75,336
Withholding taxes	461,153	472,874
Salaries and salary related expenses	313,274	403,924
Other liabilities	230,806	208,009
Total	1,610,323	1,936,693

40. Equity

a. Share capital

The nominal value of shares issued by the Bank is ISK 1 per share or a multiple thereof. All currently issued shares have a nominal value of ISK 1 per share, and are fully paid. The holders of shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per nominal value of ISK 1 at shareholders' meetings. Reference is made to the Bank's Articles of Association for more information about the share capital.

	31.12.2018	31.12.2017
Share capital according to the Bank's Articles of Association	1,844,996	1,815,061
Nominal amount of treasury shares	0	10,000
Authorised but not issued shares	838,635	878,571

b. Changes made to the nominal amount of share capital

The Bank's share capital was increased twice during the first half of 2018, in total for a nominal value of ISK 30 million. In March 2018 and in May 2018 the share capital was increased by ISK 19,957,356 and ISK 9,978,678, respectively, in nominal value in relation to exercise of issued warrants.

c. Share capital increase authorisations

According to the Bank's Articles of Association dated 18 December 2018, the Board of Directors is authorised to increase the share capital of the Bank by up to ISK 100 million through subscription for new shares. This authorisation is based on temporary provision I to the Articles of Association and is valid until 15 March 2022.

Temporary provision IV to the Articles of Association authorises the Board of Directors to issue warrants and increase the share capital accordingly. According to section A of temporary provision IV the Board of Directors is authorised to increase share capital by up to ISK 480 million to serve issued warrants. According to section B of temporary provision IV the Board of Directors is furthermore granted a conditioned authorisation to increase the share capital by an additional amount of ISK 200 million to serve issued warrants. The authorisation under section B of temporary provision IV is directly linked to the Board of Directors' authorisation under section A of temporary provision I.

The aforementioned authorisation under section B of temporary provision IV currently stands at ISK 150 million. However, should the Board of Directors utilise its authorisation according to section A of temporary provision I and increase the Bank's share capital by ISK 100 million, the authorisation under section B of temporary provision IV will increase from ISK 150 million to ISK 200 million, as stipulated in the provision. The Board of Directors' authorisation under temporary provision IV to increase share capital thus currently totals ISK 630 million but can increase to ISK 680 million by the usage by the Board of Directors of its authorisation pursuant to section A of temporary provision I. This authorisation is valid until 14 July 2022.

The Board of Directors is furthermore authorised to increase the share capital of the Bank in stages by up to ISK 50,000,000 in nominal value, for the purposes of fulfilling share option agreements in accordance with the Bank's share incentive scheme. This authorisation is based on temporary provision I, cf. paragraph B of the provision, to the Articles of Association and is valid until 30 November 2021.

Temporary provision III to the Articles of Association moreover authorises the Board of Directors to issue new share capital in the maximum amount of ISK 58,635,392 nominal value, to serve warrants which have been issued.

A copy of the Bank's Articles of Association, including the temporary provisions, is available on the Bank's website, www.kvika.is, reference is made to them for more information.

Kvika Amounts are in ISK thousands

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41. Warrants

In October 2016 the Bank issued warrants for ISK 130,000,000 in nominal value, the warrants are valid for 36 months from date of issue. The subscription rate for each new share on exercise of the warrants shall be equal to 3.84 per share with a 5% annual increase. During 1H 2018 a part of the warrants were exercised for a nominal value of ISK 29,936,034. The holders of the remaining warrants issued in October 2016 are authorised to subscribe for ISK 58,635,392 in nominal value.

In 2017 and during 1H 2018 the Bank issued warrants for ISK 629,500,000 in nominal value. The warrants issued in 2017 are valid for five years from date of issue and the warrants issued in 2018 are valid until 18 December 2022. The holders of the warrants issued in 2017 can exercise them as follows: (1) to a third (1/3) of the subscription shares in the period from when two years have elapsed from the issue of the warrants until three years have elapsed from the issue of the warrants, (2) to a third (1/3) of the subscription shares in the period from when three years have elapsed from the issue of the warrants until five years have elapsed from the issue of the warrants, and (3) to a third (1/3) of the subscription shares in the period from when four years have elapsed from the issue of the warrants until five years have elapsed from the issue of the warrants. The holders of the warrants issued in 2018 can exercise them as follows: (1) to a third (1/3) of the subscription shares in the period from 18 December 2019 until 18 December 2020, (2) to a third (1/3) of the subscription shares in the period from 18 December 2020 until 18 December 2022, and (3) to a third (1/3) of the subscription shares in the period from 18 December 2021 until 18 December 2022. The subscription rate for each new share on exercise of the warrants shall be 5.56 with a 7.5% annual increase for 604,000,000 in nominal value issued in September 2017, 6.30 with a 7.5% annual increase for 22,000,000 in nominal value issued in December 2017 and 7.90 with a 7.5% annual increase for 3,500,000 in nominal value issued in May 2018. A more detailed coverage on the warrants and their terms can be found in the Bank's Articles of Association, reference is made to them for more information.

42. Capital adequacy ratio (CAD)

Equity at the end of the year was ISK 12,970 million (31.12.2017: 10,982 million), equivalent to 14.7% of total assets according to the statement of financial position (31.12.2017: 14.5%). The capital adequacy ratio of the Group, calculated in accordance with Article 84 of Act No. 161/2002 on Financial Undertakings, was 25.1% (31.12.2017: 21.1%). The minimum according to the Act is 8.0%. The ratio is calculated as follows:

Capital base	**31.12.2018**	**31.12.2017**
Total equity	12,969,999	10,982,276
Goodwill and intangibles	(2,379,281)	(2,284,340)
Deferred tax asset	(608,858)	(464,414)
Tier 1 capital	9,981,860	8,233,523
Subordinated liabilities	1,947,511	1,058,741
Accrued interests	(61,005)	(19,097)
Tier 2 capital	1,886,506	1,039,643
Shares in financial institutions	(171,272)	(216,862)
Subordinated fixed income securities	(54,595)	(201,855)
Total capital base	11,642,499	8,854,450

Capital requirements	**31.12.2018**	**31.12.2017**
Credit risk	2,554,624	2,140,527
Market risk	357,978	480,415
Operational risk	801,581	738,179
Total Capital requirements	3,714,184	3,359,121
Surplus capital	7,928,315	5,495,329
Capital adequacy ratio (CAD)	25.1%	21.1%
Minimum capital requirements	14.5%	14.5%

The Icelandic Financial Supervisory Authority (FME) supervises the Bank on a consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the Bank as a whole. The Bank's regulatory capital calculations for credit risk and market risk are based on the standardised approach and the capital calculations for operational risk are based on the basic indicator approach.

Minimum capital requirement is based on the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and is reviewed by the FME through the Supervisory Review and Evaluation Process (SREP). The Bank's minimum regulatory capital requirement, based on the SREP from 2017, is 14.5%. The minimum regulatory capital requirement including the additional capital requirements imposed following the implementation of CRD IV is 20.25% as at 31 December 2018.

Notes to the Consolidated Financial Statements

Risk management

43. Risk management framework

a. Board of Directors

The Bank's Board of Directors has overall responsibility for the establishment and oversight of the Group's risk management framework and risk appetite setting. Risk management policies are reviewed regularly to reflect changes in market conditions and the Group's activities. The Group, through training and management standards and procedures, aims to develop a disciplined and constructive control environment in which all employees understand their roles and obligations.

b. Board of Directors sub-committees

The Bank's Board of Directors has established three sub-committees, the Risk Committee, Audit Committee and Remuneration Committee. In accordance with the Bank´s articles of association, three members have been appointed to each committee, thereof at least two Board members. It is not permitted to appoint employees of the Bank to any committee. Members shall have the necessary experience and knowledge for each committee´s tasks according to applicable laws and rules. Each committee has incorporated procedural rules which have been confirmed by the Board of Directors.

The Risk Committee is intended to perform a consultative and supervisory role for the Bank’s Board of Directors, including for the formation of the Bank’s risk policy and risk appetite. The Risk Committee supervises the arrangement and activity of risk management, credit risk, market risk, liquidity risk, operational risk, reputational risk and other risk as applicable.

The Audit Committee is intended to perform a consultative and supervisory role for the Bank’s Board of Directors, including to ensure the quality of the annual accounts and other financial information of the Bank and the independence of the Bank’s audit. The Audit Committee monitors the work process for the preparation of financial statements, the functioning of internal controls as well as internal and external auditing.

The Remuneration Committee is intended to perform a consultative and supervisory role for the Bank’s Board of Directors in connection with the Bank’s remuneration and that they support the objectives and interests of the Bank

c. CEO

The CEO is responsible for the effective implementation through the corporate governance structure and committees. The CEO has established three committees, which are responsible for developing and monitoring risk management policies in their specified areas.

d. Committees

The Bank operates three committees that are involved in risk management: an Asset and Liability Committee (ALCO), a Credit Committee and an Operations Committee.

The ALCO Committee meets regularly and each department reports on its operations and positions activity since the previous meeting. The committee addresses matters regarding the Bank's risk management, financing, capital management and proprietary trading.

The Credit Committee addresses matters regarding the Bank's loan activities. The committee is responsible for the approval of individual loans as well as deciding on credit limits for individual clients in derivative trades, and is the primary forum for the discussion of loan activity policy.

The Operations Committee is responsible for supervision and implementation of the Bank's security and quality policies. The security policy mainly addresses data security and operational security in IT systems, physical security for the personnel and proper access controls and monitoring in the Bank's premises. The quality work is aimed at upholding proper quality in work processes, IT systems and services to support performance and profitability, lower operational risk and increase the customer experience.

e. Risk management

The purpose of the Bank's risk management unit is to identify, quantify, control and report on the risks that the Group is exposed to in its daily activities. The unit also participates in drafting the overall risk policy and has representatives on the ALCO committee, Credit committee and the Operations committee. The unit’s main activities include monitoring and managing credit risk, market risk, liquidity risk and operational risk. The Board of Directors sets the rules and guidelines regarding the Group's risk policy and the obligations of risk management and credit control. The division reports regularly on the Group’s positions and exposure to risk to the Board of Directors, the CEO and to the ALCO committee.

f. Compliance Officer

The Compliance Unit is responsible for the supervision of securities transactions within the Bank, i.e. monitoring and assessing the adequacy and effectiveness of measures and procedures put in place to detect and minimise any risk of failure by the Bank to comply with its obligations under the Act on Securities Transactions. The compliance officer is also responsible for coordinating and monitoring the Bank’s compliance with applicable anti-money laundering and terrorist financing laws and regulations. The Compliance Unit also assesses and manages the Bank´s compliance risk.

g. Internal Audit

Internal Audit is responsible for providing an objective opinion on the Group’s operations, as well as advice which aims to increase the Group’s value and to strengthen risk management and internal control. The Internal Audit’s main task, is to estimate whether adequate processes and systems are in place, and whether they are relevant and efficient. The Internal Auditor is recruited by the Board of Directors and is located accordingly in the hierarchy. Its operations cover all units of operations, including the subsidiary Júpiter Capital Management hf. and the associate company Akta Capital Management hf.

44. Hedging

Securities held as a hedge against derivatives positions of customers make up a part of the Group's portfolio of assets. The Group hedges currency exposure between the Group's loan portfolio and debts to the extent possible, but does not apply hedge accounting.

Notes to the Consolidated Financial Statements

45. Credit risk - overview

a. Definition

One of the Group's primary sources of risk is counterparty credit risk. Credit risk is defined as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

b. Management

The risk management unit is responsible for managing and reporting on credit risk. The Group uses a variety of tools and processes to manage credit risk, including collaterals, hedges and loan portfolio management.

c. Credit approval process

The originating department prepares a proposal for each loan or credit line which is presented to the credit committee for approval. The proposal consists of a basic description of the client, the purpose of the loan, a simple credit assessment and arguments for or against granting the loan. The committee decides whether there is need for further credit assessment and on what terms the loan may be granted.

A more thorough credit assessment may be conducted if considered appropriate and can include an assessment of a borrower's fundamental credit strength as well as the value of any collateral. To assess the borrower's capacity to meet his or her obligations the committee can request stress test analysis of the borrower's cash flow or call for third party assessments.

d. Collateral

Securing loans with collateral is a traditional method to reduce credit risk. The Group uses different methods to reduce credit risk by obtaining collateral from customers where appropriate. Such collateral gives the Group right to the collateralised assets for current and future obligations incurred by the customer.

The Group places emphasis on pricing loans according to the value and quality of pledged collateral. The Group applies appropriate haircuts on all collateral in order to ensure proper risk mitigation. For all collateral in listed securities, the Group maintains the right to liquidate collateral in case its market value falls below a predefined limit.

To a very large extent the Group's loan portfolio consists of senior loans, most of which are highly collateralised.

e. Credit rating, control and provisioning

The risk management unit is responsible for credit rating and reviewing the loan portfolio. In case of any significant delay of payments or defaults the unit carefully analyses the underlying assets and loan documents and organizes the process of collection.

The Group monitors the value of collateral by listed securities on a real time basis, and takes prompt action when necessary.

f. Loan portfolio management

To ensure an effective diversification of the loan portfolio the board has set a limit framework defining maximum exposure as a ratio of the Group’s equity and/or the total size of the loan portfolio. These limits include limitation on joint exposure to associated clients, exposure to individual and associated industries, single regions and countries etc. It is the responsibility of risk management to monitor that these limits are not being violated and to report discrepancies to the credit committee.

g. Impairment

Provisioning for loan impairments is estimated on the basis of expected loss models assessing the portfolio as a whole as well as individual lending. Risk management suggest a level of provisioning for the portfolio, based on the expected loss assessment. Risk management reassess impairments in the event of collateral decay, delayed payments, indication of increased risk, or other early warning signs. Provisions require approval from the credit committee. Refer to note 85 for more information on the Group's impairment policy.

h. Derivatives

The Group offers derivative contracts in the form of swap contracts on highly liquid securities. On the day when the contract is entered into, the Group purchases the underlying security and hedges its exposure to price changes. Collateral is in the form of cash or listed, highly liquid securities. The risk management sets rules about the level of collateralisation and monitors the compliance to these rules. Contracts are closed if required levels of collateralisation are not met.

i. Securities used for hedging

The Group hedges itself for market risk of derivative contracts by purchasing the underlying securities at the commencement of the contract. Since the contracts require delivery of the underlying securities to the customer on the settlement day, the credit risk towards the issuer is immaterial.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

46. Maximum exposure to credit risk

The maximum exposure to credit risk of on-balance sheet and off-balance sheet financial instruments subject to the impairment requirements of IFRS 9, before taking into account any collateral held or other credit enhancements, is specified as follows:

	Public entities	Financial institutions	Corporate customers	Individuals	31.12.2018
Cash and balances with Central Bank	14,436,181	6,903,004			21,339,185
Fixed income securities	2,829,688	1,968,174	329,473		5,127,335
Securities used for hedging	7,850,853	3,157,437	1,104,877		12,113,167
Loans to customers		54,260	24,044,069	5,345,243	29,443,573
Derivatives		624,399	541,364	47,503	1,213,266
Other assets	23,517	56,377	1,766,389	94,786	1,941,070
	25,140,239	12,763,651	27,786,172	5,487,532	71,177,595
Loan commitments		255,329	2,818,631	388,975	3,462,935
Financial guarantee contracts		100,000	823,074		923,074
Total	25,140,239	13,118,980	31,427,877	5,876,508	75,563,603

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

	Public entities	Financial institutions	Corporate customers	Individuals	31.12.2017
Cash and balances with Central Bank	13,450,634	7,043,106			20,493,739
Fixed income securities	3,332,061	2,247,209	19,139		5,598,409
Securities used for hedging	4,051,933	1,207,944			5,259,877
Loans to customers		60,005	21,728,318	3,549,927	25,338,250
Derivatives		349,086	664,121	39,445	1,052,652
Other assets	33,732	41,520	1,626,143	96,517	1,797,913
	20,868,359	10,948,869	24,037,721	3,685,890	59,540,839
Loan commitments		298,838	2,128,138	382,601	2,809,577
Financial guarantee contracts			434,237		434,237
Total	20,868,359	11,247,706	26,600,097	4,068,492	62,784,654

47. Credit quality of financial assets

The tables below show financial assets subject to the impairment requirements of IFRS 9 broken down by rating scale where credit score 9-10 denotes the highest risk. Assets measured at fair value through profit or loss are not subject to the impairment requirements of IFRS 9 but are nevertheless included in the tables in order to give a more complete picture of the credit quality of loans to customers and reconcile the tables to the carrying amount on the balance sheet. Exposures which are non-rated relate to Legal Entities or Individuals with no Credit Score. Probability of default for these exposures is based on average probability for similar exposures and is furthermore individually assessed by credit specialists. Comparative figures have not been restated.

a. Credit quality of financial assets by rating class is specified as follows:

31.12.2018

Loans to customers:	Stage 1	Stage 2	Stage 3	FVTPL	Total
Credit score 1-4	16,152,412	10,693	11,158	648,966	16,823,228
Credit score 5-6	5,493,100	31,662		858,937	6,383,699
Credit score 7-8	596,103	287,862	31,814	373,741	1,289,520
Credit score 9-10	51,116	281,862			332,978
In default		156,446	309,702		466,147
Non-rated	2,999,188	1,090,911		278,879	4,368,979
Gross carrying amount	25,291,919	1,859,436	352,673	2,160,522	29,664,550
Expected credit loss	(160,684)	(27,930)	(32,363)		(220,977)
Book value	25,131,235	1,831,506	320,310	2,160,522	29,443,573

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

47. Credit quality of financial assets (cont.)

Loan commitments, guarantees and unused credit facilities:	Stage 1	Stage 2	Stage 3	FVTPL	Total
Credit score 1-4	2,802,424	971			2,803,394
Credit score 5-6	753,562	326		183,141	937,030
Credit score 7-8	280,896	3,101			283,997
Credit score 9-10	76	5,716			5,792
In default			5,108		5,108
Non-rated	350,688				350,688
Gross carrying amount	4,187,646	10,113	5,108	183,141	4,386,008
Expected credit loss	(15,462)	(683)	(1,293)		(17,439)
Book value	4,172,184	9,430	3,814	183,141	4,368,569

Credit quality by class of financial assets, under IAS 39, is specified as follows:

31.12.2017	Neither past due nor individually impaired	Past due but not individually impaired	Individually impaired	Total	Less specific impairment allowance	Less collective impairment allowance	Carrying amount
Cash and balances with Central Bank	20,493,739			20,493,739			20,493,739
Fixed income securities	5,598,409			5,598,409			5,598,409
Securities used for hedging	5,259,877			5,259,877			5,259,877
Loans to customers	23,767,646	1,813,169	46,146	25,626,960	(28,436)	(260,274)	25,338,250
Derivatives	1,052,652			1,052,652			1,052,652
Other assets	1,802,986		16,300	1,819,286	(16,373)	(5,000)	1,797,913
Total	57,975,309	1,813,169	62,445	59,850,923	(44,809)	(265,274)	59,540,839

b. Breakdown of loans to customers into not past due and past due, under IFRS 9

31.12.2018	Claim value	Expected credit loss	Carrying amount
Not past due	28,900,493	(197,946)	28,702,547
Past due 1-30 days	570,167	(4,857)	565,309
Past due 31-60 days	158,379	(3,921)	154,458
Past due 61-90 days			0
Past due 91-180 days	11,158	(2)	11,156
Past due 181-360 days			0
Past due more than 360 days	24,353	(14,251)	10,102
Total	29,664,550	(220,977)	29,443,573

Past due but not individually impaired, under IAS 39

Past due but not individually impaired financial assets are those assets where contractual payments are 1 or more days past due but the Group believes that impairment is not appropriate on the basis of the level of security or future cash flows of the borrower. Past due loans are reported as the total claim value and not only those payments that are past due.

