

Interim Consolidated Financial Statements

1 January - 31 March 2016

Unaudited

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ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The Interim Financial Statements of Arion Bank for the period from 1 January to 31 March 2016 include the Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Outlook

Iceland's economic indicators continue to be strong. Economic growth was 4.0% in 2015, inflation continues to be below the Central Bank's inflation target and unemployment was 3.8% in March. Arion Research forecasts that economic growth will remain strong. Inflation, however, is expected to rise and peak at 4.5% in Q2 2017.

The long-awaited currency auction releasing offshore ISK and the first steps towards lifting the capital controls are both scheduled to take place before this autumn's general election.

The Bank's objective is to further diversify its funding as access to the international capital markets continues to improve.

Arion Bank has acquired all shares in the insurance company Vörður, which is the fourth largest insurance company in Iceland. The acquisition is subject to regulatory approval and the Bank expects a final decision on this matter to have been made by the autumn.

Kaupthing ehf., now a holding company, has expressed its interest in selling its 87% shareholding in Arion Bank, held by its subsidiary Kaupskil ehf. A formal sales process is expected to begin shortly in cooperation between Kaupthing and the Bank.

Operations during the period

Net earnings amounted to ISK 2,883 million for the period ended 31 March 2016, and the Group's equity amounted to ISK 204,661 million at the end of the period. The capital ratio of the Group, based on the reported capital base at 31 March 2016, was 27.0% and the corresponding Tier 1 ratio was 26.2%. According to the Financial Undertakings Act No. 161/2002 the official capital ratio shall be based on the audited or reviewed capital base. Since the interim financial statements for the first three months are not audited the official capital ratio is based on audited capital base at year end 2015 and risk weighted assets at 31 March 2016. The official capital ratio at 31 March 2016 was 26.6% and the Tier 1 ratio was 25.8%, which comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also strong at period end and well above the regulatory minimum.

One of Arion Bank's main tasks in recent years has been to improve the quality of its loan portfolio and to reduce the amount of problem loans. The Bank has succeeded in this respect as the distribution of loans between individuals and companies is satisfactory and the ratio of problem loans has decreased to 2.1%.

In January, the subsidiary BG12 slhf. sold its entire shareholding in Bakkavor Group Ltd. The main effect from the sale was recognized as a valuation change in the Statement of Comprehensive Income in 2015. During the first quarter of 2016 the total effect through the Statement of Comprehensive Income was ISK 498 million.

The main change on the Balance Sheet from year end 2015 is related to the funding of the Bank, i.e. the issue of bonds. This has resulted in an increase in liquid assets and Loans to customers on the assets side and a decrease in Deposits on the liabilities side. Loans to customers increased by ISK 13,654 million during the period. The increase is mainly related to new lending in the fishing industry, wholesale and retail trade and the real estate sector.

In January Arion Bank reached an agreement with Kaupthing under which Arion Bank issued a bond in the amount of USD 747.8 million (ISK 97 billion). The bond was issued under Arion Bank's EMTN programme and is a 7-year instrument, callable on interest payment dates during the first two years. The bond bears floating LIBOR plus 2.6% interest for the first two years and will then be repriced at market terms. The bond offsets loans in foreign currency, taken by Arion Bank from the Central Bank of Iceland and later purchased by Kaupthing, and Kaupthing deposits in foreign currency at Arion Bank. The bond issue forms part of the capital control liberalization process relating to Kaupthing, first announced by the Ministry of Finance and Economic Affairs on 8 June 2015.

In April Arion Bank issued a total of EUR 300 million (ISK 42 billion) in new senior unsecured bonds. Orders totaling over EUR 500 million from more than 70 investors were received. The 3-year bonds have a fixed coupon of 2.50% and were sold at rates corresponding to a 2.70% margin over interbank rates. This represents the second euro benchmark issue by Arion Bank. Part of the new issuance, ISK 31 billion, was used to partially prepay the EMTN bond held by Kaupthing.

In 2016 the Bank started to issue privately placed bonds under its EMTN programme. This is an important step for the Bank to diversify its funding. Arion Bank will continue the issuance of private placements depending on market conditions and funding needs.

Arion Bank continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. In the first three months of 2016 the Bank issued a total of ISK 12.4 billion of covered bonds in the domestic market, of which ISK 4.6 billion were inflation-linked bonds and ISK 7.8 billion were fixed rate bonds. Arion Bank will continue to issue covered bonds on a regular basis on the domestic market in 2016.

ENDORSEMENT AND STATEMENT BY THE BOARD OF DIRECTORS AND THE CEO

The Group had 1,163 full-time equivalent positions at the end of the period compared with 1,147 at the end of 2015; 884 of these positions were at Arion Bank, compared with 876 at the end of 2015.

Group ownership

On behalf of its creditors Kaupthing ehf., through its subsidiary Kaupskil ehf., holds 87% of the shares in Arion Bank hf. The remaining shareholding of 13% is held by Icelandic State Financial Investments on behalf of the Icelandic government.

The Board of Directors has seven members, four women and three men. The ratio of men to women is therefore in compliance with the law which states that companies with more than 50 people should ensure that the ratio of either sex on the board of directors should not be less than 40%. Six Directors are appointed by Kaupskil ehf. and one by Icelandic State Financial Investments.

Endorsement of the Board of Directors and the Chief Executive Officer

The Interim Financial Statements of Arion Bank for the period ended 31 March 2016 have been prepared in accordance with International Financial Reporting Standards (IAS 34 Interim Financial Statements) as adopted by the European Union and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions.

It is our opinion that the Interim Financial Statements give a true and fair view of the financial performance of the Group for the period ended 31 March 2016 and its financial position as at 31 March 2016.

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

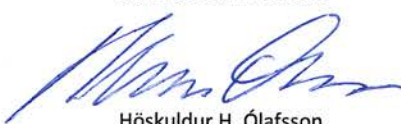
The Board of Directors and the CEO have today discussed the Interim Financial Statements of Arion Bank for the period ended 31 March 2016 and confirm them by means of their signatures.

Reykjavík, 11 May 2016

Board of Directors

 Benedikt Olgeirsson	 Monica Caneman Chairman	 Måns Höglund
 Brynjólfur Bjarnason	 Guðrún Johnsen	 Póra Hallgrímsdóttir
	 Kírstín Þ. Flygenring	

Chief Executive Officer


Höskuldur H. Ólafsson

INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE PERIOD FROM 1 JANUARY TO 31 MARCH 2016

	Notes	2016 1.1. -31.3.	2015 1.1. -31.3.
Interest income		14,870	11,644
Interest expense		(7,597)	(5,861)
Net interest income	5	7,273	5,783
Fee and commission income		5,240	5,057
Fee and commission expense		(2,021)	(1,300)
Net fee and commission income	6	3,219	3,757
Net financial income	7	(301)	7,539
Share of profit of associates	23	677	4,211
Other operating income	8	1,235	491
Operating income		12,103	21,781
Salaries and related expense	9	(4,108)	(3,492)
Other operating expense	10	(3,234)	(2,896)
Bank levy	11	(742)	(730)
Net impairment	12	(503)	1,782
Earnings before tax		3,516	16,445
Income tax expense	13	(737)	(1,720)
Net earnings from continuing operations		2,779	14,725
Net gain from discontinued operations, net of tax	14	104	183
Net earnings		2,883	14,908
Other comprehensive income			
Net gain on AFS financial assets, net of tax		(188)	-
Exchange difference on translating foreign subsidiaries	31	72	(5)
Net other comprehensive income to be reclassified to profit or loss in subsequent periods		(116)	(5)
Total comprehensive income		2,767	14,903
Attributable to			
Shareholders of Arion Bank		2,368	14,864
Non-controlling interest		399	44
Total comprehensive income		2,767	14,908
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	16	1.13	7.34

The notes on pages 10 to 54 are an integral part of these Interim Financial Statements.

INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 2016

Assets	Notes	31.3.2016	31.12.2015
Cash and balances with Central Bank	16	70,218	48,102
Loans to credit institutions	17	91,672	87,491
Loans to customers	18	694,004	680,350
Financial instruments	19-21	132,729	133,191
Investment property	21	6,382	7,542
Investments in associates	23	896	27,299
Intangible assets	24	9,153	9,285
Tax assets	25	209	205
Other assets	26	23,343	17,578
Total Assets		<u>1,028,606</u>	<u>1,011,043</u>
Liabilities			
Due to credit institutions and Central Bank	20	11,288	11,387
Deposits	20	433,228	469,347
Financial liabilities at fair value	20	9,577	7,609
Tax liabilities	25	4,722	4,922
Other liabilities	27	44,669	49,461
Borrowings	20,28	310,540	256,058
Subordinated liabilities	20,29	9,921	10,365
Total Liabilities		<u>823,945</u>	<u>809,149</u>
Equity			
Share capital and share premium	31	75,861	75,861
Other reserves	31	4,432	4,548
Retained earnings		114,861	112,377
Total Shareholders' Equity		<u>195,154</u>	<u>192,786</u>
Non-controlling interest		9,507	9,108
Total Equity		<u>204,661</u>	<u>201,894</u>
Total Liabilities and Equity		<u>1,028,606</u>	<u>1,011,043</u>

The notes on pages 10 to 54 are an integral part of these Interim Financial Statements.

INTERIM CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE PERIOD FROM 1 JANUARY TO 31 MARCH 2016

	Share capital and share premium	Other reserves	Retained earnings	Total share- holders' equity	Non- controlling interest	Total equity
Equity 1 January 2016	75,861	4,548	112,377	192,786	9,108	201,894
Net earnings	-	-	2,484	2,484	399	2,883
Other comprehensive income	-	(116)	-	(116)	-	(116)
Total comprehensive income	-	(116)	2,484	2,368	399	2,767
Equity 31 March 2016	<u>75,861</u>	<u>4,432</u>	<u>114,861</u>	<u>195,154</u>	<u>9,507</u>	<u>204,661</u>
Equity 1 January 2015	75,861	1,632	83,218	160,711	1,501	162,212
Net earnings	-	-	14,864	14,864	44	14,908
Other comprehensive income	-	(5)	-	(5)	-	(5)
Total comprehensive income	-	(5)	14,864	14,859	44	14,903
Equity 31 March 2015	<u>75,861</u>	<u>1,627</u>	<u>98,082</u>	<u>175,570</u>	<u>1,545</u>	<u>177,115</u>

The notes on pages 10 to 54 are an integral part of these Interim Financial Statements.

INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 31 MARCH 2016

	2016	2015
	1.1.-31.3.	1.1.-31.3.
Operating activities		
Net earnings	2,883	14,908
Non-cash items included in net earnings and other adjustments	(5,569)	(16,599)
Changes in operating assets and liabilities	(2,995)	74,942
Interest received	11,381	10,116
Interest paid	(4,035)	(2,643)
Dividend received	203	44
Income tax paid	(967)	(581)
Net cash from operating activities	<u>901</u>	<u>80,187</u>
Investing activities		
Acquisition of associates	-	(13)
Proceeds from sale of associates	27,080	1,379
Acquisition of intangible assets	(214)	(193)
Acquisition of property and equipment	(356)	(84)
Proceeds from sale of property and equipment	210	2
Net cash from investing activities	<u>26,720</u>	<u>1,091</u>
Financing activities		
Payment of subordinated liabilities	-	(10,315)
Net cash used in financing activities	<u>-</u>	<u>(10,315)</u>
Net increase in cash and cash equivalents	27,621	70,963
Cash and cash equivalents at beginning of the year	110,000	91,715
Effect of exchange rate changes on cash and cash equivalents	(1,848)	1,076
Cash and cash equivalents	<u>135,773</u>	<u>163,754</u>
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	411	232
Settlement of loans through foreclosure on collateral from customers with view to resale	(411)	(232)

The notes on pages 10 to 54 are an integral part of these Interim Financial Statements.

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE PERIOD FROM 1 JANUARY TO 31 MARCH 2016

	2016 1.1.-31.3.	2015 1.1.-31.3.
Non-cash items included in net earnings and other adjustments		
Net interest income	(7,273)	(5,783)
Net impairment	503	(1,782)
Income tax expense	737	1,720
Bank levy	742	730
Net foreign exchange loss (gain)	142	(308)
Net loss (gain) on financial instruments	362	(7,187)
Depreciation and amortisation	424	444
Share of profit of associates and fair value change	(677)	(4,211)
Investment property, fair value change	(25)	-
Net gain from discontinued operations, net of tax	(104)	(183)
Other changes	(400)	(39)
Non-cash items included in net earnings and other adjustments	(5,569)	(16,599)
Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	608	344
Loans to credit institutions, excluding bank accounts	(1,224)	12,730
Loans to customers	(14,472)	4,789
Financial instruments and financial liabilities at fair value	256	907
Investment property	1,533	(1,034)
Other assets	(1,108)	(607)
Due to credit institutions and Central Bank	(98)	(2,392)
Deposits	(37,743)	10,907
Borrowings	56,867	48,180
Other liabilities	(7,614)	1,118
Changes in operating assets and liabilities	(2,995)	74,942
Cash and cash equivalents		
Cash and demand deposits	70,218	63,575
Due from credit institutions	77,582	108,770
Mandatory reserve with Central Bank	(12,027)	(8,591)
Cash and cash equivalents	135,773	163,754

The notes on pages 10 to 54 are an integral part of these Interim Financial Statements.

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NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

GENERAL INFORMATION

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Interim Financial Statements for the period ended 31 March 2016 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Interim Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standard, IAS 34 Interim Financial Reporting, as adopted by the European Union and additional requirements in the Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions. The Interim Financial Statements do not include all the information and disclosures required in the Annual Financial Statements, and should be read in conjunction with Arion Bank's Annual Financial Statements for the year 2015. The statements are available at Arion Bank's website www.arionbanki.is.

The Interim Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 11 May 2016.

Basis of measurement

The Interim Financial Statements are prepared on the historical cost basis except for the following:

- financial assets and financial liabilities held for trading are measured at fair value;
- financial assets and financial liabilities at fair value are measured at fair value;
- financial assets classified as available-for-sale are measured at fair value;
- investment properties are measured at fair value; and
- non-current assets and disposal groups classified as held for sale are stated at the lower of their carrying amount and fair value, less costs to sell.

Functional and presentation currency

The Interim Financial Statements are presented in Icelandic Krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the period the exchange rate of the ISK against the USD was 123.37 and 140.42 for the EUR (31.12.2015: USD 130.08 and EUR 141.28).

2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Interim Financial Statements 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.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

The key sources of estimation uncertainty are within impairment losses and reversal of impairment losses on loans.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

3. The Group

Shares in main subsidiaries in which Arion Bank held a direct interest at the end of the period

	Operating activity	Currency	Equity interest	
			31.3.2016	31.12.2015
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland	Retail banking	ISK	100.0%	100.0%
BG12 slhf., Katrínartún 2, Reykjavík, Iceland	Holding company	ISK	62.0%	62.0%
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Eignarhaldsfélagið Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland	Real estate	ISK	100.0%	100.0%
Kolufell ehf., Borgartún 19, Reykjavík, Iceland	Real estate	ISK	68.9%	68.9%
Okkar líftryggingar hf., Laugavegur 182, Reykjavík, Iceland	Life insurance	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjörður, Iceland	Payment solutions	ISK	100.0%	100.0%

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

OPERATING SEGMENT REPORTING

Segment information is presented in respect of the Group's operating segments based on the Group's management and internal reporting structure. Segment performance is evaluated based on earnings before tax. In presenting the geographic information, segment revenue has been based on the geographic location of customers.

Inter segment pricing is determined on an arm's length basis. Operating segments pay and receive interest to and from Treasury on an arm's length basis to reflect the allocation of capital, funding cost and relevant risk premium.

Operating segments

The Group comprises the following operating segments:

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

Corporate Banking provides comprehensive financial services and customized solutions to larger corporate clients in Iceland. Corporate Banking provides a full range of conventional lending products, deposit accounts as well as value added electronic corporate solutions to meet the needs of each customer.

Investment Banking is divided into Corporate Advisory, Capital Markets and Research. Corporate Advisory advises customers on securities offerings and the admission of securities for trading on regulated securities markets and also provides M&A advisory services. Capital Markets handles securities brokerage and foreign exchange trading for the Bank's customers. Research publishes regular analyses of listed securities, the major business sectors, markets and the Icelandic economy and also produces economic forecasts. Investment Banking's customers are private individuals, companies and institutions. Investment Banking is responsible for the holding companies BG12 slhf., EAB 1 ehf. and Kolufell ehf.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of services. This includes among other deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into five clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Retail Banking's 23 branches all around Iceland have a total of more than 100,000 customers.

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

Other divisions and Subsidiaries include market making in domestic securities and currencies. The subsidiaries are Eignarhaldsfélagið Landey ehf., Okkar líftryggingar hf., Valitor Holding hf. and other smaller entities of the Group.

Headquarters include Overhead, Risk Management, Finance (excluding Treasury), Legal and Operations.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

4. Operating segments

	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub- sidiaries	Head- quarters and Elimination	Total
1.1.-31.3.2016								
Net interest income	157	1,585	832	4,028	642	176	(147)	7,273
Net fee and commission income	949	256	324	721	(114)	916	167	3,219
Net financial income	7	9	(115)	27	(5)	128	(352)	(301)
Share of profit of associates	-	1	498	-	-	214	(36)	677
Other operating income	5	-	321	4	5	877	23	1,235
Operating income	1,118	1,851	1,860	4,780	528	2,311	(345)	12,103
Operating expense	(389)	(162)	(337)	(1,335)	(50)	(1,790)	(3,279)	(7,342)
Bank levy	-	-	-	-	-	-	(742)	(742)
Net impairment	-	194	1,324	(1,993)	-	(25)	(3)	(503)
Earnings before tax	729	1,883	2,847	1,452	478	496	(4,369)	3,516
Net seg. rev. from ext. customers	477	3,619	1,672	7,016	(2,984)	2,547	(244)	12,103
Net seg. rev. from other segments	641	(1,768)	188	(2,236)	3,512	(236)	(101)	-
Operating income	1,118	1,851	1,860	4,780	528	2,311	(345)	12,103
Depreciation and amortisation	-	-	-	78	-	156	190	424
31.3.2016								
Total assets	5,884	250,275	62,904	448,547	203,110	50,166	7,720	1,028,606
Total liabilities	1,027	194,242	22,114	396,514	182,122	30,615	(2,689)	823,945
Allocated equity	4,857	56,033	40,790	52,033	20,988	19,551	10,409	204,661
1.1.-31.3.2015								
Net interest income	94	1,475	(1)	3,265	875	61	14	5,783
Net fee and commission income	889	219	783	712	(32)	1,011	175	3,757
Net financial income	95	-	6,564	86	(143)	252	685	7,539
Share of profit of associates	-	-	304	-	-	414	3,493	4,211
Other operating income	2	-	39	2	-	338	110	491
Operating income	1,080	1,694	7,689	4,065	700	2,076	4,477	21,781
Operating expense	(373)	(127)	(204)	(1,377)	(64)	(1,337)	(2,906)	(6,388)
Bank levy	-	-	-	-	-	-	(730)	(730)
Net impairment	-	1,332	1,344	(463)	11	(439)	(3)	1,782
Earnings before tax	707	2,899	8,829	2,225	647	300	838	16,445
Net seg. rev. from ext. customers	656	3,059	7,861	6,143	(2,630)	2,195	4,497	21,781
Net seg. rev. from other segments	424	(1,365)	(172)	(2,078)	3,330	(119)	(20)	-
Operating income	1,080	1,694	7,689	4,065	700	2,076	4,477	21,781
Depreciation and amortisation	-	-	-	71	-	174	199	444
31.3.2015								
Total assets	5,151	230,701	53,241	416,131	215,406	59,038	24,656	1,004,324
Total liabilities	416	176,989	30,036	368,317	203,129	34,442	13,880	827,209
Allocated equity	4,735	53,712	23,205	47,814	12,277	24,596	10,776	177,115

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

4. Operating segments, continued

Geographic information

	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
1.1.-31.3.2016							
Net interest income	7,715	290	43	(999)	201	23	7,273
Net fee and commission income	1,315	379	115	1,401	7	2	3,219
Net financial income	(115)	(30)	(114)	(44)	3	(1)	(301)
Share of profit of associates	179	-	498	-	-	-	677
Other income	1,235	-	-	-	-	-	1,235
Operating income	10,329	639	542	358	211	24	12,103
1.1.-31.3.2015							
Net interest income	5,718	160	(1)	(91)	2	(5)	5,783
Net fee and commission income	2,776	215	98	664	3	1	3,757
Net financial income	4,784	29	(3)	2,644	75	10	7,539
Share of profit of associates	4,211	-	-	-	-	-	4,211
Other income	491	-	-	-	-	-	491
Operating income	17,980	404	94	3,217	80	6	21,781

Discontinued operations are excluded from the profit and loss segment information.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

5. Net interest income

	2016 1.1.-31.3.	2015 1.1.-31.3.
<i>Interest income</i>		
Cash and balances with Central Bank	265	142
Loans	13,110	10,509
Securities	1,328	832
Other	167	161
Interest income	14,870	11,644
<i>Interest expense</i>		
Deposits	(4,139)	(3,147)
Borrowings	(3,349)	(2,394)
Subordinated liabilities	(95)	(306)
Other	(14)	(14)
Interest expense	(7,597)	(5,861)
Net interest income	7,273	5,783
Net interest income from assets and liabilities at fair value	1,328	832
Interest income from assets not at fair value	13,542	10,812
Interest expense from liabilities not at fair value	(7,597)	(5,861)
Net interest income	7,273	5,783
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	3.1%	2.6%