	31.12.2017
Past due 1-30 days	1,522,288
Past due 31-60 days	96,162
Past due 61-90 days	990
Past due 91-180 days	188,984
Past due 181-360 days	4,745
Past due more than 360 days	0
Total	1,813,169

Individually impaired, under IAS 39

Individually impaired financial assets are those assets where there is objective evidence of impairment, the asset has been individually assessed and comparison of the carrying amount and the present value of the expected cash flow from the asset reveals a need for impairment. All individually impaired assets are considered non-performing.

31.12.2017	Impaired but not Past due	Past due 1-30 days	Past due 31-60 days	Past due 61-90 days	Past due over 90 days	Claim value
Corporate						
Services					16,109	16,109
Retail					18,895	18,895
Individuals			432		27,010	27,442
Total	0	0	432	0	62,013	62,445

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

47. Credit quality of financial assets (cont.)

c. Breakdown of loans to customers by industry

The breakdown of the loan portfolio, under IFRS 9, by industries is specified as follows:

31.12.2018	Claim value	Expected credit loss	Carrying amount	%
Financial institutions	3,988	(8)	3,979	0.0%
Corporate				
Services	11,393,477	(112,157)	11,281,320	38.3%
Holding companies	6,707,672	(18,015)	6,689,657	22.7%
Real estate, construction and industry	2,834,688	(33,759)	2,800,929	9.5%
Retail	1,034,244	(12,819)	1,021,424	3.5%
Other	2,283,070	(22,098)	2,260,972	7.7%
Individual	5,407,411	(22,120)	5,385,291	18.3%
Total	29,664,550	(220,977)	29,443,573	100.0%

The breakdown of the loan portfolio, under IAS 39, by industries is specified as follows:

31.12.2017	Claim value	Impairment allowance	Carrying amount	%
Financial institutions	60,655	(650)	60,005	0.2%
Corporate				
Services	8,596,517	(101,670)	8,494,847	33.5%
Holding companies	7,244,461	(77,675)	7,166,786	28.3%
Real estate, construction and industry	3,319,089	(35,587)	3,283,502	13.0%
Retail	1,202,059	(22,133)	1,179,925	4.7%
Other	1,620,635	(17,376)	1,603,258	6.3%
Individual	3,583,545	(33,617)	3,549,927	14.0%
Total	25,626,960	(288,710)	25,338,250	100.0%

d. Breakdown of loans to customers by seniority

The following definitions are used when ranking the loan portfolio by seniority:

- Senior I
  Loans in this category have first priority claims on the borrower's assets, are secured with collateral which can be marked to market and have asset coverage exceeding 100%.
- Senior II
  Loans in this category have sufficient coverage and liquid collateral, but the collateral can in some cases not be marked to market, e.g. unlisted shares.
- Junior
  Junior loans have second lien claims on the borrower’s assets or lower levels of collateral coverage.
- Mezzanine
  Mezzanine loans are loans which are unsecured and subordinated to all of the borrower’s other liabilities.

The breakdown of loans to customers by categories, under IFRS 9, is as follows:

	Senior I	Senior II	Junior	Mezzanine	31.12.2018
Amortised cost - Stage 1	6,030,827	8,442,103	4,316,905	6,143,591	24,933,426
Amortised cost - Stage 2	1,283,008	345,169	173,640	170,558	1,972,375
Amortised cost - Stage 3	163,415	65,451		148,383	377,250
Fair value through profit and loss	181,415	837,798	907,762	233,548	2,160,522
Total	7,658,665	9,690,522	5,398,306	6,696,080	29,443,573

The breakdown of loans to customers by categories, under IAS 39, is as follows:

	Senior I	Senior II	Junior	Mezzanine	31.12.2017
Neither past due nor individually impaired	5,879,042	9,995,383	4,093,497	3,554,139	23,522,061
Past due but not individually impaired	387,816	535,733	323,319	551,611	1,798,480
Individually impaired		9,447		8,262	17,709
Total	6,266,858	10,540,564	4,416,817	4,114,011	25,338,250

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

47. Credit quality of financial assets (cont.)

e. Allowance for expected credit loss on loans to customers and loan commitments, guarantees and unused credit facilities

The following tables show changes in the expected credit loss allowance of loans to customers and for loan commitments, guarantees and unused credit facilities during the period.

31.12.2018

Expected credit loss allowance total

	Stage 1	Stage 2	Stage 3	Total
General and specific loss provision at 31.12.2017	243,944	10,856	33,911	288,710
Net remeasurement	(91,791)	39,687	23,395	(28,709)
Opening expected credit loss balance at 1.1.2018	152,153	50,543	57,305	260,001
Transfers of financial assets:				
Transfer to Stage 1 - (Initial recognition)	2,673	(223)	(2,450)	0
Transfer to Stage 2 - (significantly increased credit risk)	(15,005)	15,032	(26)	0
Transfer to Stage 3 - (credit impaired)	(614)	(30,814)	31,429	0
Net remeasurement of loss allowance	(2,893)	(512)	(24,586)	(27,990)
New financial assets, originated or purchased	101,385	12,792	6,913	121,091
Derecognitions and maturities	(61,553)	(18,204)	(25,258)	(105,015)
Write-offs			(9,671)	(9,671)
Balance as at 31 December 2018	176,146	28,614	33,657	238,416

Expected credit loss allowance for loans to customers

	Stage 1	Stage 2	Stage 3	Total
General and specific loss provision at 31.12.2017	243,944	10,856	33,911	288,710
Net remeasurement	(106,713)	38,782	22,487	(45,444)
Opening expected credit loss balance at 1.1.2018	137,231	49,638	56,398	243,266
Transfers of financial assets:				
Transfer to Stage 1 - (Initial recognition)	2,396	(215)	(2,181)	0
Transfer to Stage 2 - (significantly increased credit risk)	(14,871)	14,898	(26)	0
Transfer to Stage 3 - (credit impaired)	(568)	(30,814)	31,383	0
Net remeasurement of loss allowance	(1,998)	(911)	(25,243)	(28,152)
New financial assets, originated or purchased	92,969	12,747	6,888	112,603
Derecognitions and maturities	(54,475)	(17,411)	(25,184)	(97,069)
Write-offs			(9,671)	(9,671)
Balance as at 31 December 2018	160,684	27,930	32,363	220,977

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

	Stage 1	Stage 2	Stage 3	Total
General and specific loss provision at 31.12.2017				0
Net remeasurement	14,922	905	908	16,735
Opening expected credit loss balance at 1.1.2018	14,922	905	908	16,735
Transfers of financial assets:				
Transfer to Stage 1 - (Initial recognition)	277	(8)	(269)	0
Transfer to Stage 2 - (significantly increased credit risk)	(134)	134		0
Transfer to Stage 3 - (credit impaired)	(46)		46	0
Net remeasurement of loss allowance	(895)	399	657	162
New financial assets, originated or purchased	8,416	46	26	8,488
Derecognitions and maturities	(7,078)	(793)	(75)	(7,945)
Write-offs				0
Balance as at 31 December 2018	15,462	683	1,293	17,439

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.

31.12.2017	Specific	Collective	Total
Balance as at 1 January 2017	44,404	262,208	306,611
Charge to the income statement for the period	20,677	(1,934)	18,744
Recoveries	(20,815)	0	(20,815)
Write-offs	(15,829)	0	(15,829)
Balance as at 31 December 2017	28,436	260,274	288,710

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

48. Collateral and other credit enhancements

a. Valuation

The Group applies the same valuation methods to collateral held as other comparable assets held by the Group. The methods used for financial assets are outlined in note 61. For other types of assets the Group uses third party valuation where possible. Haircuts are then applied to account for liquidity and other factors which may affect the collateral value of the asset or other credit enhancement.

b. Loans to customers

	Deposits	Fixed income securities	Variable income securities	Real estate	Other fixed assets	Other	31.12.2018
Financial institutions	604	49,588	46,164	310,655			407,011
Corporate customers	1,441,389	194,594	8,209,045	9,974,043	173,193	976,223	20,968,489
Individuals	10,568	40,665	1,220,231	434,033			1,705,498
Total	1,452,561	284,848	9,475,440	10,718,732	173,193	976,223	23,080,997

	Deposits	Fixed income securities	Variable income securities	Real estate	Other fixed assets	Other	31.12.2017
Financial institutions	25,499	52,629	176,586				254,714
Corporate customers	605,792	81,471	8,026,087	10,357,144	29,483	453,024	19,553,001
Individuals	19,562	23,918	1,010,639	808,731			1,862,850
Total	650,853	158,018	9,213,312	11,165,875	29,483	453,024	21,670,565

Amounts have been adjusted to exclude collateral in excess of claim value, i.e. overcollateralisation. Other collateral includes financial claims, inventories, receivables and letters of credit and guarantees.

c. Derivatives

	Deposits	Fixed income securities	Variable income securities	Real estate	Other fixed assets	Other	31.12.2018
Financial institutions	596,407	233,346	1,329,991				2,159,744
Corporate customers	571,234	154,567	768,923				1,494,725
Individuals	34,028		103,944				137,972
Total	1,201,669	387,913	2,202,858	0	0	0	3,792,441

	Deposits	Fixed income securities	Variable income securities	Real estate	Other fixed assets	Other	31.12.2017
Financial institutions	182,198	188,761	1,283,782				1,654,741
Corporate customers	672,466	48,134	771,690				1,492,290
Individuals	31		63,024				63,054
Total	854,695	236,894	2,118,496	0	0	0	3,210,085

Amounts have been adjusted to exclude collateral in excess of claim value, i.e. overcollateralisation.

49. Loan-to-value

a. General

The loan-to-value ratio (LTV) is the ratio of the gross amount of the loan to the value of the collateral, if any. The general creditworthiness of a customer is viewed as the most reliable indicator of credit quality of a loan. Valuation of collateral held against loans is therefore not updated unless the creditworthiness of a borrower deteriorates.

b. Breakdown

The breakdown of loans to customers by LTV is specified as follows:

	31.12.2018	%	31.12.2017	%
Less than 50%	10,041,505	34.1%	11,880,633	46.9%
51-70%	6,286,414	21.4%	4,149,003	16.4%
71-90%	4,542,377	15.4%	3,013,046	11.9%
91-100%	525,403	1.8%	509,725	2.0%
More than 100%	3,216,506	10.9%	3,890,730	15.4%
No collateral:				
Purchased short-term retail claims	3,511,938	11.9%	1,385,120	5.5%
Other loans with no collateral	1,319,429	4.5%	509,992	2.0%
Total	29,443,573	100.0%	25,338,250	100.0%

The Group has entered into an agreement to purchase short term consumer credit (the claims) from an originator. The purchase of claims are subject to conditions such as credit rating of the borrower and maximum maturity of 24 months. Further, the originator receives final payment of the purchased claim when the claim is fully repaid, until then a part of the purchase price is held as collateral against defaults.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

50. Large exposures

In accordance with the Financial Supervisory Authority's regulation no. 625/2013 on financial institutions' large exposures, total exposure towards a customer is classified as a large exposure if it exceeds 10% of the Bank's capital base (see note 42).

According to the regulation a single exposure, net of risk adjusted mitigation, cannot exceed 25% of the capital base. Single large exposures net of risk adjusted mitigation take into account the effects of collateral held by the Bank, and other credit enhancements, in accordance with the Financial Supervisory Authority's regulation no. 625/2013.

		31.12.2018		31.12.2017
Large exposures before risk adjusted mitigation	**Number**	**Amount**	**Number**	**Amount**
10-20% of capital base	5	6,740,154	9	9,531,399
20-25% of capital base	1	2,359,382	0	0
Exceeding 25% of capital base	1	3,472,741	2	7,126,328
Total	7	12,572,277	11	16,657,727
Thereof nostro accounts with foreign banks with S&P rating of A- or higher	1	2,359,382	2	4,521,688
Large exposures net of risk adjusted mitigation	1	2,359,382	2	2,275,732

No single large exposure net of risk adjusted mitigation exceeds 25% of capital base in accordance with the Financial Supervisory Authority's regulation no. 625/2013.

51. Liquidity risk

a. Definition

Liquidity risk is the risk that the Group will encounter difficulty in meeting contractual payment obligations associated with its financial liabilities that are settled by delivering cash or another financial asset. This risk mainly arises from mismatches in the timing of cash flows. The Group has internal rules that require certain matching of the maturities of assets and liabilities. Furthermore, to ensure the ability to meet liquidity needs, the Group maintains a stock of highly liquid unencumbered assets, e.g. cash, treasury bills and treasury bonds.

b. Management

Liquidity is managed by treasury and monitored by risk management. Liquidity position is reported to the ALCO committee. The Central Bank of Iceland sets minimum requirements for the coverage ratio between cash flows of assets and liabilities (LCR) and stable funding in foreign currencies (NSFR). The minimum 30 day LCR was 100% in 2017 as well as in 2018. (100% for non-ISK assets). The minimum NSFR in foreign currencies was 100% in 2017 as well as in 2018.

The Group was in compliance with internal and external liquidity requirements throughout the years 2018 and 2017. At end of December 2018 the LCR was 277% and at year-end 2017 it was 215%.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

51. Liquidity risk (cont.)

c. Maturity analysis of financial assets and financial liabilities

31.12.2018 Financial assets by type	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Gross inflow/ (outflow)**	**Carrying amount**
Non-derivative assets							
Cash and balances with Central Bank	21,339,185					21,339,185	21,339,185
Fixed income securities	4,936,503	54,595	133,230			5,124,328	5,127,335
Shares and other variable income securities	989,332		1,937,344			2,926,675	2,926,675
Securities used for hedging	21,526,794					21,526,794	21,526,794
Loans to customers	3,665,736	6,002,954	14,048,774	7,601,019	508,769	31,827,251	29,443,573
Other assets	592,443	592,986	353,118	402,522		1,941,070	1,941,070
	53,049,993	6,650,536	16,472,465	8,003,541	508,769	84,685,303	82,304,631
Derivative assets							
Inflow	9,646,806	86,784	47,909	155,880		9,937,378	
Outflow	(8,681,151)	(85,812)	(1,533)	(5,571)		(8,774,068)	
	965,654	972	46,376	150,309	0	1,163,311	1,213,266

Financial liabilities by type	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Gross inflow/ (outflow)**	**Carrying amount**
Non-derivative liabilities							
Deposits from customers	(32,904,108)	(11,450,562)	(2,066,844)	(1,912,032)	(83,029)	(48,416,575)	47,893,959
Borrowings	(1,427,044)	(8,447,186)	(5,668,787)			(15,543,017)	15,634,648
Issued bills		(1,800,000)	(1,840,000)			(3,640,000)	3,577,718
Issued bonds	(16,226)	(24,923)	(499,311)	(3,137,596)		(3,678,055)	3,160,215
Subordinated liabilities			(120,119)	(360,527)	(2,431,190)	(2,911,837)	1,947,511
Short positions held for trading	(805,334)					(805,334)	805,334
Other liabilities	(322,295)	(762,318)	(470,901)	(54,809)		(1,610,323)	1,610,323
	(35,475,008)	(22,484,990)	(10,665,961)	(5,464,964)	(2,514,219)	(76,605,142)	74,629,708
Derivative liabilities							
Inflow	12,213,045	510,776	399,690			13,123,511	
Outflow	(12,728,897)	(525,531)	(420,750)			(13,675,178)	
	(515,852)	(14,755)	(21,060)	0	0	(551,667)	593,934
Unrecognised financial items							
Loan commitments							
Inflow	505,137	1,014,347	1,417,147	601,431		3,538,062	
Outflow	(3,462,935)					(3,462,935)	
Financial guarantee contracts							
Inflow	923,074					923,074	
Outflow	(923,074)					(923,074)	
	(2,957,798)	1,014,347	1,417,147	601,431	0	75,127	
Summary							
Non-derivative assets	53,049,993	6,650,536	16,472,465	8,003,541	508,769	84,685,303	
Derivative assets	965,654	972	46,376	150,309		1,163,311	
Non-derivative liabilities	(35,475,008)	(22,484,990)	(10,665,961)	(5,464,964)	(2,514,219)	(76,605,142)	
Derivative liabilities	(515,852)	(14,755)	(21,060)			(551,667)	
Net assets (liabilities) excluding unrecognised items	18,024,787	(15,848,237)	5,831,820	2,688,886	(2,005,450)	8,691,805	
Net unrecognised items	(2,957,798)	1,014,347	1,417,147	601,431		75,127	
Net assets (liabilities)	15,066,989	(14,833,890)	7,248,967	3,290,317	(2,005,450)	8,766,933	

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

51. Liquidity risk (cont.)

31.12.2017 **Financial assets by type**	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Gross inflow/ (outflow)**	**Carrying amount**
Non-derivative assets							
Cash and balances with Central Bank	20,493,739					20,493,739	20,493,739
Fixed income securities	5,406,714	201,855			80,858	5,689,427	5,598,409
Shares and other variable income securities	2,131,471		1,208,706			3,340,177	2,837,375
Securities used for hedging	14,024,316					14,024,316	14,026,433
Loans to customers	4,063,760	2,748,727	12,829,736	6,069,743	648,233	26,360,200	25,338,250
Other assets	640,310	609,507	227,096	321,000		1,797,913	1,797,913
	46,760,310	3,560,089	14,265,538	6,390,743	729,092	71,705,772	70,092,119
Derivative assets							
Inflow	9,947,067		375,150	96,957		10,419,174	
Outflow	(9,052,929)		(375,990)	(3,988)		(9,432,907)	
	894,138	0	(840)	92,969	0	986,267	1,052,652

Financial liabilities by type	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Gross inflow/ (outflow)**	**Carrying amount**
Non-derivative liabilities							
Deposits from customers	(33,377,234)	(4,140,390)	(3,049,209)	(1,253,664)	(84,226)	(41,904,723)	41,749,497
Borrowings	(648,116)	(3,675,998)	(9,487,237)	(446)	(75,926)	(13,887,723)	13,731,375
Issued bills		(2,000,000)	(2,000,000)			(4,000,000)	3,934,757
Issued bonds	(7,992)	(15,452)	(70,203)	(748,361)		(842,007)	1,401,879
Subordinated liabilities			(57,457)	(171,101)	(1,267,459)	(1,496,017)	1,058,741
Short positions held for trading	(370,163)					(370,163)	370,163
Other liabilities	(636,290)	(756,258)	(493,383)	(50,761)		(1,936,693)	1,936,693
	(35,039,794)	(10,588,098)	(15,157,490)	(2,224,332)	(1,427,611)	(64,437,326)	64,183,104
Derivative liabilities							
Inflow	4,595,729	315,474				4,911,204	
Outflow	(4,874,413)	(350,460)				(5,224,873)	
	(278,684)	(34,986)	0	0	0	(313,670)	364,692
Unrecognised financial items by type							
Loan commitments							
Inflow	695,435	445,258	1,168,098	563,953		2,872,743	
Outflow	(2,809,577)					(2,809,577)	
Financial guarantee contracts							
Inflow	434,237					434,237	
Outflow	(434,237)					(434,237)	
	(2,114,143)	445,258	1,168,098	563,953	0	63,165	
Summary							
Non-derivative assets	46,760,310	3,560,089	14,265,538	6,390,743	729,092	71,705,772	
Derivative assets	894,138		(840)	92,969		986,267	
Non-derivative liabilities	(35,039,794)	(10,588,098)	(15,157,490)	(2,224,332)	(1,427,611)	(64,437,326)	
Derivative liabilities	(278,684)	(34,986)				(313,670)	
Net assets (liabilities) excluding unrecognised items	12,335,970	(7,062,995)	(892,792)	4,259,380	(698,519)	7,941,044	
Net unrecognised items	(2,114,143)	445,258	1,168,098	563,953		63,165	
Net assets (liabilities)	10,221,827	(6,617,737)	275,306	4,823,333	(698,519)	8,004,209	

Maturity analysis of financial assets and financial liabilities is based on contractual cash flows or, in the case of held for trading securities, expected cash flows. If an amount receivable or payable is not fixed, e.g. for inflation indexed assets and liabilities, the maturity analysis uses estimates based on current conditions.

Cash flows relating to unrecognised balance sheet items (unused loan commitments and financial guarantee contracts) are presented separately from financial assets and financial liabilities. Both contractual outflows and inflows are shown, to fully reflect the nature of these items.

It should be noted that the Group's expected cash flows sometimes vary considerably from the contractual cash flows, most significantly in that demand deposits from customers are expected to remain stable or increase in the long term. In this case the presentation used reflects the worst case scenario from the Group's perspective. Furthermore, the analysis does not consider any measures that could be taken to convert long-term assets to cash through sale.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

52. Market risk

a. Definition

Market risk constitutes risk due to changes in the market prices of financial instruments and comprises interest rate risk, currency risk and other price risk. Notes 53-58 relate to market risk exposure.

b. Management

The Group has a strict policy on controlling market risk and to keep the exposure within set limits. The risk management unit monitors market risk limits on a daily basis and reports regularly to the ALCO committee and to the CEO.

53. Interest rate risk

a. Definition

The Group's exposure to interest rate risk is twofold. On the one hand, the Group has a proprietary portfolio of bonds, where market rates affect prices and any fluctuations are recognised in the income statement. On the other hand, the Group has mismatch in assets and liabilities with fixed interest terms. These include loans and swap contracts for securities on the asset side and borrowings and deposits on the liability side. This mismatch does not create an immediate effect on the income statement but nevertheless affects the Group's economic value.

Proprietary positions which are subject to interest rate risk fall under the scope of the Group's market risk management.

b. Management

The Group takes measures to minimise interest rate risk by matching the interest rate profile and duration of assets with the Group's liabilities as well as using derivative and non-derivative financial instruments to manage effectively the risk of an adverse impact on the Group's earnings.

54. Interest rate risk associated with trading portfolios

a. Breakdown

The breakdown of financial assets and liabilities in trading portfolios by the earlier of interest repricing time or maturity is specified as follows:

	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	31.12.2018
Fixed income securities		17,913	999,491	1,561,987	2,547,944	5,127,335
Short positions - fixed income securities				(755,454)	(49,880)	(805,334)
Net imbalance	0	17,913	999,491	806,534	2,498,063	4,322,001

	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	31.12.2017
Fixed income securities	499,064			2,066,324	3,033,020	5,598,409
Short positions - fixed income securities					(370,163)	(370,163)
Net imbalance	499,064	0	0	2,066,324	2,662,857	5,228,246

b. Sensitivity analysis

The Group performs monthly sensitivity analysis on financial assets and liabilities in trading portfolios that are subject to interest rate risk. The sensitivity analysis assumes a shift in the yield curves for all currencies. A parallel shift in yield curves would have the following impact on the Group's pre-tax profit and equity, assuming all other risk factors remain constant:

	Shift in basis points		31.12.2018		31.12.2017
		Downward	Upward	Downward	Upward
Indexed	50	70,216	(70,216)	50,527	(50,527)
Non-indexed	100	69,481	(69,481)	144,730	(144,730)
Total		139,697	(139,697)	195,257	(195,257)

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

55. Interest rate risk associated with non-trading portfolios

a. Breakdown

The breakdown of financial assets and liabilities in non-trading portfolios by the earlier of interest repricing time or maturity is specified as follows:

31.12.2018

Financial assets	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Total**
Cash and balances with Central Bank	17,867,444	3,471,741				21,339,185
Loans to customers	23,872,709	1,432,779	2,821,790	1,158,425	157,870	29,443,573
Financial assets excluding derivatives	41,740,153	4,904,520	2,821,790	1,158,425	157,870	50,782,758
Effect of derivatives	22,590,158	597,560	1,500,000	3,100,000		27,787,718
Total	64,330,311	5,502,080	4,321,790	4,258,425	157,870	78,570,476

Financial liabilities	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Total**
Deposits from customers	47,893,959					47,893,959
Borrowings	1,437,087	8,610,188	5,587,373			15,634,648
Issued bills		1,779,152	1,798,565			3,577,718
Issued bonds	266,454		399,725	2,494,035		3,160,215
Subordinated liabilities					1,947,511	1,947,511
Financial liabilities excluding derivatives	49,597,500	10,389,341	7,785,664	2,494,035	1,947,511	72,214,051
Effect of derivatives	4,607,104					4,607,104
Total	54,204,604	10,389,341	7,785,664	2,494,035	1,947,511	76,821,155
Total interest repricing gap	10,125,707	(4,887,261)	(3,463,874)	1,764,389	(1,789,641)	1,749,321

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

55. Interest rate risk associated with non-trading portfolios (cont.)

31.12.2017

Financial assets	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Total**
Cash and balances with Central Bank	16,704,260	3,789,480				20,493,739
Loans to customers	22,759,578	1,780,949	531,258	211,702	54,762	25,338,250
Financial assets excluding derivatives	39,463,838	5,570,429	531,258	211,702	54,762	45,831,989
Effect of derivatives	13,675,973	350,460		3,500,000		17,526,433
Total	53,139,811	5,920,889	531,258	3,711,702	54,762	63,358,423

Financial liabilities	**Up to 1 month**	**1-3 months**	**3-12 months**	**1-5 years**	**Over 5 years**	**Total**
Deposits from customers	41,734,119		15,378			41,749,497
Borrowings	748,130	3,647,174	9,215,587	44,557	75,926	13,731,375
Issued bills		1,979,218	1,955,539			3,934,757
Issued bonds			99,250	1,302,629		1,401,879
Subordinated liabilities					1,058,741	1,058,741
Financial liabilities excluding derivatives	42,482,249	5,626,392	11,285,753	1,347,186	1,134,667	61,876,248
Effect of derivatives	3,901,598					3,901,598
Total	46,383,847	5,626,392	11,285,753	1,347,186	1,134,667	65,777,847
Total interest repricing gap	6,755,964	294,496	(10,754,495)	2,364,516	(1,079,905)	(2,419,424)

b. Sensitivity analysis

The Group performs monthly sensitivity analysis on financial assets and liabilities in non-trading portfolios subject to interest rate risk. The sensitivity analysis assumes a shift in the yield curves for all currencies. A parallel shift in yield curves would have the following impact on the Group's pre-tax profit and equity, assuming all other risk factors remain constant:

	Shift in		**31.12.2018**		**31.12.2017**
Currency	**basis points**	**Downward**	**Upward**	**Downward**	**Upward**
ISK, indexed	50	11,837	(11,614)	(30,256)	30,256
ISK, non-indexed	100	(42,882)	41,861	90,343	(90,343)
Other currencies	20	(2,228)	1,157	22	(22)
Total		(33,273)	31,404	60,109	(60,109)

Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

56. Exposure towards changes in the CPI

a. Definition

Exposure towards changes in CPI is the risk that fluctuations in the Icelandic Consumer Price Index (CPI) will affect the balance and cash flow of indexed financial instruments.

The Group is exposed to Icelandic inflation since CPI indexed assets exceed CPI indexed liabilities. All indexed assets and liabilities are valued according to the CPI measure at any given time and changes in CPI are recognised in the income statement as interest.

b. Management

The Group controls its indexation risk through derivatives contracts and sales and purchases of indexed bonds, mostly government bonds, and thus keeps its exposure to the CPI within the limits set by the ALCO committee.

c. Balance of CPI linked assets and liabilities

The net balance of CPI linked assets and liabilities is specified as follows:

	31.12.2018	**31.12.2017**
Assets	9,251,171	7,180,237
Liabilities	(7,578,412)	(5,927,047)
Total	1,672,759	1,253,191

d. Sensitivity to changes in CPI

Given the net balance of CPI linked assets and liabilities, a 1% change in the CPI would, with other things constant, result in the following changes to the Group's pre-tax profit.

		31.12.2018		**31.12.2017**
	-1%	1%	-1%	1%
Government bonds	(5,047)	5,047	(2,295)	2,295
Other fixed income securities	(20,008)	20,008	(20,049)	20,049
Loans to customers	(31,457)	31,457	(24,459)	24,459
Derivatives	(36,000)	36,000	(25,000)	25,000
Short positions	9,068	(9,068)	2,784	(2,784)
Deposits	48,716	(48,716)	46,487	(46,487)
Subordinated debt	18,000	(18,000)	10,000	(10,000)
	(16,728)	16,728	(12,532)	12,532

The effect on equity would be the same.

57. Currency risk

a. Definition

Currency risk arises when financial instruments are not denominated in the functional currency of the respective Group entity and can affect both the Group's income statement and statement of financial position. A part of the Group's financial assets and liabilities is denominated in foreign currencies.

b. Management

Currency positions are monitored by risk management and reported to the ALCO committee. Any mismatch between assets and liabilities in each currency is monitored closely and managed within limits.

The Group is subject to limits set by the Central Bank of Iceland regarding the maximum open currency position. At 31 December 2018 and 31 December 2017 the Group's position in foreign currencies was within those limits.

c. Exchange rates

The following exchange rates have been used by the Group in the preparation of these financial statements:

	Closing 31.12.2018	**Average 2018**	**Closing 31.12.2017**	**Average 2017**
EUR/ISK	133.2	127.7	125.1	120.5
USD/ISK	116.3	108.4	104.4	106.8

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

57. Currency risk (cont.)

d. Breakdown of financial assets and financial liabilities denominated in foreign currencies

31.12.2018

Financial assets	**EUR**	**USD**	**GBP**	**NOK**	**Other currencies**	**Total**
Cash and balances with Central Bank	2,976,108	6,152,291	200,764	93,690	847,261	10,270,114
Fixed income securities	133,230					133,230
Shares and other variable income securities	6	18	385,394		31	385,449
Loans to customers	1,452,927	110,112	140,375		158,935	1,862,349
Other assets	330,613	143,642	337,106			811,361
Financial assets excluding derivatives	4,892,884	6,406,062	1,063,639	93,690	1,006,227	13,462,503
Derivatives	417,793	32,155	17,884			467,832
Total	5,310,678	6,438,217	1,081,523	93,690	1,006,227	13,930,335

Financial liabilities	**EUR**	**USD**	**GBP**	**NOK**	**Other currencies**	**Total**
Deposits from customers	5,112,003	5,736,753	1,062,588	109,446	894,284	12,915,074
Borrowings	39,407	278,201				317,608
Other liabilities	2,160	290,825	4,925		1,407	299,317
Financial liabilities excluding derivatives	5,153,569	6,305,779	1,067,513	109,446	895,691	13,531,999
Derivatives	18,103	32,155				50,258
Total	5,171,673	6,337,934	1,067,513	109,446	895,691	13,582,258

Net currency position	**EUR**	**USD**	**GBP**	**NOK**	**Other currencies**	**Total**
Financial assets	5,310,678	6,438,217	1,081,523	93,690	1,006,227	13,930,335
Financial liabilities	(5,171,673)	(6,337,934)	(1,067,513)	(109,446)	(895,691)	(13,582,258)
Financial guarantee contracts	7,934					7,934
Total	146,940	100,283	14,009	(15,756)	110,536	356,012

31.12.2017

Financial assets	**EUR**	**USD**	**GBP**	**NOK**	**Other currencies**	**Total**
Cash and balances with Central Bank	1,490,412	7,222,010	755,602	154,130	1,023,763	10,645,918
Shares and other variable income securities	6	17	15,806		28	15,857
Loans to customers	2,401,215	167,266			171,349	2,739,830
Other assets	301,083	108,898	20,413	269	23,638	454,301
Financial assets excluding derivatives	4,192,716	7,498,192	791,821	154,400	1,218,779	13,855,907
Derivatives	375,150	209,183				584,333
Total	4,567,866	7,707,375	791,821	154,400	1,218,779	14,440,240

Financial liabilities	**EUR**	**USD**	**GBP**	**NOK**	**Other currencies**	**Total**
Deposits from customers	3,390,665	7,694,264	737,308	117,500	861,476	12,801,213
Borrowings	37,737					37,737
Other liabilities	138,333	27,019	121,113	38,420	101,885	426,770
Financial liabilities excluding derivatives	3,566,735	7,721,283	858,421	155,920	963,361	13,265,720
Derivatives	500,200	60,290			152,544	713,034
Total	4,066,935	7,781,573	858,421	155,920	1,115,905	13,978,754

Net currency position	**EUR**	**USD**	**GBP**	**NOK**	**Other currencies**	**Total**
Financial assets	4,567,866	7,707,375	791,821	154,400	1,218,779	14,440,240
Financial liabilities	(4,066,935)	(7,781,573)	(858,421)	(155,920)	(1,115,905)	(13,978,754)
Financial guarantee contracts	28,053	26,105				54,158
Total	528,984	(48,093)	(66,600)	(1,520)	102,874	515,644

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

57. Currency risk (cont.)

e. Sensitivity to currency risk

Given the net currency position, a 10% change in the value of the ISK would, with other things constant, result in the following changes to the Group's pre-tax profit.

	31.12.2018		31.12.2017	
Assets and liabilities denominated in foreign currencies	**-10%**	**+10%**	**-10%**	**+10%**
EUR	14,694	(14,694)	52,898	(52,898)
USD	10,028	(10,028)	(4,809)	4,809
GBP	1,401	(1,401)	(6,660)	6,660
NOK	(1,576)	1,576	(152)	152
Other currencies	11,054	(11,054)	10,287	(10,287)
Total	35,601	(35,601)	51,564	(51,564)

The effect on equity would be the same.

58. Other price risk

Other price risk arises from changes in the market prices of shares and other variable income securities in the Group's portfolio. The Group directly holds listed and unlisted shares and other variable income securities, while also gaining exposure to listed shares through portfolio options trading. The table below shows the Group's net exposure, including delta-adjusted options exposure.