6. Net fee and commission income

	1.1.-31.3.2016			1.1.-31.3.2015		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	1,021	(73)	948	1,011	(72)	939
Cards	3,141	(1,832)	1,309	2,490	(1,101)	1,389
Collection and payment services	335	(15)	320	329	(20)	309
Investment banking	181	(12)	169	675	(10)	665
Lending and guarantees	387	-	387	307	-	307
Other	175	(89)	86	245	(97)	148
Net fee and commission income	5,240	(2,021)	3,219	5,057	(1,300)	3,757

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

7. Net financial income

	2016 1.1.-31.3.	2015 1.1.-31.3.
Dividend income	203	44
Net gain (loss) on financial assets and financial liabilities classified as held for trading	361	(56)
Net (loss) gain on financial assets and financial liabilities designated at fair value through profit or loss	(723)	7,243
Net foreign exchange (loss) gain	(142)	308
Net financial income	(301)	7,539
<i>Net (loss) gain on financial assets and financial liabilities designated at fair value through profit or loss</i>		
Equity instruments designated at fair value	(536)	7,214
Interest rate instruments designated at fair value	(187)	29
Net (loss) gain on financial assets and financial liabilities designated at fair value through profit or loss	(723)	7,243

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

8. Other operating income	2016 1.1.-31.3.	2015 1.1.-31.3.
Fair value changes on investment property	25	39
Realised gain on investment property	348	-
Earned premiums, net of reinsurance	289	244
Other income	573	208
Other operating income	1,235	491

9. Personnel and salaries

Number of employees

Average number of full time equivalent positions during the period	1,150	1,113
Full time equivalent positions at the end of the period	1,163	1,112

The Bank's number of employees

Average number of full time equivalent positions during the period	878	852
Full time equivalent positions at the end of the period	884	848

Salaries and related expense

Salaries	3,198	2,688
Defined contribution pension plans	458	384
Salary related expense	452	420
Salaries and related expense	4,108	3,492

Salaries and related expense for the Bank

Salaries	2,397	1,991
Defined contribution pension plans	343	291
Salary related expense	364	301
Salaries and related expense	3,104	2,583

During the period the Group made a provision of ISK 109 million (Q1 2015: ISK 44 million) for performance plan payments, including salary related expense, thereof the Bank made a provision of ISK 104 million (Q1 2015: ISK 15 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for financial undertakings. At the end of the period the Group's accrual for performance plan payments amounts to ISK 907 million (31.12.2015: ISK 1,056 million), thereof the Bank's accrual amounts to ISK 772 million (31.12.2015: ISK 852 million).

10. Other operating expense	2016 1.1.-31.3.	2015 1.1.-31.3.
Administration expense	2,431	2,143
Depositors' and investors' guarantee fund	220	217
Depreciation of property and equipment	216	173
Amortisation of intangible assets	208	271
Claims incurred, net of reinsurance	144	74
Other expense	15	18
Other operating expense	3,234	2,896

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

11. Bank levy

The Bank levy is 0.376% on total debt excluding tax liabilities, in excess of ISK 50 billions. Non-financial subsidiaries are exempt from this tax. The tax is assessed on financial institutions to meet the funding of a special index and interest relief provided to individual tax payers.

12. Net impairment

	2016	2015
	1.1.-31.3.	1.1.-31.3.
Increase in book value of loans to corporates	1,557	1,959
Increase in book value of loans to individuals	643	398
Net change in impairment of loans to corporates	(827)	394
Net change in impairment of loans to individuals	(1,846)	(941)
Net change in collective impairment on loans	(30)	(3)
Impairment of intangible assets	-	(25)
Net impairment	(503)	1,782

13. Income tax expense

Current tax expense	929	1,224
Deferred tax expense	(192)	496
Income tax expense	737	1,720

<i>Reconciliation of effective tax rate</i>	1.1.-31.3.2016		1.1.-31.3.2015	
Earnings before tax		3,516		16,445
Income tax using the Icelandic corporation tax rate	20.0%	703	20.0%	3,289
Additional 6% tax on financial institutions	4.6%	162	2.0%	334
Non-deductible expenses	0.8%	29	0.0%	3
Tax exempt revenue	(7.7%)	(272)	(13.9%)	(2,291)
Non-deductible taxes	4.2%	148	0.9%	146
Other changes	(0.9%)	(33)	1.5%	239
Effective tax rate	21.0%	737	10.5%	1,720

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

14. Net gain from discontinued operations, net of tax

	2016	2015
	1.1.-31.3.	1.1.-31.3.
Income from real estates and other assets	199	249
Expense related to real estates and other assets	(95)	(66)
Net gain from discontinued operations, net of tax	104	183

15. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2016	2015	2016	2015
	1.1.-31.3.	1.1.-31.3.	1.1.-31.3.	1.1.-31.3.
Net earnings attributable to the shareholders of Arion Bank	2,264	14,681	2,368	14,864
Weighted average number of outstanding shares for the period, million	2,000	2,000	2,000	2,000
Basic earnings per share	1.13	7.34	1.18	7.43

There were no instruments at the end of the period that could potentially dilute basic earnings per share (31.12.2015: none).

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

NOTES TO THE INTERIM CONSOLIDATED STATEMENT OF FINANCIAL POSITION

16. Cash and balances with Central Bank	31.3.2016	31.12.2015
Cash on hand	5,925	4,921
Cash with Central Bank	52,266	30,546
Mandatory reserve deposit with Central Bank	12,027	12,635
Cash and balances with Central Bank	70,218	48,102

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

17. Loans to credit institutions

Bank accounts	77,582	74,533
Money market loans	12,359	7,976
Other loans	1,731	4,982
Loans to credit institutions	91,672	87,491

18. Loans to customers

31.3.2016	Individuals	Corporates	Total
Overdrafts	17,465	24,463	41,928
Credit cards	10,403	1,113	11,516
Mortgage loans	272,279	13,607	285,886
Other loans	35,247	343,918	379,165
Provision on loans	(11,926)	(12,565)	(24,491)
Loans to customers	323,468	370,536	694,004
31.12.2015			
Overdrafts	16,840	24,248	41,088
Credit cards	10,842	1,054	11,896
Mortgage loans	271,895	12,889	284,784
Other loans	38,058	334,849	372,907
Provision on loans	(13,016)	(17,309)	(30,325)
Loans to customers	324,619	355,731	680,350

The total book value of pledged loans that were pledged against amounts borrowed was ISK 146 billion at the end of the period (31.12.2015: ISK 199 billion). At the end of the period pledged loans comprised mortgage loans to individuals. At year end 2015 pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies.

Further analysis of loans is provided in Risk Management Disclosures.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

18. Loans to customers, continued

Changes in the provision for losses on loans to customers

	Specific	Collective	Total
1.1.-31.3.2016			
Balance at the beginning of the year	25,341	4,984	30,325
Provision for losses	2,673	30	2,703
Write-offs	(8,569)	-	(8,569)
Payment of loans previously written off	32	-	32
Balance at the end of the period	19,477	5,014	24,491
1.1.-31.3.2015			
Balance at the beginning of the year	22,214	4,467	26,681
Provision for losses	547	3	550
Write-offs	(889)	-	(889)
Payment of loans previously written off	17	-	17
Balance at the end of the period	21,889	4,470	26,359

Significant accounting estimates and judgements

Key sources of estimation uncertainty are impairment losses on loans.

The Group reviews its loan portfolios to assess impairment at least quarterly as further described in Note 54 in the Annual Financial Statements for 2015. The specific component of the total allowance for impairment applies to financial assets evaluated individually for impairment and is based on management's best estimate of the present value of the cash flows that are expected to be received. In estimating these cash flows, management makes judgements about a debtor's financial situation and the net realisable value of any underlying collateral. Each impaired asset is assessed on its merits, the workout strategy and estimate of cash flows considered recoverable are independently reviewed by the Credit Risk function.

19. Financial instruments

	31.3.2016	31.12.2015
Bonds and debt instruments	78,567	78,794
Shares and equity instruments with variable income	34,169	35,504
Derivatives	1,970	2,401
Securities used for hedging	18,023	16,492
Financial instruments	132,729	133,191

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

20. Financial assets and financial liabilities

31.3.2016	Amortised cost	Trading	Designated at fair value	Available for sale	Total
<i>Loans</i>					
Cash and balances with Central Bank	70,218	-	-	-	70,218
Loans to credit institutions	91,672	-	-	-	91,672
Loans to customers	694,004	-	-	-	694,004
Loans	855,894	-	-	-	855,894
<i>Bonds and debt instruments</i>					
Listed	-	4,410	72,704	-	77,114
Unlisted	-	107	1,346	-	1,453
Bonds and debt instruments	-	4,517	74,050	-	78,567
<i>Shares and equity instruments with variable income</i>					
Listed	-	2,572	11,756	-	14,328
Unlisted	-	820	10,414	5,615	16,849
Bond funds with variable income, unlisted	-	1,044	1,948	-	2,992
Shares and equity instruments with variable income	-	4,436	24,118	5,615	34,169
<i>Derivatives</i>					
OTC derivatives	-	1,970	-	-	1,970
Derivatives	-	1,970	-	-	1,970
<i>Securities used for hedging</i>					
Bonds and debt instruments, listed	-	1,438	-	-	1,438
Shares and equity instruments with variable income, listed	-	16,164	-	-	16,164
Shares and equity instruments with variable income, unlisted	-	421	-	-	421
Securities used for hedging	-	18,023	-	-	18,023
Other financial assets	9,402	-	-	-	9,402
Financial assets	865,296	28,946	98,168	5,615	998,025
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank	11,288	-	-	-	11,288
Deposits	433,228	-	-	-	433,228
Borrowings	310,540	-	-	-	310,540
Subordinated liabilities	9,921	-	-	-	9,921
Liabilities at amortised cost	764,977	-	-	-	764,977
<i>Financial liabilities at fair value</i>					
Short position in bonds	-	5,635	-	-	5,635
Derivatives	-	3,942	-	-	3,942
Financial liabilities at fair value	-	9,577	-	-	9,577
Other financial liabilities	35,582	-	-	-	35,582
Financial liabilities	800,559	9,577	-	-	810,136