			31.12.2018			31.12.2017
	Average	**Max**	**Exposure**	**Average**	**Max**	**Exposure**
Listed shares	840,266	1,306,331	751,470	1,114,793	2,306,393	1,266,507
Unlisted shares	971,302	1,432,666	1,391,018	467,468	955,408	690,951
Unlisted unit shares	1,018,325	1,978,813	784,187	1,017,295	1,710,146	879,916
Total			2,926,675			2,837,375

59. Operational risk

a. Definition

Operational risk is the risk of financial losses resulting from the failure or inadequacy of internal processes or systems, from employee error or from external events. Operational risk includes legal risk, but excludes reputational risks. It is therefore inherent in all areas of business activities.

b. Management

Operational risk can be reduced through staff training, process re-design and enhancement of the control environment. The risk management unit monitors operational risk by tracking loss events, quality deficiencies, potential risk indicators and other early-warning signals. The unit takes an active role in internal control and quality management.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

Financial assets and financial liabilities

60. Accounting classification of financial assets and financial liabilities

The accounting classification of financial assets and financial liabilities under IFRS 9 is specified as follows:

31.12.2018 **Financial assets**	**Amortised cost**	**Manda-torily at fair value through P/L**	**Total carrying amount**
Cash and balances with Central Bank	21,339,185		21,339,185
Fixed income securities		5,127,335	5,127,335
Shares and other variable income securities		2,926,675	2,926,675
Securities used for hedging		21,526,794	21,526,794
Loans to customers	27,283,050	2,160,522	29,443,573
Derivatives		1,213,266	1,213,266
Other assets	1,941,070		1,941,070
Total	50,563,305	32,954,592	83,517,897

Financial liabilities	**Amortised cost**	**Manda-torily at fair value through P/L**	**Total carrying amount**
Deposits from customers	47,893,959		47,893,959
Borrowings	15,634,648		15,634,648
Issued bills	3,577,718		3,577,718
Issued bonds	3,160,215		3,160,215
Subordinated liabilities	1,947,511		1,947,511
Short positions held for trading		805,334	805,334
Derivatives		593,934	593,934
Other liabilities	1,610,323		1,610,323
Total	73,824,374	1,399,268	75,223,642

31.12.2017*

Financial assets	**Held for trading**	**Designated at fair value**	**Loans and receivables**	**Other at amortised cost**	**Total carrying amount**
Cash and balances with Central Bank			20,493,739		20,493,739
Fixed income securities	5,598,409				5,598,409
Shares and other variable income securities	2,833,752	3,623			2,837,375
Securities used for hedging	14,026,433				14,026,433
Loans to customers			25,338,250		25,338,250
Derivatives	1,052,652				1,052,652
Other assets			1,797,913		1,797,913
Total	23,511,246	3,623	47,629,902	0	71,144,771

Financial liabilities	**Held for trading**	**Designated at fair value**	**Loans and receivables**	**Other at amortised cost**	**Total carrying amount**
Deposits from customers				41,749,497	41,749,497
Borrowings				13,731,375	13,731,375
Issued bills				3,934,757	3,934,757
Issued bonds				1,401,879	1,401,879
Subordinated liabilities				1,058,741	1,058,741
Short positions held for trading	370,163				370,163
Derivatives	364,692				364,692
Other liabilities				1,936,693	1,936,693
Total	734,855	0	0	63,812,941	64,547,796

* Comparative figures have not been restated in accordance with IFRS 9.

Notes to the Consolidated Financial Statements

61. Financial assets and financial liabilities measured at fair value

a. Fair value hierarchy

The fair value of financial assets and liabilities that are traded in active markets are based on quoted market prices. For other financial instruments the Bank determines fair value using various valuation techniques. IFRS 13 specifies a fair value hierarchy based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources whereas unobservable inputs reflect the Bank's market assumptions. These two types of inputs result in the following fair value hierarchy:

- Level 1

  Inputs are quoted market prices (unadjusted) in active markets for identical instruments.

- Level 2

  Inputs are not quoted market prices but are observable either directly, i.e. as prices, or indirectly, i.e. derived from prices. This category includes financial instruments valued using quoted prices in active markets for similar instruments, quoted prices for similar or identical instruments in markets that are considered less than active and other instruments which are valued using techniques which rely primarily on inputs that are directly or indirectly observable from market data.

- Level 3

  Inputs are not observable or unobservable inputs have a significant effect on the valuation. This category includes instruments that are valued based on quoted prices for similar instruments for which significant unobservable adjustments are required to reflect the differences between the instruments.

b. Valuation process

The Bank's ALCO committee is responsible for fair value measurements of financial assets and financial liabilities classified as level 2 or level 3 instruments. The valuation is carried out by personnel from Risk and Treasury and is revised at least quarterly, or when there are indications of significant changes in the underlying inputs.

c. Valuation techniques

The Group uses widely recognised valuation techniques, including net present value and discounted cash flow models, comparison with similar instruments for which market observable prices exist, Black-Scholes and other valuation models.

Valuation techniques include recent arm's length transactions between knowledgeable, willing parties, if available, reference to the current fair value of other instruments that are substantially the same, the discounted cash flow analysis and option pricing models. Valuation techniques incorporate all factors that market participants would consider in setting a price and are consistent with accepted methodologies for pricing financial instruments. Periodically, the Group calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument, without modification or repackaging, or based on any available observable market data.

For more complex instruments, the Group uses proprietary models, which usually are developed from recognised valuation models. Some or all of the inputs into these models may not be market observable, and are derived from market prices or rates or are estimated based on assumptions. When entering into a transaction, the financial instrument is recognised initially at the transaction price, which is the best indicator of fair value, although the value obtained from the valuation model may differ from the transaction price. This initial difference, usually an increase in fair value, indicated by valuation techniques is recognised in income depending upon the individual facts and circumstances of each transaction and no later than when the market data becomes observable.

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

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

61. Financial assets and financial liabilities measured at fair value (cont.)

d. Fair value hierarchy classification

The fair value of financial assets and financial liabilities measured at fair value in the statement of financial position is classified into the fair value hierarchy as follows:

31.12.2018

Financial assets	**Level 1**	**Level 2**	**Level 3**	**Carrying amount**
Mandatorily measured at fair value through profit and loss				
Fixed income securities	4,992,391		134,944	5,127,335
Shares and other variable income securities	1,686,097	376,399	864,180	2,926,675
Securities used for hedging	21,476,591	50,203		21,526,794
Loans to customers			2,160,522	2,160,522
Derivatives		1,213,266		1,213,266
Total	28,155,079	1,639,867	3,159,646	32,954,592

Financial liabilities	**Level 1**	**Level 2**	**Level 3**	**Carrying amount**
Mandatorily measured at fair value through profit and loss				
Short positions held for trading	805,334			805,334
Derivatives		593,934		593,934
Total	805,334	593,934	0	1,399,268

There were no transfers between levels during the year.

31.12.2017

Financial assets	**Level 1**	**Level 2**	**Level 3**	**Carrying amount**
Held for trading				
Fixed income securities	5,296,556	301,852		5,598,409
Shares and other variable income securities	1,718,159	587,810	527,782	2,833,752
Securities used for hedging	14,003,674	22,760		14,026,433
Derivatives		1,052,652	0	1,052,652
Designated at fair value				
Shares and other variable income securities			3,623	3,623
Total	21,018,390	1,965,074	531,405	23,514,869

Financial liabilities	**Level 1**	**Level 2**	**Level 3**	**Carrying amount**
Held for trading				
Short positions held for trading	370,163			370,163
Derivatives		364,692		364,692
Total	370,163	364,692	0	734,855

There were no transfers between levels during the year.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

61. Financial assets and financial liabilities measured at fair value (cont.)

e. Reconciliation of changes in Level 3 fair value measurements

31.12.2018	**Fixed income securities**	**Shares and other var. income securities**	**Loans to customers**	**Derivatives**	**Total**
Balance as at 1 January 2018	0	531,405	0	0	531,405
Reclassification into Level 3 in accordance with IFRS 9			2,081,352		2,081,352
Total gains and losses in profit or loss	11,059	(17,865)	237,973		231,167
Purchases	127,400	521,140	596,618		1,245,158
Repayments	(3,515)		(755,420)		(758,936)
Capital decrease		(16,638)			(16,638)
Sales		(153,863)			(153,863)
Balance as at 31 December 2018	134,944	864,180	2,160,522	0	3,159,646

31.12.2017	**Fixed income securities**	**Shares and other var. income securities**	**Loans to customers**	**Derivatives**	**Total**
Balance as at 1 January 2017	0	571,924	0	75,294	647,218
Total gains and losses in profit or loss		32,479		(139,751)	(107,272)
Additions through business combinations		670			670
Purchases		587,238		64,457	651,695
Repayments		77,691			77,691
Capital decrease		(6,311)			(6,311)
Sales		(732,286)			(732,286)
Balance as at 31 December 2017	0	531,405	0	0	531,405

f. Change in unrealised gains or losses related to Level 3 financial assets held at year-end

Net financial income - 2018	**Shares and other var. income securities**
Financial assets mandatorily measured at fair value through profit or loss	(17,865)
Total	(17,865)
Net financial income - 2017	
Financial assets designated at fair value through profit or loss	32,479
Total	32,479

g. Fair value measurements for Level 3 financial assets

Level 3 assets consist primarily of illiquid, unlisted bonds, shares and share certificates and loans measured at fair value. Each asset is evaluated separately but assets within an asset group share a valuation method. The following valuation methods are in use in 2018:

Asset class	**Method**	**Significant unobservable input**	**Range**	**Book value 31.12.2018**
Unlisted bonds	Expected recovery	Value of assets	90-100%	134,944
Unlisted shares	Market price	Recent trades	-	864,180
Loans to customers	Expert model	Value of assets and collateral	-	2,160,522
Total				3,159,646

Asset class	**Method**	**Significant unobservable input**	**Range**	**Book value 31.12.2017**
Unlisted shares	P/B multiplier	Equity	1.0-1.5	531,405
Total				531,405

Given the methods used, the possible range of the significant unobservable inputs is wide. When determining the values used the Group considers the financial strength of the entity in question, recent trades if any and multipliers for comparable instruments.

h. The effect of unobservable inputs in Level 3 fair value measurements

The Group believes its estimates represent appropriate approximations of fair value and that the use of different valuation methodologies and reasonable changes in assumptions or unobservable inputs would not significantly change the estimates.

A 10% change in the estimates would have the following effect on profit before taxes:

	+10%	**-10%**
Shares and other variable income securities	86,418	(86,418)
Total	86,418	(86,418)

Notes to the Consolidated Financial Statements

62. Financial assets and financial liabilities not measured at fair value

The Group holds financial instruments which are not measured at fair value. Except for loans to customers, the Group believes that the best estimate of the fair value of these financial instruments is equal to the carrying amount at the reporting date and does therefore not report a fair value for these financial instruments. Loans to customers measured at amortised cost are classified as level 3, in the fair value hierarchy, and have a book value of ISK 27,283 million at end of December 2018. The estimated fair value of loans to customers measured at amortised cost at end of December 2018 is ISK 27,265 million.

Cash and balances with Central Bank includes several components as detailed in note 19. These assets are either balances available on-demand or on very short notice, or other assets easily converted to cash. Other financial assets consist primarily of short-term receivables. The carrying amount of these assets is therefore a reasonable approximation of their fair value.

Deposits and other borrowings are typically either short-term or have variable interest rates. Other liabilities consist primarily of accounts payables, withholding taxes and other short-term payables. The carrying amount of these liabilities is therefore considered a reasonable approximation of their fair value.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

Segment information

63. Business segments

Segment reporting is based on the same principles and structure as internal reporting to senior management and the Board of Directors. Segment performance is evaluated on profit before cost allocation and tax.

Reportable segments
The Group defines five reportable segments which reflect the reporting structure of the Bank.

- Corporate Banking
  Corporate Banking offers various forms of banking services and related advisory services, in addition to providing specialised lending services.
- Corporate Finance
  Corporate Finance provides its customers with impartial and independent advice concerning purchases, sales and mergers and acquisitions of companies.
- Capital Markets
  Capital Markets offers securities and foreign currency brokerage, derivatives brokerage and forward contracts to clients, which include institutional investors, corporates and high net worth individuals.
- Proprietary Trading and Treasury
  Proprietary Trading and Treasury provide market making services to its clients as well as providing the Bank with treasury services.
- Asset Management
  Products and services offered include asset management involving both domestic and foreign assets, private banking, and private pension plans.

Information about other divisions of the Bank, e.g. non-revenue generating divisions, is presented under the heading Support functions and eliminations.

2018	Corporate Banking	Corporate Finance	Capital Markets	Proprietary trading and Treasury	Asset Management	Support functions and eliminations	Total
Net interest income	1,526,894	(4,010)	162,089	(15,676)	4,179	27,381	1,700,857
Net fee and commission income	622,501	579,018	671,971	73,711	1,919,013	(168,534)	3,697,680
Net financial income	224,551	212	1,365	285,490	10,278	(288)	521,609
Share in profit of associates	(301,863)	0	0	0	(1,086)	0	(302,949)
Other operating income (expense)	91,351	26	79	2,039	30,130	(36,319)	87,305
Net operating income	2,163,434	575,246	835,503	345,564	1,962,514	(177,759)	5,704,502
Salaries and related expenses	(219,882)	(291,232)	(334,743)	(167,892)	(726,716)	(997,198)	(2,737,663)
Other operating expenses	(329,799)	(57,109)	(78,178)	(42,358)	(271,844)	(491,676)	(1,270,964)
Net impairment	19,303	(17,562)	(504)	0	(532)	(16,100)	(15,395)
Revaluation on investment properties	114,582						114,582
Profit (loss) before cost allocation and tax	1,747,637	209,343	422,078	135,314	963,423	(1,682,733)	1,795,062
Net segment revenue from external customers	1,662,509	545,246	1,808,166	(75,420)	1,936,760	(172,759)	5,704,502
Net segment revenue from other segments	500,924	30,000	(972,663)	420,984	25,754	(5,000)	(0)

2017	Corporate Banking	Corporate Finance	Capital Markets	Proprietary trading and Treasury	Asset Management	Support functions and eliminations	Total
Net interest income	1,410,974	(22)	151,067	(9,305)	10,623	(807)	1,562,530
Net fee and commission income	574,796	415,372	649,487	97,679	1,167,572	(92,760)	2,812,146
Net financial income	250,730	(3,712)	(13,351)	303,671	12,487	(2,590)	547,234
Share in loss of discontinued operations	8,403	0	0	0	0	0	8,403
Share in profit of associates	48,833	0	0	0	15,079	0	63,912
Other operating income (expense)	16,011	0	66	661	8,675	(10,408)	15,005
Net operating income	2,309,747	411,638	787,269	392,706	1,214,436	(106,565)	5,009,230
Salaries and related expenses	(189,552)	(197,610)	(308,837)	(163,675)	(577,107)	(959,446)	(2,396,227)
Other operating expenses	(346,162)	(81,869)	(80,582)	(39,974)	(209,051)	(515,822)	(1,273,460)
Net impairment	(14,228)	0	0	0	0	0	(14,228)
Revaluation on investment properties	92,258						92,258
Profit (loss) before cost allocation and tax	1,852,064	132,158	397,851	189,057	428,278	(1,581,834)	1,417,573
Net segment revenue from external customers	1,594,593	411,638	1,353,319	541,810	1,214,436	(106,565)	5,009,230
Net segment revenue from other segments	715,154	0	(566,050)	(149,105)	0	0	0

Internal reporting is based on the results of the Bank, which accounts for around 90% (2017: 91%) of the net operating income of the Group, and does not take into account the effects of consolidation. As a result, elimination entries are needed to reconcile internal reporting with consolidated results. Elimination entries arise primarily from interest calculated on internal balances, share in the results of subsidiaries and fees charged for services the parent provides to subsidiaries.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

Other information

64. Operating lease commitments

The Group leases under operating leases office premises for its operations. In some leases the rent is based on the Icelandic Consumer Price Index and changes accordingly. Future non-cancellable minimum operating lease payments are specified as follows:

	31.12.2018	31.12.2017
Up to 1 year	106,820	91,745
1-5 years	332,660	328,839
Later than 5 years	143,663	204,016
Total	583,144	624,600

65. Pledged assets

The Group has pledged assets, in the ordinary course of banking business, to the Central Bank of Iceland to the amount of ISK 2.7 billion as at 31 December 2018 (2017: ISK 2.7 billion) to secure settlement in the Icelandic clearing systems. Further pledges have been placed in the ordinary course of banking business for netting and set-off arrangements in the total amount of ISK 0.9 billion as at 31 December 2018 (2017: ISK 0.6 billion).

66. Related parties

a. Definition of related parties

The Group has a related party relationship with the board members of the Bank, the CEO of the Bank and key employees (together referred to as management), associates as disclosed in note 26, shareholders with significant influence over the Bank (defined as holding 10% or greater of the shares in the Bank as disclosed in note 70), close family members of individuals identified as related parties and entities under the control or joint control of related parties.

b. Arm's length

Transactions with related parties are carried out at arm's length and subject to an annual review by the Bank's internal auditor.

c. Effects on statement of financial position

31.12.2018	Loans & receivables	Deposits & payables
Shareholders	0	0
Management	79,231	212,291
Associates	7,450	3,004,717
Total	86,681	3,217,008

31.12.2017	Loans & receivables	Deposits & payables
Shareholders	0	50,427
Management	2,061	122,464
Associates	267,495	4,783,028
Total	269,556	4,955,918

d. Effects on income statement

2018	Interest income	Interest expense	Fees received	Fees paid
Shareholders	0	0	0	0
Management	6,770	3,608	3,070	10,603
Associates	9,842	103,908	43,527	0
Total	16,612	107,517	46,597	10,603

2017	Interest income	Interest expense	Fees received	Fees paid
Shareholders	0	2,334	3,151	0
Management	239	2,892	268	3,506
Associates	0	11,814	278,989	0
Total	239	17,041	282,408	3,506

Further information about salaries and benefits paid to the Board of Directors, the CEO and Managing Directors is provided in note 12.

67. Remuneration policy

The Board of Directors has adopted a remuneration policy at the proposal of the Remuneration Committee. The Bank's Annual General Meeting approved the Bank's current remuneration policy in March 2018. The Board of Directors will submit an updated remuneration policy to the Bank's Annual General Meeting for approval in March 2019.

The remuneration policy conforms to Article 57 of Act No. 161/2002 on Financial Undertakings, Act No. 2/1995 on Public Limited Companies and the Icelandic FSA's rules No. 388/2016 on Incentive Schemes. A more detailed description of the policy can be found on the Bank's website, www.kvika.is.

Notes to the Consolidated Financial Statements

68. Incentive scheme

The Board of Directors has approved a performance based incentive scheme at the proposal of the Remuneration Committee. The scheme forms a part of the remuneration policy adopted by the Bank.

a. Description

The incentive scheme conforms to the Icelandic FSA's directive No. 388/2016 on Incentive Schemes. Payments according to the scheme are based on key performance indicators (KPIs) that reflect the goals of the Bank, the division and the employee. The basis for performance based pay reflects sound risk management and does not induce excessive risk taking. Performance based pay to individual employees shall not exceed 25% of their annual base salary and 40% of the performance based pay shall be deferred for three years. Performance based pay that does not exceed 10% of annual base salary is not subject to deferral. A more detailed description of the scheme can be found in the Bank's remuneration policy on it's website, www.kvika.is.

b. Performance based payments through profit and loss

	2018 Cash	2017 Cash
Non-deferred	18,875	6,210
Deferred	10,950	4,140
Salary related expenses	9,281	3,033
Cancelled deferred performance based payments	(5,627)	0
Total	33,479	13,383

c. On-balance sheet deferred performance based payments

	31.12.2018	31.12.2017
Deferred cash payments	19,348	9,674
Deferred cash payments, acquired via merger	35,461	41,087
Total	54,809	50,761

69. Share-based payments

The remuneration policy approved by the Board of Directors of the Bank in 2017 included a share-based incentive scheme. The Board of Directors is authorised to increase the share capital of the Bank, in accordance with the Articles of Association, to fulfil any obligations arising from the scheme. The Board of Directors does however not intend to move forward with the scheme and updated the Bank's remuneration policy accordingly.

a. Description

In 2017 the Bank set up a new stock options plan. This plan was structured with the conditions set out in article 10 in law 90/2003 on income tax in mind. The average weighted exercise price is equal to 5.58 per share with a per annum increase of 5%. The options were issued to most employees, taking into consideration the conditions set out the Bank's remuneration policy, and the total nominal amount issued amounts to 8,543,799 shares. The options do not allow for cash settlement and vest evenly over 36 months following signing. The options are conditional on the employee remaining employed by the Bank and various other conditions which meet demands set by the Financial Supervisory Authority.

b. Movements in the number of stock options outstanding and their related weighted average exercise prices

The grant date fair value of the options granted through the scheme was as follows:

	Average exercise price per share	Stock options (thousands)
At 1 January 2017	0.00	16,251
Granted in 2017	5.58	8,544
Exercised	5.37	(16,251)
At 31 December 2017	0.00	8,544
Granted in 2018	0.00	0
Exercised	0.00	0
At 31 December 2018	0.00	8,544
Exercisable stock options at 31 December 2018	0.00	0

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

70. Shareholders of the Bank

Shareholder	Country	31.12.2018 %	31.12.2017 %	Beneficial owners
Lífeyrissjóður verzlunarmanna	Iceland	9.49%	8.96%	
RES II ehf.	Iceland	9.17%	9.32%	Sigurður Bollason (100%)
Vátryggingafélag Íslands hf.	Iceland	8.66%	23.57%	
K2B fjárfestingar ehf.	Iceland	7.70%	7.52%	Svanhildur Nanna Vigfúsdóttir (100%)
Arion banki hf.	Iceland	4.91%	-	
Íslandsbanki hf.	Iceland	4.26%	-	
Lífsverk lífeyrissjóður	Iceland	3.58%	2.19%	
Sindrandi ehf.	Iceland	2.48%	2.52%	Bogi Þór Siguroddsson (50%), Linda Björk Ólafsdóttir (50%)
Mízar ehf.	Iceland	2.09%	6.20%	Guðmundur Steinar Jónsson (100%)
Breiðahvarf ehf.	Iceland	1.90%	1.93%	Sigurður Sigurgeirsson (100%)
Akta HS1	Iceland	1.86%	0.86%	Investement fund managed by Akta sjóðir hf.
Titania ehf.	Iceland	1.79%	-	Berglind Björk Jónsdóttir (50%), Sigurður Örn Eiríksson
MK 4 ehf.	Iceland	1.68%	1.25%	Sigfinna Lóa Skarphéðinsdóttir (36%), Elfa Ágústa Magnúsdóttir (16%), Héðinn Karl Magnússon (16%), Magnús Berg Magnússon (16%), Þóra Magnúsdóttir (16%)
P 126 ehf.	Iceland	1.59%	2.17%	Einar Sveinsson (100%)
Eignarhaldsfélagið VGJ ehf.	Iceland	1.45%	1.29%	Eiríkur Vignisson (90%), Sigríður Eiríksdóttir (10%)
Frjálsi lífeyrissjóðurinn	Iceland	1.43%	-	
Festa - lífeyrissjóður	Iceland	1.41%	-	
Miðeind ehf	Iceland	1.36%	1.17%	Vilhjálmur Þorsteinsson (100%)
Landsbréf - Úrvalsbréf	Iceland	1.27%	-	Investement fund managed by Landsbréf hf.
RPF ehf.	Iceland	1.22%	1.36%	Gunnar Sverrir Harðarson (50%), Þórarinn Arnar Sævarsson (50%)
Akta HL1	Iceland	1.14%	0.37%	Investement fund managed by Akta sjóðir hf.
Stekkur fjárfestingarfélag ehf	Iceland	1.12%	1.14%	Kristinn Aðalsteinsson (100%)
Birta lífeyrissjóður	Iceland	1.01%	-	
Others, each less than 1%		27.43%	27.62%	2018: 710, 2017: 102
		100.00%	99.45%	
Treasury shares		0.00%	0.55%	
Issued share capital		100.00%	100.00%	

Beneficial owners are defined as owners holding a share of 10% or greater, directly or indirectly. The information presented is, among other things, based on publicly available information.

71. Other matters

Legal proceedings

Virðing (now the Bank) was sued for damages with a subpoena which was brought to the courts on 1 November 2016. The main claim in the suit is a payment of ISK 301 million plus interest while the reserve claim is that the courts recognise that the Bank is liable to pay damages. The matter involves an alleged insufficient advice by Auður Capital hf. (which later merged with Virðing) in relation to the plaintiff's investment as a co-investor in a fund which is managed by Virðing (now the Bank). The District Court of Reykjavik ruled in the case on 24 January 2018 and acquitted the Bank of the plaintiff's claims. The case was subsequently appealed by the plaintiff to the National Court (Icelandic: Landsréttur) who acquitted the Bank of the plaintiff's claims on 30 November 2018. The plaintiff has appealed to the Supreme Court of Iceland who has agreed to hear the case. The date on which the case will be heard has not been decided.

Merger of the class B share capital with the class A share capital

On a meeting of shareholders on 18 January 2018 a resolution was passed on merging the class B share capital with the class A share capital of the Bank, and amending the Articles of Association accordingly.

Intended listing on the Nasdaq Iceland main market

On a meeting in July 2018, the Board of Directors of the Bank approved a proposal to look into listing the Bank's shares on the NASDAQ OMX Iceland Main Market during the following six to twelve months. The Board of Directors approved on 18 December 2018 to aim to finalise the listing before the end of Q1 2019.

Acquisition of GAMMA Capital Management hf.

On 19 November 2018, the Bank and the shareholders of GAMMA Capital Management hf. ("GAMMA") signed a sales and purchase agreement regarding the Bank's acquisition of all the share capital in GAMMA. The transaction was subject to approval from regulatory authorities and approval from Kvika's shareholders. The purchase price amounts to ISK 2,406 million based on GAMMA's book value of performance related fees at end of June 2018. A part of the purchase price is conditional based on certain conditions and it will be paid both with cash as well as with depositary units in funds managed by GAMMA. On 18 December 2018, the shareholders of the Bank gave their approval for the acquisition and on 19 January 2019 the Icelandic Financial Supervisory Authority gave its approval. The approvals of the Icelandic Competition Authority and the British Financial Conduct Authority are still pending. More information can be found on the Bank's website, www.kvika.is.

72. Events after the reporting date

There are no material events after the reporting date.

Notes to the Consolidated Financial Statements

Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these Consolidated Financial Statements, and have been applied consistently by Group entities.

73. Basis of consolidation

a. Subsidiaries

Subsidiaries are entities controlled by the Group. Control exists when the Group is exposed to, or has rights to, variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. The Group reassesses its relationship with an entity when there is a change in one or more of the elements of control.

b. Business combinations

The Group uses the acquisition method to account for the acquisition of subsidiaries. The cost of an acquisition is measured as the fair value, at the date of exchange, of the assets given, liabilities incurred or assumed and equity instruments issued. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest.

The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recognised as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised immediately in the income statement.

Any contingent consideration is measured at fair value at the date of acquisition. If an obligation to pay contingent consideration that meets the definition of a financial instrument is classified as equity, then it is not remeasured and settlement is account for within equity. Otherwise, other contingent consideration is remeasured at fair value at each reporting date and subsequent changes in the fair value of the contingent consideration are recognised in profit and loss.

c. Non-controlling interest

Non-controlling interest represent the portion of profit or loss and equity not owned, directly or indirectly, by the Bank. Non-controlling interest is presented separately in the income statement and is included in equity in the statement of financial position, separately from equity attributable to owners of the Bank.

The Group chooses on an acquisition-by-acquisition basis whether to measure non-controlling interest in an acquiree at fair value or according to the proportion of non-controlling interests in the acquiree's net assets. Changes in the Bank's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions. In such circumstances the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interest is adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the Bank.

d. Fiduciary services

The Group provides custody services, fund management and discretionary and advisory investment management services which require the Group to make decisions on the handling, acquisition or disposal of financial instruments on behalf of its clients.

The financial statements of managed funds and investment portfolios managed by the Group on behalf of customers are not included in the financial statements, as they do not constitute assets or liabilities of the Group.

e. Transactions eliminated on consolidation

Intra-bank balances, income and expenses, and unrealised gains and losses arising from intra-bank transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with associates are eliminated against the investment to the extent of the Group's interest in the associate. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

f. Structured entities

Structured entities are entities that have been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

The Group acts as investment manager or investment advisor, for example, to a number of investment funds operated by the fund management companies Júpíter rekstrarfélag hf. and Rekstrarfélag Virðingar hf. The purpose of these fund management companies is to generate fees from managing assets on behalf of third-party investors by providing investment strategies. These investment funds are financed through the issue of units to investors. The Group has no contractual obligation to provide financial support to these structured entities.

From time to time, the Group makes seed capital investments in certain fund products in order to establish track records for new products, to test new investment strategies or to launch new products at a viable minimum size.

The Group has set up a formal procedure to assess whether or not to consolidate investment funds managed and administered by the Group on behalf of its customers and other investors in the consolidated financial statements. As part of this assessment, the Group reviews all facts and circumstances including the purpose and design of the investment fund, to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal 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.

Notes to the Consolidated Financial Statements

74. Foreign currency

a. Foreign currency transactions

Transactions in foreign currencies are translated into the functional currency of the respective Group's entity using the exchange rate at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated to the functional currency using the exchange rate at the reporting date. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated using the exchange rate at the date the fair value was determined.

Foreign currency differences are posted as a separate line item under net financial income as disclosed in notes 8 and 77.

b. Foreign operations

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into the functional currency at spot exchange rate current at the reporting date. The income and expenses of foreign operations are translated into the functional currency at the spot exchange rates at the dates of the transactions.

Translation differences on foreign operations are presented as a separate category in the statement of changes in equity.

75. Interest income and expense

Policy applicable from 1 January 2018

Effective interest rate

Interest income and expense are recognised in the income statement using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash flows through the expected life of the financial instrument to the gross carrying amount of the financial asset or the amortised cost of the financial liability. When calculating the effective interest rate for financial instruments other than purchased or originated credit-impaired assets, the Group estimates future cash flows considering all contractual terms of the financial instrument but not ECL. For purchased or originated credit-impaired financial assets, a credit-adjusted effective interest rate is calculated using estimated future cash flows including ECL.

Amortised cost and gross carrying amount

The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured on initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any expected credit loss allowance. The gross carrying amount of a financial asset is the amortised cost of a financial asset before adjusting for any expected credit loss allowance.

Presentation

Interest income and expense presented in the income statement includes interest on:

- financial assets measured at amortised cost
- financial liabilities measured at amortised cost
- derivatives

Further information about the accounting classification of financial assets and financial liabilities is provided in notes 60 and 82.

Policy applicable before 1 January 2018

Interest income and expense were recognised in the income statement using the effective interest method. The effective interest rate was the rate that exactly discounted estimated future cash flows to the carrying amount of the financial asset or liability, over the expected life of the financial instrument. Estimated future cash flows took into account all contractual terms of the financial instruments but not future credit losses.

Interest income and expense presented in the income statement includes interest on:

- financial assets classified as loans and receivables
- financial assets classified as available for sale
- financial liabilities carried at amortised cost
- derivatives

Further information about the accounting classification of financial assets and financial liabilities is provided in notes 60 and 82.

Notes to the Consolidated Financial Statements

76. Fee and commission income and expense

Policy applicable from 1 January 2018

The Group earns income from providing various services to its customers. This includes fees for managing assets on behalf of customers, commissions received for equity and bond transactions and fees and commissions for various other financial services. Fee 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.

Fee and commission income and expense are recognised in the income statement when an agreement with a customer meets all of the following criteria:
- the parties to the contract have approved the contract and are committed to perform their respective obligations
- performance obligations have been established for services to be transferred
- the payment terms have been established for the services to be transferred
- the transaction price can be allocated to each individual service in the agreement
- it is probable that a consideration will be collected in exchange for the services that will be transferred to the customer

The following applies to recognition of income for various types of fees and charges:
- Fees that are earned gradually as the services are performed, such as management fees in asset management, are recognised as income at the rate these services are delivered. In practice, these are on a straight line basis
- Fees attributable to a specific service or action are recognised as income when the service has been performed. Examples of such fees are brokerage and payment commissions

Policy applicable before 1 January 2018

Fee 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. Fee and commission income and expenses comprise the following:
- Fee and commission income is recognised in the income statement as the services are provided
- Fee and commission expenses relate mainly to transaction fees, which are expensed as the services are received

77. Net financial income

Net financial income comprises the following:
- Realised and unrealised gains or losses from price changes of fixed income securities measured at fair value
- Realised and unrealised gains or losses from price changes of variable income securities
- Interest income from fixed income securities carried at fair value through profit or loss
- Dividends
- Fair value changes in derivatives
- Foreign exchange difference

78. Dividend income

Dividend income is recognised when the right to receive income is established. Usually this is the ex-dividend date for equity securities. Dividends are presented as a component of net financial income.

79. Administrative expenses

Administrative expenses comprise expenses other than interest expenses, fee and commission expenses and expenses related to fair value changes. A breakdown of administrative expenses is provided in note 10.

80. Employee benefits

a. Short-term employee benefits
Short-term employee benefits obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus or profit-sharing plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

b. Defined contribution plans
Obligations for contributions to defined contribution plans are expensed in profit or loss as the related service is provided. The Group has no further obligations once those contributions have been paid.

c. Share-based payments
Equity-settled share-based payments to employees are measured at the fair value of the equity instruments at grant date. The grant date fair value of equity-settled share-based payment awards granted to employees is recognised as an employee expense, with a corresponding increase in equity, over the period that the employees become unconditionally entitled to the awards. The amount recognised as an expense is adjusted to reflect the number of awards for which the related service and non-market performance conditions are expected to be met, such that the amount ultimately recognised as an expense is based on the number of awards that meet the related service and non-market performance conditions at the vesting date.

Notes to the Consolidated Financial Statements

81. Income tax

Income tax comprises current and deferred tax. Income tax is recognised in the income statement, except to the extent that it relates to items recognised directly in other comprehensive income or equity, in which case it is recognised there.

Current tax liabilities include the estimated tax payable next year on current year's profit according to the tax rates prevailing at reporting date, in addition to corrections on tax from previous years.

The deferred income tax asset and/or liability has been calculated and recognised in the statement of financial position. The calculation is based on the difference between assets and liabilities as presented in the tax return on the one hand, and in the consolidated financial statements on the other, taking into consideration tax losses carried forward. This difference is due to the fact that the tax assessment is based on premises that differ from those governing the financial statements, mostly due to temporary differences arising from the recognition of revenue and expense in the tax returns and in the financial statements.

Deferred tax assets and tax liabilities are offset in the statement of financial position when there is a legal right to settle on a net basis and they are levied by the same taxing authority on the same entity or on different entities subject to joint taxation.

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

82. Financial assets and financial liabilities

a. Recognition
The Group initially recognises loans and advances, deposits, debt securities issued and subordinated liabilities on the date on which they are originated. All other financial assets and liabilities are initially recognised on the trade date, which is the date when the Group becomes a party to the contractual provisions of the instrument.

b. Classification

Financial assets - Policy applicable from 1 January 2018

The Group's financial assets are classified into one of two measurement categories, i.e. at amortised cost or at fair value through profit or loss. The measurement basis of individual financial assets is determined based on an assessment of the cash flow characteristics of the assets and the business models under which they are managed.