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

20. Financial assets and financial liabilities, continued

31.12.2015	Amortised cost	Trading	Designated at fair value	Available for sale	Total
<i>Loans</i>					
Cash and balances with Central Bank	48,102	-	-	-	48,102
Loans to credit institutions	87,491	-	-	-	87,491
Loans to customers	680,350	-	-	-	680,350
Loans	815,943	-	-	-	815,943
<i>Bonds and debt instruments</i>					
Listed	-	2,526	74,757	-	77,283
Unlisted	-	99	1,412	-	1,511
Bonds and debt instruments	-	2,625	76,169	-	78,794
<i>Shares and equity instruments with variable income</i>					
Listed	-	2,138	13,869	-	16,007
Unlisted	-	1,668	10,665	5,852	18,185
Bond funds with variable income, unlisted	-	1,090	222	-	1,312
Shares and equity instruments with variable income	-	4,896	24,756	5,852	35,504
<i>Derivatives</i>					
OTC derivatives	-	2,401	-	-	2,401
Derivatives	-	2,401	-	-	2,401
<i>Securities used for hedging</i>					
Bonds and debt instruments, listed	-	1,519	-	-	1,519
Shares and equity instruments with variable income, listed	-	14,276	-	-	14,276
Shares and equity instruments with variable income, unlisted	-	697	-	-	697
Securities used for hedging	-	16,492	-	-	16,492
Other financial assets	4,581	-	-	-	4,581
Financial assets	820,524	26,414	100,925	5,852	953,715
<i>Liabilities at amortised cost</i>					
Due to credit institutions and Central Bank	11,387	-	-	-	11,387
Deposits	469,347	-	-	-	469,347
Borrowings	256,058	-	-	-	256,058
Subordinated liabilities	10,365	-	-	-	10,365
Liabilities at amortised cost	747,157	-	-	-	747,157
<i>Financial liabilities at fair value</i>					
Short position in bonds	-	4,616	-	-	4,616
Derivatives	-	2,993	-	-	2,993
Financial liabilities at fair value	-	7,609	-	-	7,609
Other financial liabilities	38,667	-	-	-	38,667
Financial liabilities	785,824	7,609	-	-	793,433

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

20. Financial assets and financial liabilities, continued

<i>Bonds and debt instruments designated at fair value specified by issuer</i>	31.3.2016	31.12.2015
Financial and insurance activities	8,610	9,258
Public sector	58,160	59,246
Corporates	7,280	7,665
Bonds and debt instruments designated at fair value	74,050	76,169

The total amount of pledged bonds was ISK 22.4 billion at the end of the period (31.12.2015: ISK 21.5 billion). Pledged bonds comprise Icelandic and foreign Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

21. Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of assets and liabilities by valuation technique:

Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;

Level 2: valuation techniques for which all significant inputs are market observable, either directly or indirectly; and

Level 3: valuation techniques which include significant inputs that are not based on observable market data.

For assets and liabilities that are recognised at fair value on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorisation (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting period.

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

31.3.2016	Level 1	Level 2	Level 3	Total
<i>Assets at fair value</i>				
Bonds and debt instruments	32,991	45,405	171	78,567
Shares and equity instruments with variable income	13,986	14,542	5,641	34,169
Derivatives	-	1,970	-	1,970
Securities used for hedging	17,528	495	-	18,023
Investment property	-	-	6,382	6,382
Assets at fair value	64,505	62,412	12,194	139,111
<i>Liabilities at fair value</i>				
Short position in bonds	5,635	-	-	5,635
Derivatives	-	3,942	-	3,942
Liabilities at fair value	5,635	3,942	-	9,577

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Fair value hierarchy, continued

31.12.2015	Level 1	Level 2	Level 3	Total
<i>Assets at fair value</i>				
Bonds and debt instruments	32,813	45,799	182	78,794
Shares and equity instruments with variable income	14,331	15,299	5,874	35,504
Derivatives	-	2,401	-	2,401
Securities used for hedging	15,706	786	-	16,492
Investment property	-	-	7,542	7,542
Assets at fair value	62,850	64,285	13,598	140,733
<i>Liabilities at fair value</i>				
Short position in bonds	4,616	-	-	4,616
Derivatives	-	2,993	-	2,993
Liabilities at fair value	4,616	2,993	-	7,609

Transfers from Level 2 to Level 1 amounted to ISK 68 million during the period (2015: ISK 8,106 million). There have been no transfers from Level 1 to Level 2 during the period (2015: none).

The level of the fair value hierarchy of assets is determined at the end of each reporting period.

<i>Movements in Level 3 assets measured at fair value</i>	Investment property		Financial assets		Total	
	31.3.2016	31.12.2015	31.3.2016	31.12.2015	31.3.2016	31.12.2015
Balance at the beginning of the year	7,542	6,842	6,056	1,276	13,598	8,118
Net fair value changes	25	422	(232)	5,857	(207)	6,279
Additions	437	1,026	-	77	437	1,103
Disposal	(1,622)	(843)	-	(1,154)	(1,622)	(1,997)
Transfers into Level 3	-	95	-	-	-	95
Transfers out of Level 3	-	-	(12)	-	(12)	-
Balance at the end of the period	6,382	7,542	5,812	6,056	12,194	13,598

<i>Line items where effects of Level 3 assets are recognised in the Interim Statement of Comprehensive Income</i>	2016	2015
	1.1.-31.3.	1.1.-31.3.
Net interest income	2	15
Net financial income	(234)	(16)
Other operating income	373	39
Net gain on AFS financial assets, net of tax	(188)	-
Effects recognised in the Statement of Comprehensive Income	(47)	38

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Fair value hierarchy, continued

Carrying values and fair values of financial assets and financial liabilities that are not carried at fair value in the Interim Financial Statements. The table does not include the fair values of non-financial assets and non-financial liabilities.

31.3.2016	Carrying value	Fair value	Unrealised gain (loss)
<i>Financial assets not carried at fair value</i>			
Cash and balances with Central bank	70,218	70,218	-
Loans to credit institutions	91,672	91,672	-
Loans to customers	694,004	704,135	10,131
Other financial assets	9,402	9,402	-
Financial assets not carried at fair value	865,296	875,427	10,131
<i>Financial liabilities not carried at fair value</i>			
Due to credit institutions and Central bank	11,288	11,288	-
Deposits	433,228	433,228	-
Borrowings	310,540	315,362	(4,822)
Subordinated liabilities	9,921	9,921	-
Other financial liabilities	35,582	35,582	-
Financial liabilities not carried at fair value	800,559	805,381	(4,822)
31.12.2015			
<i>Financial assets not carried at fair value</i>			
Cash and balances with Central bank	48,102	48,102	-
Loans to credit institutions	87,491	87,491	-
Loans to customers	680,350	688,196	7,846
Other financial assets	4,581	4,581	-
Financial assets not carried at fair value	820,524	828,370	7,846
<i>Financial liabilities not carried at fair value</i>			
Due to credit institutions and Central bank	11,387	11,387	-
Deposits	469,347	469,347	-
Borrowings	256,058	264,839	(8,781)
Subordinated liabilities	10,365	10,365	-
Other financial liabilities	38,667	38,667	-
Financial liabilities not carried at fair value	785,824	794,605	(8,781)

Financial assets and financial liabilities predominantly bear interest at floating rates. For assets and liabilities not at floating rates fair value is determined by Level 2 methods for which the valuation input is market observable interest rates.

Retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account mortgaging. Defaulted loans are presented at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value. Other loans, including corporate loans, are presented at book value as they are generally of a shorter duration than retail mortgages and the interest rate risk on them is therefore limited.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

21. Fair value hierarchy, continued

<i>Derivatives</i>	Notional value	Fair value	
		Assets	Liabilities
31.3.2016			
Forward exchange rate agreements, unlisted	49,997	103	691
Interest rate and exchange rate agreements, unlisted	116,111	1,509	1,366
Bond swap agreements, unlisted	3,865	38	16
Share swap agreements, unlisted	13,978	316	1,759
Options - purchased agreements, unlisted	81	4	110
Derivatives	184,032	1,970	3,942
31.12.2015			
Forward exchange rate agreements, unlisted	49,435	231	287
Interest rate and exchange rate agreements, unlisted	103,369	1,948	710
Bond swap agreements, unlisted	3,811	43	28
Share swap agreements, unlisted	13,099	178	1,934
Options - purchased agreements, unlisted	66	1	34
Derivatives	169,780	2,401	2,993

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

22. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

	Assets subject to netting arrangements			Netting potential not recognized in the balance sheet		Assets after consideration of netting potential	Assets not subject to enforceable netting arrangements	Total assets recognised on balance sheet
	Gross assets before balance sheet	Balance sheet nettings with gross	Assets recognised on balance	Financial	Collateral received			
31.3.2016								
Reverse repurchase agreements	22,586	(145)	22,441	(5,972)	-	16,469	-	22,441
Derivatives	865	-	865	(705)	-	160	1,105	1,970
Total assets	23,451	(145)	23,306	(6,677)	-	16,629	1,105	24,411
31.12.2015								
Reverse repurchase agreements	22,100	(490)	21,610	(4,929)	-	16,681	-	21,610
Derivatives	964	-	964	(400)	-	564	1,437	2,401
Total assets	23,064	(490)	22,574	(5,329)	-	17,245	1,437	24,011

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the balance sheet		Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arrangements	Total liabilities recognised on balance sheet
	Gross liabilities before balance sheet	Balance sheet nettings with gross	Liabilities recognised on balance	Financial	Collateral pledged			
31.3.2016								
Repurchase agreements	5,972	-	5,972	(5,972)	-	-	-	5,972
Derivatives	1,251	-	1,251	(705)	-	546	2,691	3,942
Total liabilities	7,223	-	7,223	(6,677)	-	546	2,691	9,914
31.12.2015								
Repurchase agreements	4,929	-	4,929	(4,929)	-	-	-	4,929
Derivatives	400	-	400	(400)	-	-	2,593	2,993
Total liabilities	5,329	-	5,329	(5,329)	-	-	2,593	7,922

Accounting policies for offsetting are provided in Note 54 in the Annual Financial Statements for 2015.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

23. Investments in associates

<i>The Group's interest in its principal associates</i>	31.3.2016	31.12.2015
Auðkenni hf., Borgartún 31, Reykjavík, Iceland	22.4%	22.4%
Bakkavor Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	-	46.0%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	39.3%	39.3%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	23.0%	23.0%
Urriðaland ehf., Laugavegur 182, Reykjavík, Iceland	41.4%	41.4%
220 Fjörður ehf., Fjarðargötu 13-15, Hafnarfjörður, Iceland	38.5%	38.5%
<i>Investments in associates</i>		
Carrying amount at the beginning of the year	27,299	21,966
Acquisitions	-	262
Dividend received	-	(611)
Transfers	-	(6,458)
Disposals	(27,080)	(17,148)
Exchange difference	-	(178)
Share of profit of associates and reversal of impairment	677	29,466
Investment in associates	896	27,299

In January 2016 the Bank's subsidiary BG12 slhf. sold its entire shareholding in Bakkavor Group Ltd. The main effect related to the sale was a valuation change recognised in the Statement of Comprehensive Income in 2015. During the first quarter of 2016 the total effects from the sale through the Statement of Comprehensive Income was ISK 498 million.