Financial assets at amortised cost
A financial asset is measured at amortised cost if the contractual terms of the financial asset give rise to cash flows that are solely payment of principal and interest and the asset is held within a business model whose objective is to collect contractual cash flows, i.e. Held to collect. After initial measurement, financial assets in this category are carried at amortised cost using the effective interest rate method. Amortisation is included in interest income in the Consolidated Statement of Comprehensive Income. The majority of the Group's loans to customers are carried at amortised cost using the effective interest rate method. Interest on loans to customers is recognised as interest income.

Impairment on financial assets measured at amortised cost is calculated using the expected credit loss approach. Loans and debt securities measured at amortised cost are presented net of allowance for credit losses in the Consolidated Statement of Financial Position.

Financial assets at fair value through profit or loss (FVTPL)
Financial assets classified at fair value through profit or loss are all other financial assets which are not classified at amortised cost or at fair value through other comprehensive income. This includes financial assets classified mandatorily at fair value through profit or loss and financial assets which are irrevocably designated by the Group at initial recognition as at fair value through profit or loss that would otherwise meet the requirements to be measured at amortised cost or at fair value through other comprehensive income. The Group may designate financial assets as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.

Financial assets at fair value through profit or loss are measured in the Consolidated Statement of Financial Position at fair value. Loans to customers which are measured at fair value through profit or loss are assets whose cash flows do no represent payments that are solely payments of principal and interest but are non-trading assets. Interest on loans to customers measured at fair value through profit or loss is recognised as interest income. Changes in fair value, as well as any gains or losses realised on disposal, are recognised in the line item Net financial income (expense) in the Consolidated Statement of Comprehensive Income.

Notes to the Consolidated Financial Statements

82. Financial assets and financial liabilities (cont.)

Business model assessment

The Group makes an assessment of the objective of a business model in which an asset is held at a portfolio level because this best reflects the way the

- the stated policies and objectives for the portfolio and the operation of those policies in practice. In particular, whether management's strategy focuses on earning contractual interest revenue, maintaining a particular interest rate profile, matching the duration of the financial assets to the duration of the liabilities that are funding those assets or realising cash flows through the sale of the assets;
- how the performance of the portfolio is evaluated and reported to the Group's management;
- the risks that affect the performance of the business model (and the financial assets held within that business model) and how those risks are managed;
- how managers of the business are compensated - e.g. whether compensation is based on the fair value of the assets managed or the contractual cash flows collected; and
- the frequency, volume and timing of sales in prior periods, the reasons for such sales and its expectations about future sales activity. However, information about sales activity is not considered in isolation, but as part of an overall assessment of how the Group's stated objective for managing the financial assets is achieved and how cash flows are realised.

Financial assets that are held for trading or managed and whose performance is evaluated on a fair value basis are measured at fair value through profit or loss because they are neither held to collect contractual cash flows nor held to both collect contractual cash flows and to sell financial assets.

Cash flow characteristics assessment

Financial assets held within the business models Held to collect and Held to collect and sell are assessed to evaluate if their contractual cash flows are comprised of solely payments of principal and interest (SPPI). SPPI payments are those which are consistent with a basic lending arrangement. Principal is the fair value of the financial asset at initial recognition and may change over the life of the instruments, e.g. due to repayments. Interest relates to basic lending returns, including compensation for the time value of money and credit risk associated with the principal amount outstanding and for other basic lending risks (expected losses, liquidity risks and administrative costs), as well as a profit margin.

Where the contractual terms introduce exposure to other risk or variability of cash flows that are inconsistent with a basic lending arrangement, the related financial asset is classified and measured at fair value through profit or loss.

Reclassifications

Financial assets are not reclassified subsequent to their initial recognition, except in the period after the Group changes its business model and if the change is significant to the Group's operations.

Financial assets - Policy applicable before 1 January 2018

The Group classified its financial assets into one of the following categories:

- loans and receivables; or
- at fair value through profit and loss, and within this category as:
  - held for trading; or
  - designated at fair value through profit or loss

Loans and receivables

Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market were classified as loans and receivables.

Financial assets classified as loans and receivables included cash and cash equivalents, loans to customers and receivables.

Financial assets classified as loans and receivables were initially recognised at fair value, which is typically equal to cost, i.e. cash advanced plus any transaction costs. They were subsequently measured at amortised cost using the effective interest method. Accrued interest, in the case of interest bearing assets, was included in the carrying amount. Interest income was recognised in net interest income.

Held for trading

A financial asset was classified as held for trading if it was purchased or incurred with the intention to resell and repurchase within a short period of time, or if it was a part of a group of defined financial instruments managed on a portfolio basis and historical data showed recent pattern of short-term profit taking or it was a derivative (except for a derivative that was a financial guarantee contract or a designated and effective hedging instrument).

Financial assets held for trading included fixed income securities, shares and other variable income securities and derivatives and securities used for hedging.

Financial assets held for trading were initially recognised at fair value, with transactions costs recognised in profit or loss. They were subsequently measured at fair value in the statement of financial position. Interest income and expense from derivatives was recognised in net interest income but all other interest income and expense, and all changes in fair value, were recognised as financial income.

Notes to the Consolidated Financial Statements

82. Financial assets and financial liabilities (cont.)

Designated at fair value

A financial asset was designated at fair value through profit and loss when it was a part of a portfolio of financial instruments that were managed on the basis of fair value and information provided to management was based on fair value.

Financial assets designated at fair value included fixed income securities and shares and other variable income securities.

Financial assets designated at fair value were initially recognised at fair value, with transactions costs recognised in profit or loss. They were subsequently measured at fair value in the statement of financial position. Interest income and expense, and all changes in fair value, were recognised as financial income.

Financial liabilities

The Group's financial liabilities are classified into one of two measurement categories, i.e. at amortised cost or at fair value through profit or loss. Financial liabilities held for trading are measured at fair value through profit or loss, all other financial liabilities are measured at amortised cost. Financial liabilities measured at amortised cost are initially recognised at fair value, which is typically equal to cost, i.e. cash advanced less any transaction costs. They are subsequently measured at amortised cost using the effective interest method. Accrued interest, in the case of interest bearing liabilities is included in the carrying amount. Interest expense is recognised in net interest income.

Derecognition

Financial assets

A financial asset is derecognised when the contractual rights to the cash flows from the asset expire, or when the Group enters into a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Group is recognised as a separate asset or liability.

The Group enters into transactions whereby it transfers assets recognised on its statement of financial position, but retains either all or substantially all of the risks and rewards of the transferred assets or a portion of them. In such cases, the transferred assets are not derecognised. Examples of such transactions are securities lending and sale and repurchase agreements.

Financial liabilities

Financial liabilities are derecognised when the obligation of the Group is discharged, cancelled or expires.

83. Offsetting

Financial assets and liabilities are offset, and the net amount reported in the statement of financial position, when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis for gains and losses arising from a group of similar transactions, such as in the Group's trading activity, or other circumstances permitted by International Financial Reporting Standards.

84. Determination of fair value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or, in its absence, the most advantageous market to which the Group has access at that date. The fair value of a liability reflects its non-performance risk. When available, the Group measures the fair value of an instrument using the quoted price in an active market for that instrument. A market is regarded as active if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

If there is no quoted price in an active market, then the Group uses valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The chosen valuation technique incorporates all of the factors that market participants would take into account in pricing a transaction. For further information on valuation techniques, refer to notes 61 - 62.

The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price – i.e. the fair value of the consideration given or received. If the Group determines that the fair value at initial recognition differs from the transaction price and the fair value is evidenced neither by a quoted price in an active market for an identical asset or liability nor based on a valuation technique that uses only data from observable markets, then the financial instrument is initially measured at fair value, adjusted to defer the difference between the fair value at initial recognition and the transaction price. Subsequently, that difference is recognised in profit or loss on an appropriate basis over the life of the instrument but no later than when the valuation is wholly supported by observable market data or the transaction is closed out.

Notes to the Consolidated Financial Statements

85. Impairment

IFRS 9 replaces the incurred loss model in IAS 39 with an expected credit loss (ECL) model. The adoption of IFRS 9 has had a significant impact on the Group's impairment methodology. The two main reasons for this impact are, on the one hand, that the impairment model of IFRS 9 is intended to reflect expected credit loss as opposed to the incurred loss model of IAS 39 and, on the other hand, that impairment under IFRS 9 should reflect a probability weighted average of possible outcomes in contrast to IAS 39 where the single most likely outcome was accounted for. IFRS 9 further requires that certain off-balance sheet items be subjected to impairment assessment, these include financial guarantees and undrawn loan commitments. ECL for off-balance sheet items is separately calculated and included in other liabilities.

Policy applicable from 1 January 2018

Expected Credit Loss

The Group recognises loss allowances for ECL on the following financial instruments that are not measured at FVTPL:

- debt instruments measured at amortised cost;
- contract assets;
- loan commitments issued; and
- financial guarantee contracts issued.

The Group estimates an ECL for each of these types of assets or exposures. However, IFRS 9 specifies three different approaches depending on the type of asset or exposure:

1. For trade receivables and contract assets without a significant financing component a simplified (lifetime expected loss) approach can be applied.
2. For assets that are credit-impaired at purchase or origination lifetime expected loss approach shall be applied.
3. For other assets/exposures a general (or three-stage) approach shall be applied.

The general approach

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

Stage 1 covers financial assets that have not deteriorated significantly in credit quality since initial recognition or (where the optional low credit risk simplification is applied) have low credit risk.

Stage 2 covers financial assets that have deteriorated significantly in credit quality since initial recognition (unless the low credit risk simplification has been applied and is relevant) but that do not have objective evidence of a credit loss event.

Stage 3 covers financial assets that have objective evidence of a credit loss event at the reporting date.

12-month expected credit losses are recognised in stage 1, while lifetime expected credit losses are recognised in stages 2 and 3. IFRS 9 draws a distinction between financial instruments that have not deteriorated significantly in credit quality since initial recognition and those that have. ‘12-month expected credit losses’ are recognised for the first of these two categories. ‘Lifetime expected credit losses’ are recognised for the second category. Measurement of the expected credit losses is determined by a probability-weighted estimate of credit losses over the expected life of the financial instrument.

An asset moves from 12-month expected credit losses to lifetime expected credit losses when there has been a significant deterioration in credit quality since initial recognition. Hence the ‘boundary’ between 12-month and lifetime losses is based on the change in credit risk not the absolute level of risk at the reporting date.

There is also an important operational simplification that permits companies to stay in ‘12-month expected credit losses’ if the absolute level of credit risk is ‘low’. This applies even if the level of credit risk has increased significantly.

There is also a third stage. This applies to assets for which there is objective evidence of impairment (essentially the same as objective evidence of an incurred loss in IAS 39). In Stage 3 the credit loss allowance is still based on lifetime expected losses but the calculation of interest income is different.

In the periods subsequent to initial recognition, interest is calculated based on the amortised cost net of the loss provision, whereas the calculation is based on the gross carrying value in Stages 1 and 2.

Finally, it is possible for an instrument for which lifetime expected credit losses have been recognised to revert to 12-month expected credit losses should the credit risk of the instrument subsequently improve so that the requirement for recognising lifetime expected credit losses is no longer met.

Notes to the Consolidated Financial Statements

85. Impairment (cont.)

Expected credit losses

Expected credit losses are defined as the difference between all the contractual cash flows that are due to an entity and the cash flows that it actually expects to receive (‘cash shortfalls’). This difference is discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets).

12 month expected credit losses

12-month expected credit losses are a portion of the lifetime expected credit losses. They are calculated by multiplying the probability of a default occurring on the instrument in the next 12 months by the total (lifetime) expected credit losses that would result from that default. They are not the expected cash shortfalls over the next 12 months. They are also not the credit losses on financial instruments that are forecast to actually default in the next 12 months.

Lifetime expected credit losses

Lifetime expected credit losses are the expected shortfalls in contractual cash flows, taking into account the potential for default at any point during the life of the financial instrument.

Definition of default

The Group considers a financial asset to be in default if one of the following applies:

- the borrower is 60 days past due of one of his exposures with the Bank;
- the borrower is registered as in delinquency by Creditinfo (Icelandic: vanskilaskrá);
- the borrower is registered in public records as filed for bankruptcy, has terminated his business or is no longer a going concern;
- the borrower is considered to be unlikely to pay as determined by the Bank's Risk Management department. Events that are likely to lead to default as determined by the Risk Management department include the following:
  - breach of covenants of loan commitments;
  - loan concessions or stressed restructuring; or
  - Risk Management's internal risk assessment is 4 or 5.
- the borrower has been in default in accordance with above at any point for the previous three months.

The Risk Management department can manually override automatic default triggers if the following applies:

- the reason for reported default triggers is known to the Bank and not considered to be lack of willingness or ability to pay.
- re-financing of borrower’s exposures is expected and has been confirmed.

Probability of default and credit risk rating

The Group utilises an external Probability of Default model (PD model) developed and maintained by Creditinfo Iceland, an Icelandic credit bureau, for the Group. The PD model is based on information compiled by Creditinfo on the creditworthiness of corporates and individuals in Iceland based both on personal and demographic factors. It predicts the probability of default in the next 12 months. The model has been calibrated to using historical default rate information representative of the Group's portfolio. The model is designed as a point in time model and correlation between forecasted and actual default rates and macroeconomic forecasts has been identified. This enables the Group to calculate different forward looking probabilities of default given different forecasts for changes in gross domestic product, inflation rate and unemployment rate. Lifetime PD for loans in stage 3 is 100% as by definition they are already in default.

For the purpose of estimating lifetime PD for loans in stage 2 the Group has determined that 12 month PD is an appropriate proxy for marginal PD over the lifetime of the loan. The 12 month PD is adjusted with a survival rate for each year until maturity with the following formula: $PD_t = PD_{12} * SR_t$ where PD_{12} is the 12 month PD from the credit rating model and SR_t is the survival rate at time t, which is calculated recursively as $SR_t = SR_{t-1} * (1-PD_t)$. The Group monitors the appropriateness of the assumption as a part of it’s yearly validation and monitoring process.

Notes to the Consolidated Financial Statements

85. Impairment (cont.)

Significant increase in credit risk

When considering whether a significant increase in credit risk (SICR) has occurred the Group considers both quantitative and qualitative factors. In general the Group will rely on a quantitative analysis based on the PD model but will additionally consider qualitative factors based on the information available to the Group.

Quantitative SICR assessment

The Group has defined the following criteria's for SICR:

1. 20 days past due of any of the client's exposures
2. Grading migrations – SICR has occurred if the current grade has increased compared to the origination grade more or equal to the following thresholds:

Origination grade	Threshold grade
1	7
2	7
3	7
4	7
5	7
6	8
7	8
8	9
9	10

Migration of one or two risk grading in the PD model is considered to be a significant increase in risk and therefore warrant a transfer to stage 2, depending on the origination grade. However, the Group considers risk grades less than 5 for corporations to be low risk and therefore excludes any movement between categories that does not result in a rating above that level. Ratings above 10 are considered to indicative of default and therefore warrant elevation to stage 3 unless overridden based on other available information or expert judgement.

Qualitative SICR assessment

Risk Management is responsible for managing the credit risk of the Group which includes a qualitative SICR assessment. Risk Management reviews on a monthly basis large exposures, unsecured loans and loans that are past due on a loan by loan basis.

Exposure at default

Lifetime definition

The Group considers the lifetime of each exposure to be the contractual maturity of each loan. The Group considers this to be the case as any lending subsequent to that period would be based on an independent lending decision at that time based on the prevailing market terms. The Group only considers contractual cash flows when estimating exposure at default. The average lifetime of the Group's exposures is short and historically the Group has had few prepayments and no changes in that pattern are foreseen. It does therefore not consider the likelihood of prepayment when concluding on the lifetime of the assets.

Committed facilities

The Group considers the off-balance portion of exposure at default to be 50% (credit conversion factor) of any facilities not drawn upon that are considered committed. Such facilities include overdrafts, credit cards and guarantees. The credit conversion factor is subject to expert review on a case by case basis. The Bank does not consider credit line facilities to be committed facilities as disbursements are subject to predetermined conditions and constitute a separate credit review. These predetermined conditions will in most cases lead directly to an increase in posted collateral and disbursements therefore stay within acceptable collateral coverage.

Expected credit loss measurement

IFRS 9 requires the Group to determine an expected credit loss (ECL) amount on a probability-weighted basis as the difference between the cash flows that are due to the Group in accordance with the contractual terms of a financial instrument and the cash flows that the Group expects to receive. The Group has implemented an ECL model which is consistent with regulatory and best practices. The model is based on four components.

Probability of Default (PD). This is an estimate of the likelihood of default over a given time horizon. The Bank uses an external PD model developed by CreditInfo for the Group.

Exposure at Default (EAD). This is an estimate of the exposure at a future date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, and expected drawdowns on committed facilities.

Loss Given Default (LGD). This is an estimate of the loss arising on default. It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from any collateral. It is expressed as a percentage of EAD and derived from value of underlying collaterals.

Discount rate. This is used to discount an expected loss to present value at the reporting date using the effective interest rate (EIR) at initial recognition.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

85. Impairment (cont.)

Forward looking probability weighted scenarios

The Group's management has identified and probability weighted three macro-economic scenarios. The development of macro-economic variables and the corresponding weights are based on the Group's management judgement. The Group incorporates the following forward-looking macro-economic variables into its probability weighted expected credit loss calculations: (i) gross domestic product, (ii) inflation rate and (iii) unemployment rate.

The following table shows key macroeconomic variables used in modelling the allowance for credit losses. Projections for the base case scenario, upside and downside scenarios are averages for the next 12 months.

		Scenarios	
2019	**Base case**	**Upside**	**Downside**
GDP growth	2.80%	3.90%	1.50%
Inflation rate	3.50%	2.50%	4.80%
Unemployment rate	3.20%	2.70%	4.00%

Policy applicable before 1 January 2018

General principle

The carrying amount of the Group's non-financial assets and financial assets not at fair value through profit and loss was reviewed at each reporting date to determine whether there was any indication of impairment. If any such indication existed, the asset's recoverable amount was estimated. An impairment was recognised in the income statement whenever the carrying amount of an asset or its cash-generating unit exceeded its recoverable amount.