The Group accounts for investments in associates based on the equity method less applicable impairment. The impairment testing uses management valuation techniques and assumptions such as EBITDA multiples. Alternative assumptions could potentially result in significantly different carrying values but the management is of the opinion that the impaired value is based on the most probable outcomes under current market conditions.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

24. Intangible assets

Intangible assets comprise four categories: Goodwill, Infrastructure, Customer relationships and related agreements and Software. Goodwill arises on the acquisition of subsidiaries. Infrastructure and Customer relationships and related agreements originate as a premium in connection with the acquisition of business activities in subsidiaries, while Software originates from the acquisition of software licenses and the introduction of the software into the Group's operations.

	Goodwill	Infra-structure	Customer relationship and related agreements	Software	Total
31.3.2016					
Balance at the beginning of the year	2,407	3,021	854	3,003	9,285
Additions and transfers	-	-	-	111	111
Additions, internally developed	-	-	-	103	103
Exchange difference	(128)	-	-	(10)	(138)
Amortisation	-	-	(52)	(156)	(208)
Intangible assets	2,279	3,021	802	3,051	9,153
31.12.2015					
Balance at the beginning of the year	2,171	3,046	1,539	2,840	9,596
Additions and transfers	506	-	(435)	530	601
Additions, internally developed	-	-	-	289	289
Exchange difference	(270)	-	(40)	(57)	(367)
Impairment	-	(25)	(2)	-	(27)
Amortisation	-	-	(208)	(599)	(807)
Intangible assets	2,407	3,021	854	3,003	9,285

25. Tax assets and tax liabilities

	31.3.2016		31.12.2015	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	3,260	-	3,272
Deferred tax	209	1,462	205	1,650
Tax assets and tax liabilities	209	4,722	205	4,922

26. Other assets

	31.3.2016	31.12.2015
Non-current assets and disposal groups held for sale	5,825	5,082
Property and equipment	6,748	6,766
Accounts receivable	3,661	2,433
Unsettled securities trading	4,120	685
Sundry assets	2,989	2,612
Other assets	23,343	17,578

Vast majority of the Non-current assets and disposal groups held for sale consist of real estates that are generally the result of foreclosures on companies and individuals.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

27. Other liabilities	31.3.2016	31.12.2015
Accounts payable	15,570	23,296
Provision for settled FX loans	2,882	2,882
Unsettled securities trading	2,191	754
Depositors' and investors' guarantee fund	2,881	2,873
Insurance claim	2,701	2,574
Withholding tax	436	1,643
Bank levy	3,559	2,811
Sundry liabilities	14,449	12,628
Other liabilities	44,669	49,461

28. Borrowings	First issued	Maturity	Maturity type	Terms of interest	31.3.2016	31.12.2015
Covered bond in ISK	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,476	4,483
Covered bond in ISK	2014	2021	At maturity	Fixed, CPI linked, 3.50%	7,611	5,096
Covered bond in ISK	2015	2022	At maturity	Fixed, 6.50%	15,391	7,737
Covered bond in ISK	2014	2029	At maturity	Fixed, CPI linked, 3.50%	17,865	15,279
Covered bond in ISK	2005	2033	Amortizing	Fixed, CPI linked, 3.75%	16,983	17,108
Covered bond in ISK	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	2,195	2,249
Covered bond in ISK	2008	2045	Amortizing	Fixed, CPI linked, 4.00%	6,181	6,182
Covered bond in ISK	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	77,893	77,916
Covered bonds					148,595	136,050
Senior unsecured bond in NOK	2013	2016	At maturity	Floating, NIBOR +5.00%	-	1,547
Senior unsecured bond in EUR	2009	2018	Amortizing	Floating, EURIBOR +1.00%	1,180	1,177
Senior unsecured bond in ISK	2010	2018	Amortizing	Floating, REIBOR +1.00%	1,636	1,600
Senior unsecured bond in EUR	2015	2018	At maturity	Fixed, 3.125%	42,106	43,350
Senior unsecured bond in RON	2016	2019	At maturity	Fixed, 3.80%	1,106	-
Senior unsecured bond in SEK	2016	2019	At maturity	Floating, 3 month STIBOR +2.65% ..	4,188	-
Senior unsecured bond in NOK	2015	2020	At maturity	Floating, NIBOR +2.95%	12,080	11,900
Senior unsecured bond in USD	2016	2023	At maturity	Floating, 3 month LIBOR +2.60%	92,874	-
Bonds issued					155,170	59,574
Central Bank, secured, various curr. ...	2010	2022	At maturity	Floating, LIBOR + 3.00%	-	56,024
Bills issued					6,457	4,081
Other					318	329
Other loans/bills					6,775	60,434
Borrowings					310,540	256,058

Book value of listed bonds was ISK 213,425 million at the end of the period (31.12.2015: ISK 196,927 million). Market value of those bonds was ISK 216,016 million (31.12.2015: ISK 205,720 million).

The Group did not repurchase own debts during the period (2015: ISK 10 billion).

29. Subordinated liabilities	Issued	Maturity	Maturity type	Terms of interest	31.3.2016	31.12.2015
Tier II capital in various currencies	2010	2020	At maturity	Floating, EURIBOR/LIBOR + 5.00% .	9,921	10,365
Subordinated liabilities					9,921	10,365

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

30. Pledged assets

<i>Pledged assets against liabilities</i>	31.3.2016	31.12.2015
Assets, pledged as collateral against borrowings	172,029	222,046
Assets, pledged as collateral against loans from credit institutions and short positions	22,441	21,611
Pledged assets against liabilities	194,470	243,657

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 172 billion at the end of the period (31.12.2015: ISK 222 billion). At the end of the period those assets were pool of mortgage loans to individuals but at year end 2015 pledged loans comprised mortgage loans to individuals, loans to real estate companies, wholesale and retail and industry and energy companies. The book value of those borrowings was ISK 149 billion at the end of the period (31.12.2015: ISK 192 billion).

The Group has pledged bonds against short term lending from the Central Bank of Iceland and against short positions, related to swap agreements, to hedge market risk of those assets.

31. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	31.3.2016	Number (million)	31.12.2015
Issued share capital	2,000	75,861	2,000	75,861

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

<i>Other reserves</i>	31.3.2016	31.12.2015
Statutory reserve	1,637	1,637
Available-for-sale reserve	2,714	2,903
Foreign currency translation reserve	81	8
Other reserves	4,432	4,548

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

OTHER INFORMATION

32. Legal matters

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

Contingent liabilities

Investigation and legal proceedings regarding alleged breaches of competition law

The Icelandic Competition Authority (ICA) has opened a formal investigation into the alleged abuse of an alleged collective dominant position by the three largest retail banks in Iceland, including Arion Bank. The investigation was initiated by separate complaints from BYR hf. and MP Banki hf. made in 2010. The complaints from BYR hf. and MP Banki hf. concern the terms of the banks' mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition. The extent of the investigation and outcome is still uncertain. However, if the Bank were deemed to have violated the Competition Act, it could result in a fine or restrictions by the ICA.

With a writ issued in June 2013, Kortþjónustan ehf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbanki hf., Borgun hf. and Valitor hf. to the amount of ISK 1.2 billion plus interest, due to damage Kortþjónustan hf. contends the five parties caused the company due to violations of the Competition Act. The Bank has put forward its arguments in the case and has demanded the rejection of Kortþjónustan's claims. The case has been put on hold as Kortþjónustan's court-appointed evaluator prepares its report on Kortþjónustan's alleged loss.

Legal proceedings regarding damages

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., have filed two cases against the Bank claiming damages in the amount of more than ISK 4 billion plus interest. The plaintiffs claim that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagið Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. The Bank believes it likely that it will be acquitted of the plaintiffs' claims in both cases and has not therefore made any provision.

In its judgment in case No. 612/2012, pronounced on 24 April 2013, the Supreme Court judged that Valitor hf. had not been authorized to rescind an agreement between the company and Datacell ehf. In January 2015 Datacell ehf. and Sunshine Press Productions ehf. brought legal action against Valitor hf. for the payment of compensation relating to damage which the companies considered they had sustained on account of the aforementioned rescinding by Valitor hf. of the agreement. Court-appointed assessors were subsequently asked to assess the damage in question at the request of the plaintiffs. The assessors announced their conclusions in March 2016. Valitor hf. is now considering what its next steps in the case are.

Other legal matters

Legal proceedings regarding CPI loans

Recently, three cases were heard by the Icelandic courts for the purpose of verifying the legitimacy and the presentation of loans linked to the Consumer Price Index (CPI). In short, the Supreme Court upheld the arguments of the lenders in two of those cases: case no 160/2015 and case no. 243/2015. In the third case, the District Court of Reykjavík acquitted a lender of a borrower's claim, on similar grounds to the two previous cases (judgment in case no E-338/2013). The Bank made no provision due to court cases regarding the CPI.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

32. Legal matters, continued

The uncertainty regarding the book value of foreign currency loans

Uncertainty over the legality of FX loans has continued in 2016 and the Group constantly monitors judgments involving itself and others to refine its provisions on foreign currency loans. Although there is more clarity in the matters of FX loans there still remains uncertainty regarding foreign currency linked loans in certain respects, such as regarding the legality of particular loans. Nevertheless, the Group considers its portfolio of foreign currency linked loans to be fully provisioned for the most likely outcome.

Legal matters concluded

In April 2013 the ICA imposed an ISK 500 million fine on Valitor hf. for abusing its dominant position on the payment card market and violating conditions set out in an earlier decision of the ICA. In a Judgement of the Supreme Court in April 2016 the Supreme Court upheld the ICA's decision from April 2013. Valitor paid the fine in 2013.

33. Visa Inc. acquisition of Visa Europe Ltd.

In November 2015 Visa Inc. and Visa Europe Ltd. announced a definitive agreement for Visa Inc. to acquire Visa Europe Ltd. The transaction consists of upfront consideration with the potential for an additional earn-out following the fourth anniversary of closing. Arion Bank is member of Visa Europe Ltd. through its subsidiary Valitor Holding hf. The transaction is subject to regulatory approvals and is expected to be completed in the second quarter of 2016. In relation to this transaction the Group reports AFS financial asset. The value of the AFS asset is based on the Group's expected share of profit from the sale of Visa Europe Ltd. The total gain from this transaction was estimated ISK 2,903 million in 2015 after taking into account estimated tax effects and conditional payment to Landsbankinn hf., which was part of the agreement when Arion Bank acquired 38% shareholding in Valitor Holding hf. from Landsbankinn hf. in 2014. During the period a loss of ISK 188 million has been recognised in Other Comprehensive Income.

34. Acquisition of the insurance company Vörður

In October 2015 Arion Bank concluded a conditional purchase agreement with BankNordik regarding majority ownership in the Icelandic insurer Vörður and full ownership in 2017. Following remarks from Icelandic authorities and referees, new agreement was finalised in April 2016 stating that Arion Bank would acquire 100% shareholding in Vörður. The company will be classified as subsidiary of Arion Bank. The purchase price is ISK 5.3 billion, conditional on the approval of the relevant Icelandic authorities. Net earnings of Vörður amounted to ISK 658 million in 2015 and total assets amounted to ISK 11,330 million at year end 2015. The sale is expected to be complete in the coming months.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

OFF BALANCE SHEET INFORMATION

35. Obligations

	31.3.2016	31.12.2015
<i>Financial guarantees, unused overdraft and loan commitments the Group has granted its customers</i>		
Financial guarantees	17,259	19,162
Unused overdrafts	41,285	42,100
Loan commitments	89,825	126,068

Depositors' and Investors' Guarantee fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without conclusion of the matter. Even though the law has not been amended Icelandic bank's have made quarterly payments to a separate division within the fund since 2010. Despite this change in execution and due to uncertainty of the shape of future legislation the liability brought forward from previous years is not changed from the balance of ISK 2,669 million. The Group has granted the Fund a guarantee for obligations amounting to ISK 3,210 million.

36. Assets under management and under custody

31.3.2016 31.12.2015

Assets under management	970,685	996,648
Assets under custody	1,465,909	1,427,269

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

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

37. Events after Balance Sheet date

In April 2016 Arion Bank issued new senior unsecured bonds for a total of EUR 300 million, or ISK 42 billion. The 3-year bonds have a fixed interest rate of 2.50%. On 6 May 2016 approximately 75% of the proceeds, or ISK 31 billion, was used to prepay senior unsecured bonds in USD, issued in January 2016, that was part of Kaupthing hf.'s stability contribution to the Icelandic state.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

RELATED PARTY

38. Related party

The Group has a related party relationship with Kaupskil ehf., being the ultimate controlling party with 87% stake in Arion Bank, the Board of Directors of Kaupskil ehf. and Kaupthing hf., being the parent company of Kaupskil ehf.

Icelandic State Financial Investments (ISFI, a separate state institution under the Ministry of Finance) manages a 13% stake in Arion Bank and thus has influence over the Group. ISFI and related entities are defined as related parties.

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

No unusual transactions took place with related parties during the period. Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

31.3.2016

	Assets	Liabilities	Net balance
<i>Balances with related parties</i>			
Shareholders with control over the Group	211	(9,975)	(9,764)
Board of Directors and key Management personnel	228	(142)	86
Associates and other related parties	128	(100)	28
Balances with related parties	567	(10,217)	(9,650)

31.12.2015

<i>Balances with related parties</i>			
Shareholders with control over the Group	212	(50,158)	(49,946)
Board of Directors and key Management personnel	232	(59)	173
Associates and other related parties	2,132	(241)	1,891
Balances with related parties	2,576	(50,458)	(47,882)

Through the ownership of ISFI the Group has a related party relationship with Landsbankinn hf. Landsbankinn hf. provides banking services to the Bank's subsidiary Valitor hf. and has a traditional bank to bank relationship with Arion Bank hf. The Group holds assets amounting to ISK 7,646 million (31.12.2015: ISK 14,038 million) by Landsbankinn hf. and liabilities amounting to ISK 1,147million at the end of the period (31.12.2015: ISK 1,499 million). Those amounts are not included in the table above.

Kaupthing hf. holds senior unsecured bonds, issued by Arion Bank in January 2016, for the amount of ISK 92,874 million at the end of the period. This amount is not included in the table above.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

RISK MANAGEMENT DISCLOSURES

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

Further information regarding risk management is available in the Annual Financial Statements for 2015 and in the Pillar 3 Risk Disclosures for 2015, published on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not audited.

39. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off-balance sheet items such as commitments and financial guarantees.

Maximum exposure to credit risk

The following table shows the maximum exposure to credit risk for the components of the Interim Statement of Financial Position, at the end of the reporting period before the effect of mitigation due to collateral agreements or other credit enhancements.

	31.3.2016	31.12.2015
Maximum exposure to credit risk related to on-balance sheet items		
Cash and balances with Central Bank	70,218	48,102
Loans to credit institutions	91,672	87,491
Loans to corporates	370,536	355,731
Loans to individuals	323,468	324,619
Financial instruments	85,971	86,770
Other assets with credit risk	9,402	4,581
Total on-balance sheet maximum exposure to credit risk	951,267	907,294
Maximum exposure to credit risk related to off-balance sheet items		
Financial guarantees	17,259	19,162
Unused overdrafts	41,285	42,100
Loan commitments	89,825	126,068
Total off-balance sheet maximum exposure to credit risk	148,369	187,330
Maximum exposure to credit risk	1,099,636	1,094,624

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Credit risk, continued

<i>Loans to customers specified by sectors</i>	31.3.2016	31.12.2015
Individuals	46.6%	47.7%
Real estate activities and construction	15.1%	15.1%
Fishing industry	12.0%	11.1%
Information and communication technology	4.4%	4.7%
Wholesale and retail trade	8.1%	7.6%
Financial and insurance activities	4.8%	4.9%
Industry, energy and manufacturing	3.3%	3.1%
Transportation	0.8%	0.9%
Services	2.9%	2.9%
Public sector	1.2%	1.2%
Agriculture and forestry	0.8%	0.8%
	100.0%	100.0%

Collateral and other credit enhancements

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- Retail loans to individuals: Mortgages on residential properties.
- Corporate loans: Real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

The value of collateral is based on estimated market value. The valuation of real estate is built on market price, official valuation of the Icelandic Property Registry, or the opinion of internal or external specialists. The valuation of fishing vessels takes into account related fishing quota.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses.

The collateral value in the table below is capped by the exposure amount.

Collateral held against different types of financial assets

	Cash and securities	Real estate	Fishing vessels	Other collateral	Total
31.3.2016					
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	407	286,989	3	3,988	291,387
Real estate activities and construction	1,263	91,170	8	2,580	95,021
Fishing industry	57	10,056	64,580	6,802	81,495
Information and communication technology	234	2,323	-	17,555	20,112
Wholesale and retail trade	290	21,438	3	23,031	44,762
Financial and insurance activities	15,030	4,676	-	1,546	21,252
Industry, energy and manufacturing	447	14,153	-	4,675	19,275
Transportation	80	898	154	3,365	4,497
Services	20	5,286	40	2,806	8,152
Public sector	118	3,488	-	82	3,688
Agriculture and forestry	5	4,201	-	131	4,337
Financial instruments	7,323	-	-	-	7,323
Financial guarantees	727	4,063	955	1,755	7,500
Collateral held against different types of financial assets	26,001	448,741	65,743	68,316	608,801

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Credit risk, continued

31.12.2015	Cash and securities	Real estates	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	428	289,862	24	4,107	294,421
Real estate activities and construction	1,032	89,039	8	1,025	91,104
Fishing industry	53	7,956	57,945	7,037	72,991
Information and communication technology	76	2,369	-	18,630	21,075
Wholesale and retail trade	210	20,424	7	22,912	43,553
Financial and insurance activities	15,947	4,367	-	1,577	21,891
Industry, energy and manufacturing	461	12,792	3	4,416	17,672
Transportation	91	875	173	3,891	5,030
Services	13	4,847	40	2,623	7,523
Public sector	73	3,732	-	99	3,904
Agriculture and forestry	5	3,493	-	112	3,610
Financial instruments	7,474	-	-	-	7,474
Financial guarantees	885	4,232	623	1,445	7,185
Collateral held against different types of financial assets	26,748	443,988	58,823	67,874	597,433

Collateral repossessed

During the period the Group took possession of assets due to foreclosures. The total amount of real estates the Group took possession of during the period and still holds at period end amount to ISK 411 million (31.12.2015: ISK 2,761 million) and other assets ISK 2 million (31.12.2015: ISK 7 million). The assets are held for sale, see Note 26.

	Neither past due nor impaired	Past due but not impaired	Individually impaired	Total
Credit quality by class of financial assets				
31.3.2016				
Cash and balances with Central Bank	70,218	-	-	70,218
Loans to credit institutions	91,672	-	-	91,672
Loans to customers				
Loans to corporates	349,133	19,508	1,895	370,536
Loans to individuals	294,183	23,957	5,328	323,468
Financial instruments	81,975	-	-	81,975
Other assets with credit risk	9,402	-	-	9,402
Credit quality by class of financial assets	896,583	43,465	7,223	947,271
31.12.2015				
Cash and balances with Central Bank	48,102	-	-	48,102
Loans to credit institutions	87,491	-	-	87,491
Loans to customers				
Loans to corporates	337,153	17,302	1,276	355,731
Loans to individuals	291,277	26,532	6,810	324,619
Financial instruments	82,714	-	-	82,714
Other assets with credit risk	4,581	-	-	4,581
Credit quality by class of financial assets	851,318	43,834	8,086	903,238

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Credit risk, continued

Neither past due nor impaired loans

The Bank uses internal credit rating models to monitor the development of credit risk and to estimate customers' probability of default (PD). The Bank rates customers with one of three models. For large corporates the Bank uses quantitative information based on financial statements as well as qualitative data. Credit ratings of individuals and SMEs are based on statistical models using historical information which has been found to be predictive. The models are updated annually and recalibrated with current data with the aim of improving their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement.

The table below shows loans to customers that are neither past due nor impaired, broken down by the Bank's classification scale, where 5 denotes the highest risk.