Reversal of impairment

If, in a subsequent period, the amount of an impairment loss decreased and the decrease could be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss was recognised as reduction of cost in the income statement. An impairment loss recognised for goodwill was not reversed in a subsequent period.

Calculation of recoverable amount

The recoverable amount of the Group's investments in financial assets carried at amortised cost was calculated as the present value of estimated future cash flows, discounted at the original effective interest rate.

The recoverable amount of other assets was the greater of their fair value less cost to sell and value in use. In assessing value in use, the estimated future cash flows were discounted to their present value using a pre-tax discount rate that reflected current market assessments of the time value of money and the risks specific to the asset. For an asset that did not generate largely independent cash inflows, the recoverable amount was determined for the cash-generating unit to which the asset belongs.

Indications of impairment

Objective evidence of impairment includes information about one or more of the following:

- Indications of significant financial difficulties of the borrower, including financial restructuring and refinancing concessions that a lender would not otherwise consider
- A breach of contract, such as a default on instalments or on interest or principal payments
- An observable decrease in the estimated future cash flows from a group of loans due to adverse changes in the economic conditions of a sector or region in which the borrower operates, even if the decrease cannot yet be identified with the individual financial assets in the group
- The disappearance of an active market for an asset held as collateral

Impairment losses expected as a result of events taking place after the reporting date, no matter how likely, are not recognised.

Calculation of impairment losses

Impairment loss is calculated by comparing the carrying amount of individual loans with the present value of their expected future cash flows, discounted at their original effective interest rate. In the case of loans at variable interest rates, the discount rate used is their current effective interest rate.

Individually assessed loans

Impairment losses on individually assessed loans are determined by an evaluation of the exposures on a case-by-case basis. This procedure is applied to all loans that are considered individually significant. In making the assessment, the following factors are considered:

- The Group's aggregate exposure towards the customer
- The amount and timing of expected receipts and recoveries
- The likely recovery upon liquidation or bankruptcy
- Complexity and uncertainty related to ranking of creditor claims and legal standing
- The realisable value of securities or other credit mitigants and the likelihood of successful repossession
- The likely deduction of any costs involved in recovery of amounts outstanding

Notes to the Consolidated Financial Statements

85. Impairment (cont.)

Collectively assessed loans

Impairment losses on collectively assessed loans are determined by an evaluation of the exposures on a group of loans with similar risk characteristics. This procedure is applied to all loans that are not considered individually significant, or have been individually assessed but showed no indications of impairment. This loss covers loans that are impaired at the reporting date but which will not be individually identified as such until some time in the future.

The collective impairment loss is determined after taking into account the following:

- Historical loss experience in portfolios of similar risk characteristics, for example, by industry sector, loan grade or product
- The estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan
- Management's judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience

Estimates of changes in future cash flows for groups of assets are consistent with changes in observable data from period to period, for example changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to minimise any differences between loss estimates and actual losses.

Loan write-offs

The carrying amount of impaired loans is reduced through the use of an allowance account. Loans are written off, partially or in full, when there is no realistic prospect of recovery.

86. Cash and balances with Central Bank

Cash and balances with Central Bank include notes and coins on hand, balances held with the Central Bank and other financial institutions, and highly liquid financial assets with original maturities of three months or less from the acquisition date that are subject to an insignificant risk of changes in their fair value, and are used by the Group in the management of its short-term commitments.

Cash and balances with Central Bank are carried at amortised cost in the statement of financial position.

87. Fixed income securities

Fixed income securities are initially measured at fair value and subsequently accounted for depending on their classification as discussed in note 82.

88. Shares and other variable income securities

Shares and other variable income securities consist of equity investments and unit shares in mutual funds. Shares and other variable income securities are initially measured at fair value and subsequently accounted for depending on their classification as discussed in note 82.

89. Securities used for hedging

Securities used for hedging consist of non-derivative financial assets that are used to hedge the Group's exposure arising from derivative contracts with customers. Securities used for hedging are measured at fair value as discussed in note 82.

90. Loans to customers

Loans are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and include loans provided by the Group to its customers, participation in loans from other lenders and purchased loans that are not quoted in an active market and which the Group has no intention of selling immediately or in the near future.

Loans are initially recognised at fair value, which is the cash advanced, plus any transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and advances. The carrying amount of impaired loans is reduced through the use of an allowance account.

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

Notes to the Consolidated Financial Statements

91. Derivatives

A derivative is a financial instrument or another contract that falls under the scope of IFRS 9 and generally has the following three characteristics:

- Its value changes due to changes in an underlying variable, such as bond price, share price, security or price index (including CPI), foreign currency exchange rate or interest rate
- The contract requires no initial investment or an initial 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
- Settlement takes place at a future date

The Group uses derivatives for trading purposes and to hedge its exposure to market price risk, foreign exchange risk and inflation and interest risk arising from operating, financing and investing activities. The Group does not apply hedge accounting.

Derivative assets and liabilities are initially recognised and subsequently measured at fair value in the statement of financial position. Derivatives with positive fair values are classified as financial assets and derivatives with negative fair values as financial liabilities. Revenue from derivatives is split into interest income and net income from financial instruments at fair value and presented in the corresponding line items in the income statement.

92. Investment properties

An investment property is an asset which is specified for leasing to third parties, for returns or for both purposes. Investment properties are initially recognised at cost and subsequently measured at fair value. Changes in fair value are recognised as gains or loss in the income statement.

93. Intangible assets

a. Asset categories

The Group groups intangible assets into three categories:

- Software

  Software comprise acquired software licences and external costs associated with the development of bespoke applications.
- Goodwill

  Goodwill arises in business combinations. It is recognised as of the acquisition date and measured as the aggregate of (a) the fair value of the consideration transferred, (b) the recognised amount of any non-controlling interest in the acquiree, and (c) the fair value of any previously held equity interest in the acquiree, less the net recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed, all measured as at the acquisition date. The consideration transferred includes the fair value of assets transferred, liabilities incurred and equity interests issued by the Group. In addition, consideration transferred includes the fair value of any contingent consideration.
- Other intangible assets

  Other intangible assets comprise licences and acquired trademarks used in the operation of the Group.

The Group has not defined any internally generated intangible assets.

b. Initial recognition

Intangible assets are initially recognised at cost.

c. Subsequent measurement

The Group uses the cost model for measurement after recognition and intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. Intangible assets are reviewed for indications of impairment or changes in estimated future economic benefits at each reporting date. If such indications exist, then the asset's recoverable amount is estimated. Goodwill is tested annually for impairment.

For impairment testing, assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that is largely independent of the cash inflows of other assets or cash generating units (CGUs). Goodwill arising from a business combination is allocated to CGUs or groups of CGUs that are expected to benefit from the synergies of the combination.

The recoverable amount of an asset or CGU is the greater of its value in use and its fair value less costs to sell. Value in use is based on the estimated future cash flows, 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 or CGU.

An impairment loss is recognised if the carrying amount of an asset or CGU exceeds its recoverable amount.

Impairment losses are recognised in profit or loss. They are allocated first to reduce the carrying amount of any goodwill allocated to the CGU, and then to reduce the carrying amounts of the other assets in the CGU on a pro rata basis.

An impairment loss in respect of goodwill is not reversed. For other assets, an impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

Kvika Amounts are in ISK thousands

Notes to the Consolidated Financial Statements

93. Intangible assets (cont.)

d. Amortisation

Intangible assets with finite useful life are amortised using the straight-line method over their estimated useful economic life, with the amortisation recognised in the income statement. The estimated useful life of intangible assets is as follows:

Software	5-10 years
Other intangible assets with finite useful life	10 years

Depreciation of property and equipment and amortisation of intangible assets are presented together as a separate line item in administrative expenses as disclosed in note 10. Further breakdown is provided in notes 29-30.

94. Property and equipment

a. Asset categories

The Group groups tangible assets into two categories:

- Real estate, which includes office and residential buildings, land and building rights
- Other property and equipment, which includes automobiles, furniture and fixtures, computers and other office equipment

b. Initial recognition

Property and equipment is initially recognised at cost, which includes direct expenses related to the purchase.

c. Subsequent measurement

The Group uses the cost model for the measurement after recognition and property and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses. Property and equipment is reviewed for indications of impairment or changes in estimated future economic benefits at each reporting date. If such indications exist, the assets are analysed to assess whether their carrying amount is fully recoverable.

d. Subsequent cost

The Group recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred if it is probable that the future economic benefits embodied with the item will flow to the Group and the cost of the item can be measured reliably. The decision, if subsequent costs are added to the acquisition cost of property and equipment, is based on whether an identified component, or part of such component, has been replaced or not, or if the nature of the subsequent cost means a contribution of a new component. All other costs are expensed in the income statement when incurred.

e. Depreciation

Depreciation is recognised in the income statement on a straight-line basis over the estimated useful lives of each component of an item of property and equipment. The estimated useful lives are as follows:

Real estate	15-50 years
Other property and equipment	3-5 years

Where parts of an item of property and equipment have different useful lives, those components are accounted for separately.

Depreciation of property and equipment and amortisation of intangible assets are presented together as a separate line item in administrative expenses as disclosed in note 10. Further breakdown is provided in notes 29-30.

95. Investments in associates

Associates are those entities in which the Group has significant influence, but not control, over the financial and operating policies. Significant influence generally exists when the Group holds between 20% and 50% of the voting power, including potential voting rights, if any. Investments in associates are initially recognised at cost.

The Group's share of the total recognised gains and losses of associates is included in the financial statements of the Group on an equity accounted basis, from the date the significant influence commences until the date it ceases.

If the Group's share of loss exceeds its interest in an associate, the Group's carrying amount is reduced to zero and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

Notes to the Consolidated Financial Statements

96. Other assets

Other assets are measured at amortised cost.

97. Assets classified as held for sale

Non-current assets that are expected to be recovered primarily through sale rather than through continuing use, are classified as held for sale. Immediately before classification as held for sale, the assets are remeasured in accordance with the Group's accounting policies. Thereafter the assets are measured at the lower of their carrying amount and fair value less cost to sell. Impairment losses on initial classification as held for sale and subsequent gains or losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

98. Deposits from customers

Deposits consist of time deposits and demand deposits. Money market deposits are included in borrowings. Deposits are recognised at amortised cost, including accrued interest.

99. Borrowings

Borrowings are mostly comprised of money market deposits. They are initially recognised at fair value less attributable transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in their carrying amount.

When the Group sells a financial asset and simultaneously enters into an agreement to repurchase the asset, or a substantially similar asset, at a fixed price at a future date ("repo" or "stock lending"), the arrangement is accounted for as a borrowing and the underlying asset continues to be recognised in the Group’s statement of financial position.

100. Issued bills

Issued bills are initially recognised at fair value less attributable transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in their carrying amount.

101. Issued bonds

Issued bonds are initially recognised at fair value less attributable transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in their carrying amount.

102. Subordinated liabilities

Subordinated liabilities are initially recognised at fair value less attributable transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in their carrying amount.

103. Short positions held for trading

Short positions are obligations of the Group to deliver financial assets borrowed by the Group and sold to third parties. Short positions are carried at fair value through profit or loss with all fair value changes recognised in the income statement under net financial income.

104. Other liabilities

Other liabilities are measured at amortised cost.

105. Financial guarantees

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the terms of a debt instrument.

Financial guarantee liabilities are initially recognised at their fair value. The guarantee liability is subsequently measured as follows:

- from 1 January 2018: at the higher of the loss allowance determined in accordance with IFRS 9 and the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15; and
- before 1 January 2018: at the higher of the amount representing the initial fair value amortised over the life of the guarantee and the present value of any expected payment, when a payment under the guarantee has become probable.

Liabilities arising from financial guarantees are included with provisions.

Notes to the Consolidated Financial Statements

106. Share capital

a. Treasury shares

Acquired own shares and other equity instruments (treasury shares) are deducted from equity. No gain or loss is recognised in income statement on the purchase, sale, issue or cancellation of treasury shares. Consideration paid or received is recognised directly in equity. Incremental transaction costs of treasury share transactions are accounted for as a deduction from equity, net of any related income tax benefit.

b. Share premium

Share premium represents excess of payment above nominal value (ISK 1 per share) that shareholders have paid for shares sold by the Group.

c. Dividends on share capital

Dividends on share capital are deducted from equity in the period in which they are approved by the Group's shareholders meetings.

107. Nature and purpose of equity reserves

a. Option reserve

The option reserve represents the cumulative charge to the income statement for options to purchase shares in the Bank granted under the Bank's Remuneration policy, which is discussed in notes 67-69.

b. Warrants reserve

The warrants reserve represents the consideration received for outstanding warrants, as disclosed in note 41.

c. Deficit reduction reserve

The deficit reduction reserve was created as a part of a share capital reduction approved by the Bank's Annual General Meeting in April 2014. The reserve has no specified purpose and can only be used with the approval of a shareholders' meeting.

d. Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations, until the operations are sold, dissolved or abandoned.

e. Restricted retained earnings

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 retained earnings reserve, net of tax, which is not subject to dividend payments. When shareholding in subsidiary or associate is sold or written off the restricted retained earnings reserve shall be released and the amount transferred to retained earnings.

f. Accumulated deficit - retained earnings

Accumulated deficit (retained earnings if positive) consists of undistributed profits and losses accumulated, less transfers to other reserves.

108. Earnings per share

The Group presents basic and diluted earnings per share (EPS) data for its ordinary shares. Basic EPS is calculated by dividing the profit or loss that is attributable to ordinary shareholders of the Bank by the weighted average number of ordinary shares outstanding during the period. Diluted EPS is calculated by adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares, which comprise share options granted to employees and issued warrants.

109. New standards and interpretations

The Group has adopted amendments to existing standards which became effective for the first time in 2018. The amendments did not have a material effect on these financial statements.

A number of new standards, amendments to standards and interpretations were not yet effective for the year ended 31 December 2018 and have not been applied in the preparation of these financial statements. Early adoption of new standards and amendments is not planned. Following is a summary of the new standards which are likely to affect the Group's Consolidated Financial Statements.

IFRS 16 Leases, which will become effective for annual reporting periods beginning on or after 1 January 2019, establishes a comprehensive framework for lease agreements. The standard requires lessees to account for all leases under a single on-balance sheet model. It does not significantly change the accounting for leases for lessors. The standard includes two recognition exemptions for lessees; lease 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 recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset.

The Group has performed an impact assessment of IFRS 16. Based on information on hand and the results of the assessment, the Group does not anticipate that the impact on the statement of financial position will be substantial.

Notes to the Consolidated Financial Statements

110. Use of estimates and judgements

In the process of applying the Group's accounting policies, management makes use of judgements and estimates which are based on various assumptions. These judgements and estimates can affect the reported amounts of assets and liabilities, income and expense.

Assumptions and estimates are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances, and are reviewed on an on-going basis. The estimates form the basis for judgements about the carrying value of assets and liabilities that are not readily available from other sources and actual results may differ. Judgement may also be required in circumstances not involving estimates, e.g. when determining the substance of a particular transaction, contract or relationship.

The areas where the use of judgements and estimates has the most significant effect on the amounts recognised in the statement of financial position or the income statement are disclosed in this note.

a. Fair value of financial instruments
The fair value of financial instruments that are not quoted in active markets is determined using valuation techniques which are reviewed regularly as discussed in note 61.

b. Impairment of financial assets
As outlined in note 85, the use of estimates and judgement is an important component of the calculation of impairment losses. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience. Unforeseen events could, however, result in further impairment losses which would have a material effect on the income statement and statement of financial position.

c. Impairment of intangible assets
The carrying amount of intangible assets are reviewed annually to determine whether there is indication of impairment as disclosed in note 93. If any such indication exists the asset's recoverable amount is estimated. An impairment loss is recognised if the carrying amount of an asset exceeds its recoverable amount.

d. Deferred tax assets
Judgement is required to determine the extent to which deferred tax assets are recognised in the statement of financial position, based on the likely timing and level of future taxable profits.

Appendixes:

1. Statement on the Corporate Governance of Kvika banki hf. 2018

2. Non-Financial Information

Unaudited

Statement on the Corporate Governance of Kvika banki hf. 2018

Kvika's business strategy

Kvika banki hf. (hereinafter referred to as “Kvika” or “the bank”) is a specialized bank focusing on asset management and investment services.

In autumn 2018, all of the employees of Kvika participated in the strategic planning of the bank and decided, among other things, to uphold long-term thinking as the guiding principle. This entails Kvika’s business strategy being geared towards developing solid business relationships and long-term results.

Kvika focuses on specific groups and clients, emphasizing exceptional, tailor-made services. The bank's size enables it to adapt to its environment with the aim of maintaining profitability and customer service. The bank strives to develop and maintain a powerful infrastructure that can be used to generate income.

Corporate banking finances enterprises and the investments of the bank’s clients. Corporate banking also makes use of the bank's expertise and network to broker loans to other institutional investors.

Asset and Fund Management emphasizes offering clients a broad range of services for investing in Iceland as well as on foreign markets. The aim is to provide the best asset and fund management services, guided by clients’ long-term interests.

Capital Markets offers clients comprehensive securities brokerage and FX market services.

Corporate Finance provides various types of advisory services in connection with investments and financing. The principal focus is on corporate acquisitions and divestments, as well as initial public offerings.

The return on equity is determined by the decisions that are made in accordance with the risk appetite, which reflects the profitability targets, since an emphasis is placed on utilising the equity as efficiently as possible with regard to risk. Decisions regarding the composition of the balance sheet take into account the best utilisation of equity to generate income, but are restricted by risk appetite and funding at any given time.