31.3.2016	Risk classification					Not rated	Total
	1	2	3	4	5		
Individuals	54,954	147,625	59,888	21,922	6,186	3,608	294,183
Real estate activities and construction	36,531	24,346	31,165	3,403	146	3,807	99,398
Fishing industry	22,906	40,820	5,435	4,890	2,593	2,194	78,838
Information and communication technology	16,951	6,103	6,254	65	43	10	29,426
Wholesale and retail trade	9,928	21,027	17,719	1,961	273	-	50,908
Financial and insurance activities	2,698	16,889	11,255	496	-	770	32,108
Industry, energy and manufacturing	3,198	14,773	2,847	390	168	7	21,383
Transportation	3,217	1,312	1,006	142	21	-	5,698
Services	2,889	4,717	9,346	734	5	290	17,981
Public sector	467	3,400	2,477	1,044	127	622	8,137
Agriculture and forestry	357	1,571	2,701	627	-	-	5,256
Neither past due nor impaired loans	154,096	282,583	150,093	35,674	9,562	11,308	643,316
31.12.2015							
Individuals	54,822	148,472	63,027	18,553	4,693	1,710	291,277
Real estate activities and construction	36,550	23,792	29,776	3,790	154	3,279	97,341
Fishing industry	21,807	33,232	7,657	5,415	1,249	1,341	70,701
Information and communication technology	17,346	4,252	8,949	126	-	-	30,673
Wholesale and retail trade	9,447	18,356	18,260	2,064	198	33	48,358
Financial and insurance activities	3,012	17,784	11,308	223	-	456	32,783
Industry, energy and manufacturing	3,088	14,256	2,930	324	135	-	20,733
Transportation	3,320	1,094	1,040	274	28	-	5,756
Services	2,326	4,805	9,918	539	19	-	17,607
Public sector	357	3,396	2,342	1,038	133	545	7,811
Agriculture and forestry	336	1,558	2,887	609	-	-	5,390
Neither past due nor impaired loans	152,411	270,997	158,094	32,955	6,609	7,364	628,430

Exposures that are 'Not rated' are typically due to newly formed entities and entities for which the Bank's rating models are not applicable.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

39. Credit risk, continued

Past due but not impaired loans by class of loans

	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
31.3.2016						
Loans to corporates	8,331	7,146	1,970	691	1,370	19,508
Loans to individuals	5,210	7,395	4,183	1,291	5,878	23,957
Past due but not impaired loans	13,541	14,541	6,153	1,982	7,248	43,465
31.12.2015						
Loans to corporates	9,638	3,779	1,681	662	1,542	17,302
Loans to individuals	3,706	9,437	5,237	554	7,598	26,532
Past due but not impaired loans	13,344	13,216	6,918	1,216	9,140	43,834

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

<i>Impaired loans to customers specified by sector</i>	31.3.2016		31.12.2015	
	Impair- ment amount	Gross carrying amount	Impair- ment amount	Gross carrying amount
Individuals	9,616	14,944	10,593	17,403
Real estate activities and construction	1,556	2,042	1,515	1,867
Fishing industry	243	341	257	373
Information and communication technology	301	321	308	332
Wholesale and retail trade	730	1,142	681	893
Financial and insurance activities	552	652	5,953	6,011
Industry, energy and manufacturing	1,012	1,342	828	1,025
Transportation	4,574	4,581	4,433	4,440
Services	619	938	504	682
Public sector	141	216	143	215
Agriculture and forestry	133	181	126	186
	19,477	26,700	25,341	33,427

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's capital base according to FME rule No. 625/2013. The legal maximum for individual large exposures is 25% of the capital base, net of eligible collateral.

The Group has no large exposure at the end of the period before taking account of eligible collateral (31.12.2015: One large exposure of ISK 22 billion without eligible collateral).

No.	31.3.2016		31.12.2015	
	Gross	Net	Gross	Net
1	<10%	<10%	11%	11%
Sum of large exposure gross and net > 10%	0%	0%	11%	11%

No large exposure exceeds the legal limit of 25% of the Group's capital base at the end of the period.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments.

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair value of financial instruments. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities. This mismatch is characterised by a gap between the interest fixing period of assets and liabilities, with a large amount of liabilities being demand deposits while the interest rates of assets are predominantly fixed to some extent, resulting in a repricing risk for the Group. The Group also faces interest basis risk between interest bearing assets and interest bearing liabilities due to different types of floating rate indices in different currencies, of which the largest one is EUR.

Interest rate risk in the banking book

The following table shows the Group's interest bearing assets and liabilities by interest fixing periods. The figures for loans to customers and borrowings are shown on a fair value basis, see Note 21, and are therefore different from the amounts shown in the Interim Financial Statements. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category.

The Group's interest bearing assets and liabilities by interest rate adjustment periods

31.3.2016	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	64,293	-	-	-	-	64,293
Loans to credit institutions	91,672	-	-	-	-	91,672
Loans to customers	379,107	61,296	120,890	4,412	138,430	704,135
Financial instruments	51,903	3,703	8,442	7,535	242	71,825
Assets	586,975	64,999	129,332	11,947	138,672	931,925
Liabilities						
Due to credit institutions and Central Bank	11,260	-	28	-	-	11,288
Deposits	378,325	41,395	11,515	1,207	786	433,228
Borrowings	115,432	4,317	48,905	23,223	123,398	315,275
Subordinated liabilities	9,921	-	-	-	-	9,921
Liabilities	514,938	45,712	60,448	24,430	124,184	769,712
Derivatives and other off-balance sheet items (net position) ..	(48,005)	-	48,526	-	-	521
Net interest gap	24,032	19,287	117,410	(12,483)	14,488	162,734

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk, continued

31.12.2015	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	43,181	-	-	-	-	43,181
Loans to credit institutions	87,491	-	-	-	-	87,491
Loans to customers	347,571	64,594	127,907	5,255	142,869	688,196
Financial instruments	43,925	10,002	8,556	7,786	242	70,511
Assets	522,168	74,596	136,463	13,041	143,111	889,379
Liabilities						
Due to credit institutions and Central Bank	11,387	-	-	-	-	11,387
Deposits	464,998	3,501	848	-	-	469,347
Borrowings	72,010	4,509	48,705	12,982	126,632	264,838
Subordinated liabilities	10,365	-	-	-	-	10,365
Liabilities	558,760	8,010	49,553	12,982	126,632	755,937
Derivatives and other off-balance sheet items (net position) ..	(46,330)	(1,802)	49,346	-	-	1,214
Net interest gap	(82,922)	64,784	136,256	59	16,479	134,656

Interest rate risk in the trading book

The following table shows the total basis point value (BPV) of the Group's bond and derivatives in the trading book at market value (MV). BPV denotes the change in value given a basis point (0.01%) yield change.

	31.3.2016			31.12.2015		
	MV	Duration	BPV	MV	Duration	BPV
Trading financial instruments, long positions						
ISK, CPI Indexed linked	4,241	3.4	(1.5)	4,544	3.6	(1.6)
ISK, Non Indexed linked	8,353	(1.6)	1.4	5,849	(1.8)	1.1
FX	84,294	(0.6)	5.3	64,226	(0.6)	3.9
Total	96,888	(0.5)	5.2	74,619	(0.5)	3.4
Trading financial instruments, short positions						
ISK, CPI Indexed linked	185	10.1	(0.2)	393	9.7	(0.4)
ISK, Non Indexed linked	9,020	0.8	(0.7)	7,953	0.3	(0.3)
FX	84,615	(0.5)	4.4	64,172	(0.5)	2.9
Total	93,820	(0.4)	3.5	72,518	(0.3)	2.3

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk, continued

Indexation risk

The Group is exposed to indexation risk when there is a mismatch between index-linked assets and liabilities.

Transaction maturity profile of indexed assets and liabilities

31.3.2016	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI indexed linked				
Loans to customers	10,910	83,832	203,119	297,861
Financial instruments	3,963	-	-	3,963
Off-balance sheet position	842	6,892	-	7,734
Assets, CPI indexed linked	15,715	90,724	203,119	309,558
Liabilities, CPI indexed linked				
Deposits	75,247	11,237	1,966	88,450
Borrowings	2,155	14,265	117,102	133,522
Other	-	-	786	786
Liabilities, CPI indexed linked	77,402	25,502	119,854	222,758
Net on-balance sheet position	(62,529)	58,330	83,265	79,066
Net off-balance sheet position	842	6,892	-	7,734
CPI Balance	(61,687)	65,222	83,265	86,800
31.12.2015				
Assets, CPI indexed linked				
Loans to customers	13,629	76,393	209,485	299,507
Financial instruments	3,412	-	-	3,412
Off-balance sheet position	749	7,940	-	8,689
Assets, CPI indexed linked	17,790	84,333	209,485	311,608
Liabilities, CPI indexed linked				
Deposits	72,352	12,899	1,916	87,167
Borrowings	2,128	14,164	112,350	128,642
Off-balance sheet position	-	-	782	782
Liabilities, CPI indexed linked	74,480	27,063	115,048	216,591
Net on-balance sheet position	(57,439)	49,330	94,437	86,328
Net off-balance sheet position	749	7,940	-	8,689
CPI Balance	(56,690)	57,270	94,437	95,017

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk, continued

Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Group is exposed to currency risk through a currency mismatch between assets and liabilities. ISK denominated deposits are a primary source of funding for the Group whereas a substantial part of the Group's assets consists of foreign currency denominated loans to customers. Net exposures per currency are monitored centrally in the Bank.

Breakdown of assets and liabilities by currency

31.3.2016

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	69,575	211	116	56	96	38	126	70,218
Loans to credit institutions	24,251	14,770	20,621	7,051	2,486	9,725	12,768	91,672
Loans to customers	568,613	56,631	39,015	5,495	10,839	164	13,247	694,004
Financial instruments	86,738	24,082	15,548	2,930	104	3,298	29	132,729
Investment property	6,382	-	-	-	-	-	-	6,382
Investments in associates	896	-	-	-	-	-	-	896
Intangible assets	5,680	-	-	-	3,473	-	-	9,153
Tax assets	209	-	-	-	-	-	-	209
Other assets	22,724	227	227	90	49	23	3	23,343
Assets	785,068	95,921	75,527	15,622	17,047	13,248	26,173	1,028,606
Liabilities and equity								
Due to credit inst. and Central Bank ..	8,617	802	104	1	-	1	1,763	11,288
Deposits	385,293	20,533	15,025	8,680	1,308	1,382	1,007	433,228
Financial liabilities at fair value	7,716	1,161	54	-	91	34	521	9,577
Tax liabilities	4,455	-	-	-	267	-	-	4,722
Other liabilities	36,946	2,999	1,489	1,846	465	354	570	44,669
Borrowings	158,112	43,286	92,874	-	-	12,080	4,188	310,540
Subordinated liabilities	-	3,918	2,468	3,535	-	-	-	9,921
Shareholders' equity	195,154	-	-	-	-	-	-	195,154
Non-controlling interest	9,508	-	-	-	-	-	(1)	9,507
Liabilities and equity	805,801	72,699	112,014	14,062	2,131	13,851	8,048	1,028,606
Net on-balance sheet position	(20,733)	23,222	(36,487)	1,560	14,916	(603)	18,125	
Net off-balance sheet position	10,083	(16,943)	37,957	(1,266)	(13,757)	951	(17,025)	
Net position	(10,650)	6,279	1,470	294	1,159	348	1,100	