An emphasis is placed on Kvika's activities being profitable and the objective of the bank is to achieve a return on equity of at least 15%.

Kvika’s objective is for dividend payments to amount to a minimum of 25% of profits. However, dividend payments are subject to assessments of the opportunities offered by reinvesting profits in the bank's operations and growth.

Kvika's social responsibility policy is to have a positive long-term impact on the community, particularly in the areas in which it operates. Kvika therefore places a special emphasis on having a positive impact on the development and functionality of the financial market. An ambitious employment equality policy has also been agreed for the bank. Kvika also gives special importance to having a positive impact on education.

Compliance with Corporate Governance Guidelines

Kvika is obliged to implement recognized guidelines on Corporate Governance under Article 54 of the Act on Financial Undertakings no. 161/2002. Kvika complies with the Guidelines on Corporate Governance, 5th edition, published in May 2015 by the Chamber of Commerce, Nasdaq OMX Iceland and the Confederation of Icelandic Employees (the „Guidelines”) in most respects. The Guidelines are available on the website of the Chamber of Commerce www.vi.is. Kvika has not appointed a nomination committee. This is the bank´s only deviation from the Guidelines. At the next annual general meeting the Board of Directors (hereinafter “the Board”) will make a proposal to task the newly elected Board to assess the benefits and disadvantages of appointing a nomination committee, consult with shareholders on the matter and form a proposal if deemed appropriate.

Applicable laws and provisions

Kvika is a financial institution which operates in accordance with the Financial Undertakings Act No. 161/2002. Acts of law which also apply to the bank’s operations include e.g. the Securities Transactions Act No. 108/2007 and Public Limited Companies Act No. 2/1995. Kvika is licensed and regulated by the Financial Supervisory Authority (hereinafter “FME“). The regulatory framework for corporate governance practices within Kvika consists of the law applicable to entities subject to the supervision of FME as well as other applicable law and regulations, including those imposed by FME or the Central bank of Iceland. For more information on FME and summary of major laws and regulations governing the operations of the bank at any given time can be found on FME´s website www.fme.is.

Statement on the Corporate Governance of Kvika banki hf. 2018

Internal control, risk management and accounting

Kvika´s risk policy and risk appetite are regularly reviewed and approved by the Board. The Board is also responsible for ensuring that an active system of internal controls is in place. The Board defines the risk factors that the bank has to address, including their nature and extent. Furthermore, the Board also defines remedial actions to the risk in question. The implementation and execution of the internal controls rests with the bank's managing directors along with control units, i.e. Risk management, Compliance and Internal Auditor. The Board hires an internal auditor. The Board further agrees to an audit plan for each year. The CEO hires a compliance officer, with the approval of the Board. The reports and findings of the internal auditor and of the compliance officer are presented directly to the Board.

The bank's internal controls are built on risk assessment and control measures, which are intended to minimize the risk that exceeds the approved risk appetite of the bank. A part of internal controls entails formal working procedures, which the control units verify compliance to.

The Board has implemented a risk policy for the bank, for a focused and effective risk management and in order to enhance transparency in the bank´s risk taking at management level, from the Board to the operational units and individuals that directly participate in the daily operations and decisions involving any risk taking.

The bank´s Finance and accounting division is responsible for preparing the bank´s annual account in accordance with the International Financial Reporting Standards (IFRS) and additional requirements in the Icelandic Financial Statement Act. The account is audited by the bank´s external auditors, Deloitte.

The CEO reports directly to the Board when verifying the effectiveness of internal control and risk management regarding the annual account. Internal audit and risk management are meant to prevent any deficiencies in the accounting process.

The Board of Kvika regularly verifies the effectiveness of internal controls and risk management in the bank.

About the Board and its sub-committees

Each year, the Annual General Meeting of Kvika elects five board members and two alternate board members. In accordance with the bank´s Equality Policy, when electing the Board, care is taken to ensure at least 40% representation of each gender among board members and alternates. Currently the Board consists of three women and two men.

The Board has a diverse background and extensive skills, experience and expertise. The CEO is appointed by the Board. Regular Board meetings are held on a monthly basis. In 2018 the Board held 20 meetings with good attendance from the board members.

The Board manages the bank between shareholder meetings in accordance with applicable laws, regulations and articles of association. The Board tends to those operations of the bank which are not considered part of the daily business. It's main duties are to supervise the operations of the bank and ensure that they are at all times in good order. The Board is responsible for Kvika´s corporate policy. The Board shall also ensure that the bank's financial matters, including the financial reporting practices are diligently supervised. The Board shall make operational plans according to the bank's purpose as set out in the Articles of Association and form a policy to achieve set goals. The Board hires the CEO of the bank and supervises his work.

The Board has appointed three qualified individuals to each sub-committee of the Board.

Members of the Board Audit Committee are Kristín Guðmundsdóttir, as chairman, Hrönn Sveinsdóttir and Inga Björg Hjaltadóttir. Its main task is to ensure the quality of the financial statement and other financial information from the bank and the independence of its auditors. The committee met nine times over the last year.

Members of the Board Risk Committee are Kristín Guðmundsdóttir, as chairman, Guðmundur Þórðarson and Kristín Pétursdóttir. The Committee's main role is 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 and advise the Board on these issues. The committee met eight times over the last year.

Members of the Board Remuneration Committee are Guðjón Reynisson, as chairman, Inga Björg Hjaltadóttir and Kristín Pétursdóttir. The Committee's main task is to advise the Board on all remuneration issues of the bank. The committee met seven times over the last year.

All sub-committees have incorporated procedural rules that are confirmed by the Board. Due to the nature of the Committee's work neither the CEO nor other employees are eligible for membership in the Committee. The procedural rules can be found on Kvika's website www.kvika.is.

The bank´s Executive Committee consists of seven people, including the CEO, Ármann Þorvaldsson; Marinó Örn Tryggvason, Deputy CEO, Magnús Ingi Einarsson, Managing Director of Finance and Operations, Bjarni Eyvinds, Managing Director of Capital Markets, Ásgeir H. Reykfjörð Gylfason, Managing Director of Corporate banking, Hannes Frímann Hrólfsson, Managing Director of Asset Management, Lilja Jensen, General Counsel and Baldur Stefánsson, Managing Director of Corporate Finance.

The CEO provides further information on rules of procedure of the board and sub-committees.

Members of the Board

Kristín Pétursdóttir serves as Chairman of the Board. She was elected to the Board in April 2018. She was born in 1965 and graduated with a Cand. Oecon degree from the University of Iceland in 1991 and an MBA degree from Handelshöyskolen in Bergen in 1993. She was one of the founders of Auður Capital and was also the CEO from 2007 to 2013 and served as Chairman of the Board from 2013 to 2017 (Auður Capital and Virðing hf. merged in 2014). She was the CEO of Mentor hf. from 2015 to 2017, worked as Managing Director of Treasury in Kaupthing from 1997 to 2005 and Deputy CEO of Kaupthing Singer & Friedlander from 2005 to 2007. From 1993-1997 she worked for Statoil, Íslandsbanki and Skeljungur. She has previously been a Board member of Ölgerðin, Tal, Yggdrasill, Kaupthing Singer & Friedlander, Viðskiptaráð, Samtök atvinnulífsins and Samtök fjármálafyrirtækja. She is currently on the board of GRID ehf. Her company, KP Capital ehf., owns an insignificant amount of shares in Kvika. She is an independent Board member.

Statement on the Corporate Governance of Kvika banki hf. 2018

Guðmundur Þórðarson was elected to the Board in March 2017. He graduated from the University of Iceland with a business degree, Cand. Oecon., in 1997. Guðmundur has focused on managing his own investments since 2007, having previously worked in the financial sector from 1997. From 1997 to 2000 he worked in Asset Management at Landsbréf hf. From 2000 to 2003 he worked in Corporate Finance at Íslandsbanki hf. From 2003 to 2007 he worked as Managing Director of Corporate Finance at Straumur fjárfestingarbanki hf. Guðmundur also sits on the boards of Hedda eignarhaldsfélag ehf., Bergstaðastræti 27 ehf., K2B fjárfestingar ehf. and BBL II ehf. Guðmundur owns no shares in Kvika but his wife owns a 100% share in K2B fjárfestingar ehf. K2B fjárfestingar ehf. and it´s subsidiary, Hedda eignarhaldsfélag ehf. together own 8,25% of shares in the bank. Furthermore, his wife serves as the Chairman of the Board of Vátryggingafélag Íslands hf. which owns 8,67% of shares in the bank.

Inga Björg Hjaltadóttir was elected to the Board in April 2013. She graduated from the University of Iceland in 1995 with a law degree, and is licensed to plead cases before the District Courts of Iceland. Inga is one of the founders of Attentus Human Resources and has worked there since 2007, while also working as an attorney at Acta Law Firm between 2006 and 2016 and at Reykjavik Law Firm from 2016. From 2003 to 2006, she was an attorney at DP Lögmenn, and served as a Department Manager at Eimskipafélag Íslands hf. from 1999 to 2003. From 1996 to 1999 she was a lawyer and later Deputy Head of Human Resources for the City of Reykjavik. Inga has previously served on the boards of Límtré Vírnet hf., E-Farice ehf., eignarhaldsfélagið Smellinn hf. and the audit committe of the City of Reykjavík, Reykjavík Energy, Strætó BS, Malbikunarstöðinn Höfði, the Associated Icelandic Ports, Sorpa BS., Reykjavík Social Housing and the Reykjavík Fire Department. She also serves as a judge on the Labour Court, appointed by the Minister of Finance, and heads the Remuneration Committee of the City of Reykjavík. Inga does not own shares in Kvika and is an independent Board member.

Hrönn Sveinsdóttir was elected to the Board in March 2017. She graduated from the University of Iceland with a business degree, Cand. Oecon., in 1992. Hrönn serves as Managing Director of Finance and Operations of Sýn hf. Hrönn joined Sýn hf. in 2005 as Managing Director of Finance. Hrönn previously worked for Toyota Iceland (P. Samúelsson hf.) from 1992, starting as Head of Finance and Accounting before taking on the role of Managing Director of Finance and Human Resources in 1999. Hrönn has served on the boards of various firms such as Almenni lífeyrissjóðurinn, Húsasmiðjan hf., Farice ehf., P/F Kall in the Faroe Islands, ISNIC, Mamma ehf., Ódýra símafélagið and P. Samúelsson hf. Hrönn does not own shares in Kvika and is an independent Board member.

Guðjón Reynisson was elected to the Board in april 2018. He was born in 1963 and works as an independent Investor and Board member. He was the CEO of Hamleys of London from 2008 to 2017. From 2003 to 2007 he was the Managing Director of the 10-11 stores in Iceland. From 1998 to 2003 he was the Managing Director of the Sales Divison of Tal, an Icelandic phone company. He graduated with an MBA degree from the University of Iceland in 2002. He graduated with an Operations and Business degree from the Continuing Education Study of the University of Iceland in 1999 and also graduated with a degree as a licensed physical education teacher from the University of Iceland in 1986. He has been on the board of Festi hf. from 2014. He owns an insignificant amount of shares in Kvika. He is an independent Board member.

Alternate Board members are Kristín Guðmundsdóttir and Pétur Guðmundarson. Both are considered independent from Kvika.

Annual Performance Assessment

The board must annually evaluate its work and performance for the previous year. The focus of the assessment is on strategic planning, disclosure and future vision, the size and composition of the Board, performance of Board members, the work of sub-committees and performance of the CEO. The development of the bank and adherence to Board policies is reviewed and assessed. Following the annual performance assessment, the Board defines tasks in areas where improvement is called for.

Chief Executive Officer

Ármann Þorvaldsson was appointed CEO of Kvika in June 2017. He was born in 1968 and has worked in the financial sector for over twenty years. From 1997 until 2005 he was Head of Corporate Finance at Kaupthing and from 2005 until 2008 he was CEO of Kaupthing Singer & Friedlander in London. Later he worked at Ortus Secured Finance in London until 2015 when he joined Virðing hf. He headed up Virðing´s Corporate Finance division before joining Kvika. He has an MBA degree from Boston University and a BA degree in history from the University of Iceland.

The CEO is in charge of the daily operations of the bank and shall in this respect observe the policy and directions of the Board. Daily operations do not include measures which are unusual or extraordinary. The CEO shall provide the Board with reports on the bank’s operations and financial position and all important issues which may affect the bank’s operations and finances. The CEO shall adhere to the instructions of the Board and provide the bank´s external auditors with all requested information.

Information on violations of laws and regulations

Kvika 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.

Communications between the shareholders and the Board

Information is provided to shareholders on equality basis and is mainly limited to shareholders’ meetings or delivery of uniform information to all shareholders simultaneously. News from the bank’s operations are routinely published on the bank’s website and press releases are sent out as necessary when newsworthy events take place. Inside information is published simultaneously to all market participants in accordance with Icelandic law through GlobeNewswire. A thorough presentation of the bank’s operations takes place at the Annual General Meeting of the bank and information on all aspects of the bank operations are published in the bank annual accounts and financial statements.

This statement on the corporate governance practices of Kvika banki hf. was reviewed and agreed upon by the Board on 28 February 2019.

Non-Financial Information

Kvika is a specialised bank focusing on asset management and investment services.

Long-term thinking is important since solid business relationships develop over a long period. Kvika places an emphasis on providing comprehensive services to its customers and prioritising their interests.

The Bank operates for a specific target group and places an emphasis on serving its customers well. The size of the Bank enables it to adapt to its environment with the aim of maintaining returns and services to its customers. The Bank is prepared to use its infrastructure and balance sheet to bolster revenue by, for example, utilising lending procedures to lend in conjunction with others.

The return on equity is determined by the decisions that are made and decisions have to be in line with the risk appetite. Risk appetite reflects the return objectives since an emphasis is placed on utilising the equity as efficiently as possible with regard to risk. The Bank's objective is to achieve a return on equity of at least 15%. Return on equity comprises income related to the balance sheet together with commission income generated from activities that commit little equity. The Bank's policy is for dividend payments to amount to a minimum of 25% of profits, although dividend payments are subject to assessments of the opportunities offered by reinvesting profits in the Bank's operations and growth. Decisions regarding the composition of the balance sheet take into account the best utilisation of equity to generate income, although they are restricted by risk appetite and funding at any given time.

Community

The Bank's objective is to have a positive long-term impact on the community, with a particular emphasis on education. The Bank has not established a performance indicator for its performance on those matters. With a view to strengthening the educational system, Kvika has set up two incentive funds, one for vocational training students and the other for teachers. Future prosperity is founded on solid education and education is therefore increasingly considered as one of the best investments countries can make in the world. Societies that are driven by ingenuity and innovation are expected to play a leading role in the coming years. Education is also considered a fundamental element in women's struggle for equal rights, protecting children from child labour and sexual abuse, promoting human rights and democracy and supporting the protection of the environment.

Kvika realises that it can have the greatest impact on the community by focusing on the areas that relate to the Bank's activities. In the Bank's corporate social responsibility policy, a particular emphasis is placed on having a positive impact on the development and functionality of financial markets. In this context the Bank strives to find ways to better mobilise investors in Iceland, by developing more diversified investment options both for those who are already involved in the securities market as well as new investors. This emphasis is very much in line with the Bank's long-term vision value, which serves as a guiding principle in the Bank's decision-making going forward.

Kvika is the main partner of UNICEF in Iceland in the field of Banking services and the Global Parents programme. Kvika also supports various causes, which promote more positive social development through small grants.

Environment

Kvika places an emphasis on minimising the negative effects which the operations of the Bank may have on the environment and applies numerous remedies to save energy in the headquarters of the Bank, limit unnecessary printing and recycle. Employees are also encouraged to use eco-friendly modes of transport and to use teleconferencing equipment as much as possible instead of travelling. As Kvika does not consider environmental factors to be a particular risk in the activities of the Bank, Kvika has not established measurable environmental performance indicators.

Human resources and human rights

Kvika's policy is for the Bank to be an attractive workplace where all employees are given equal opportunities by preventing any kind of discrimination. The Bank's value is long-term thinking and an emphasis is placed on guaranteeing professionalism in all our dealings and ensuring that all decisions take into account the values of the Bank.

To support the above, the Bank has established, among other things, a human resources policy, non-discrimination policy, rules regarding Kvika's counter contribution for parental leave and a policy and response plan for cases of harassment, bullying and violence. Moreover, Kvika encourages and supports regular exercise among its staff.

To measure our performance and whether established targets are met, opinion polls are conducted annually among our staff to evaluate, among other things, job satisfaction, stress, equal rights, the equilibrium between working and private life, harassment, bullying and violence. Employees are also offered an annual health check at the expense of the Bank.

Corruption and bribery

Because Kvika is a financial undertaking there is a considerable risk that attempts may be made to use the Bank for money laundering and the funding of terrorism. Kvika has established rules regarding measures against money laundering and terrorist financing, which fulfil the requirements placed on financial undertakings in this field, both domestically and globally. Kvika's Compliance Officer monitors the customers of the Bank on a regular and case-by-case basis and keeps track of their transfers, money withdrawals etc. with a view to detect any unusual behaviour and prevent any money laundering and terrorist financing.

Moreover, Kvika employees are not permitted to accept or give any gifts, incentive payments or any kind of recompense which could undermine the credibility of the Bank and could lead to conflicts of interest. Kvika has set itself rules regarding gifts, incentive payments and recompenses, which stipulate that an authorisation must be sought from the managing director or CEO before accepting any benefits of this kind and which impose an obligation to notify the Compliance Officer. The Compliance Officer keeps a record of all notifications. A breach of the rules can result in a warning being issued or, as the case may be, dismissal from work.

Performance indicators

Kvika is yet to finalise establishment of measurable non-financial performance indicators to monitor how the Bank's operations affect the society, community and environment and a reporting process for compliance with its policies concerning non-financial indicators. Kvika will continue its work to establish such indicators and reporting process in the year 2019.