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

40. Market risk, continued

31.12.2015

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	47,357	252	167	37	96	37	156	48,102
Loans to credit institutions	20,923	24,741	19,478	7,260	3,182	4,125	7,782	87,491
Loans to customers	568,196	44,532	37,395	6,487	11,357	9	12,374	680,350
Financial instruments	84,752	24,852	13,227	6,145	63	3,248	904	133,191
Investment property	7,542	-	-	-	-	-	-	7,542
Investments in associates	1,043	-	-	26,256	-	-	-	27,299
Intangible assets	5,575	-	-	-	3,710	-	-	9,285
Tax assets	205	-	-	-	-	-	-	205
Other assets	16,711	482	170	177	22	14	2	17,578
Assets	752,304	94,859	70,437	46,362	18,430	7,433	21,218	1,011,043
Liabilities and equity								
Due to credit inst. and Central Bank ..	9,471	381	74	6	1	-	1,454	11,387
Deposits	388,228	18,041	50,913	6,865	1,523	2,156	1,621	469,347
Financial liabilities at fair value	6,790	584	104	10	4	-	117	7,609
Tax liabilities	4,501	-	-	-	422	-	(1)	4,922
Other liabilities	41,098	2,648	1,484	1,432	832	347	1,620	49,461
Borrowings	142,060	44,526	33,442	8,511	-	13,447	14,072	256,058
Subordinated liabilities	-	3,942	2,603	3,820	-	-	-	10,365
Shareholders' equity	192,786	-	-	-	-	-	-	192,786
Non-controlling interest	9,108	-	-	-	-	-	-	9,108
Liabilities and equity	794,042	70,122	88,620	20,644	2,782	15,950	18,883	1,011,043
Net on-balance sheet position	(41,738)	24,737	(18,183)	25,718	15,648	(8,517)	2,335	
Net off-balance sheet position	9,619	(13,684)	20,273	(1,470)	(17,856)	5,481	(2,363)	
Net position	(32,119)	11,053	2,090	24,248	(2,208)	(3,036)	(28)	

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk

Liquidity risk is defined as the risk that the Group, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

Group's assets and liabilities at carrying amount by residual maturity

31.3.2016	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Assets							
Cash and balances with Central Bank	70,218	58,191	-	12,027	-	-	-
Loans to credit institutions	91,672	50,755	40,917	-	-	-	-
Loans to customers	694,004	6,474	51,057	88,022	245,833	302,618	-
Financial instruments	132,729	6,037	7,123	5,168	52,707	10,940	50,754
<i>Derivatives - assets leg</i>	45,549	-	18,200	2,423	24,575	351	-
<i>Derivatives - liabilities leg</i>	(43,579)	-	(17,787)	(2,328)	(23,352)	(112)	-
Investment property	6,382	-	-	-	-	-	6,382
Investments in associates	896	-	-	-	-	-	896
Intangible assets	9,153	-	-	-	-	-	9,153
Tax assets	209	-	-	-	209	-	-
Other assets	23,343	1,498	5,707	1,403	795	-	13,940
Assets	1,028,606	122,955	104,804	106,620	299,544	313,558	81,125
Liabilities							
Due to credit institutions and Central Bank	11,288	11,263	-	-	25	-	-
Deposits	433,228	274,801	90,126	53,991	12,338	1,972	-
Financial liabilities at fair value	9,577	-	7,846	343	833	555	-
<i>Derivatives - assets leg</i>	(72,646)	-	(44,464)	(9,885)	(17,036)	(1,261)	-
<i>Derivatives - liabilities leg</i>	76,588	-	46,675	10,228	17,869	1,816	-
<i>Short position bonds and derivatives</i>	1,133	-	1,133	-	-	-	-
<i>Short position bonds used for hedging</i>	4,502	-	4,502	-	-	-	-
Tax liabilities	4,722	-	1,087	2,174	1,461	-	-
Other liabilities	44,669	12,305	16,733	5,294	1,242	6	9,089
Borrowings	310,540	-	5,008	6,614	75,312	223,606	-
Subordinated liabilities	9,921	-	-	-	9,921	-	-
Liabilities	823,945	298,369	120,800	68,416	101,132	226,139	9,089
Off-balance sheet items							
Financial guarantees	17,259	2,998	2,580	6,612	3,278	1,791	-
Unused overdraft	41,285	858	9,191	13,572	17,332	332	-
Loan commitments	89,825	-	32,459	30,059	22,207	5,100	-
Off-balance sheet items	148,369	3,856	44,230	50,243	42,817	7,223	-
Net assets (liabilities)	56,292	(179,270)	(60,226)	(12,039)	155,595	80,196	72,036

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

31.12.2015	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Assets							
Cash and balances with Central Bank	48,102	35,467	-	12,635	-	-	-
Loans to credit institutions	87,491	50,151	37,340	-	-	-	-
Loans to customers	680,350	3,984	42,429	90,014	234,035	309,888	-
Financial instruments	133,191	4,765	1,711	10,861	54,392	10,985	50,477
<i>Derivatives - assets leg</i>	56,171	-	24,671	1,478	29,509	513	-
<i>Derivatives - liabilities leg</i>	(53,770)	-	(24,262)	(1,421)	(27,688)	(399)	-
Investment property	7,542	-	-	-	-	-	7,542
Investments in associates	27,299	-	-	-	-	-	27,299
Intangible assets	9,285	-	-	-	-	-	9,285
Tax assets	205	-	-	-	205	-	-
Other assets	17,578	1,017	2,592	174	793	-	13,002
Assets	1,011,043	95,384	84,072	113,684	289,425	320,873	107,605
Liabilities							
Due to credit institutions and Central Bank	11,387	9,881	-	1,481	25	-	-
Deposits	469,347	268,727	95,191	89,937	13,575	1,917	-
Financial liabilities at fair value	7,609	-	6,346	536	631	96	-
<i>Derivatives - assets leg</i>	(49,199)	-	(36,552)	(5,662)	(6,518)	(467)	-
<i>Derivatives - liabilities leg</i>	52,192	-	38,282	6,198	7,149	563	-
<i>Short position bonds and derivatives</i>	1,309	-	1,309	-	-	-	-
<i>Short position bonds used for hedging</i>	3,307	-	3,307	-	-	-	-
Tax liabilities	4,922	-	-	3,274	1,648	-	-
Other liabilities	49,461	17,002	14,724	5,192	3,529	6	9,008
Borrowings	256,058	-	7,081	4,308	69,933	174,736	-
Subordinated liabilities	10,365	-	-	-	3,942	6,423	-
Liabilities	809,149	295,610	123,342	104,728	93,283	183,178	9,008
Off-balance sheet items							
Financial guarantees	19,162	3,402	2,371	7,589	3,954	1,846	-
Unused overdraft	42,100	842	10,071	14,984	15,768	435	-
Loan commitments	126,068	-	50,628	35,542	34,506	5,392	-
Off-balance sheet items	187,330	4,244	63,070	58,115	54,228	7,673	-
Net assets (liabilities)	14,564	(204,470)	(102,340)	(49,159)	141,914	130,022	98,597

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

The net stable funding ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per the definition of the Central Bank of Iceland rules No. 1032. In general, RSF is determined by applying different weights to different asset classes depending on the level of liquidity. ASF however is calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness. In 2016, the ratio for foreign currency shall be at least 90% and from 2017 the ratio shall exceed 100%.

Calculations of the NSFR are based on consolidated figures for the Bank and Arion Bank Mortgages Institutional Investor Fund. When calculating the FX ratio, a negative FX imbalance is subtracted from the numerator and a positive FX imbalance is subtracted from the denominator. The FX imbalance discrepancy between the Group's official FX imbalance and the imbalance reported in the NSFR is due to the fact that the Bank's subsidiaries have a substantial positive FX imbalance but are settled in ISK.

Net Stable Funding Ratio

	ISK	FX	Total
31.3.2016			
Available stable funding	588,805	179,696	768,501
Required stable funding	570,601	99,423	670,024
FX imbalance		10,650	
Net stable funding ratio	103%	202%	115%
31.12.2015			
Available stable funding	540,864	129,273	670,137
Required stable funding	539,841	95,511	635,352
FX imbalance		(11,363)	
Net stable funding ratio	100%	123%	105%

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

Liquidity coverage ratio

The liquidity coverage ratio (LCR) is part of the standards introduced in the Basel III Accord. The LCR is the result of a stress test that is designed to ensure that banks have the necessary assets on hand to withstand short-term liquidity disruptions. More accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, assets must be non-pledged, liquid and easily priced on the market, repoable at the Central Bank and not issued by the Group or related entities.

The Central Bank has set rules for minimum LCR. In 2016 the LCR requirement is 100% in foreign currency and 90% in total (ISK and foreign currency). The latter requirement will be 100% from 2017.

The following table shows the breakdown for the Group's LCR calculations broken down on currencies; ISK, FX and total. All amounts are weighted by their respective LCR weights as defined by the Central Bank.

Liquidity coverage ratio

	ISK	FX	Total
31.3.2016			
Liquid Assets	120,567	29,439	150,006
Liquid assets level 1 *	120,567	22,948	143,515
Liquid assets level 2 **	-	6,491	6,491
Cash outflows	133,248	33,819	167,067
Deposits	112,386	26,529	138,915
Market Borrowing	2,771	873	3,644
Other Cash outflows	18,091	6,417	24,508
Cash inflows	7,068	62,221	69,289
Short term deposits with other banks ***	2,415	60,046	62,461
Other Cash inflows	4,653	2,175	6,828
Liquidity coverage ratio (LCR) ****	96%	348%	153%
31.12.2015			
Liquid Assets	99,483	29,957	129,440
Liquid assets level 1 *	99,483	24,088	123,571
Liquid assets level 2 **	-	5,869	5,869
Cash outflows	140,073	56,511	196,584
Deposits	122,275	21,640	143,915
Market Borrowing	1,502	122	1,624
Other Cash outflows	16,296	34,749	51,045
Cash inflows	12,961	87,338	100,299
Short term deposits with other banks ***	3,768	57,881	61,649
Other Cash inflows	9,193	29,457	38,650
Liquidity coverage ratio (LCR) ****	78%	212%	134%

* Level 1 assets receive a 100% weight in LCR calculations and include the Group's Cash and balances with Central Bank, domestic bonds eligible as collateral at the Central Bank, foreign government bonds and the liquidity facility from the Icelandic government.

** Level 2 assets include the Group's covered bonds with a minimum rating of AA- and receive a 85% weight in LCR calculations.

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

**** LCR is defined as: $LCR = \frac{\text{Weighted liquid assets}}{(\text{weighted cash outflows} - \text{weighted cash inflows})}$ where weighted cash inflows are capped at 75% of weighted cash outflows.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

The following table shows the composition of the Bank's liquidity buffer. The Bank's liquidity facility with the Icelandic Government is set to expire at year-end 2016, which will affect the Bank's LCR.

Composition of liquid assets

	ISK	USD	EUR	Other	Total
31.3.2016					
Cash and balances with Central Bank	69,575	116	211	316	70,218
Short term deposits in other banks	2,415	18,877	11,375	29,794	62,461
Domestic bonds eligible as collateral at the Central Bank	21,480	-	-	-	21,480
Foreign government bonds	-	12,748	8,653	904	22,305
Government liquidity facility	29,512	-	-	-	29,512
Covered bonds with a minimum rating of AA-	-	266	2,120	5,250	7,636
Total liquidity reserve	122,982	32,007	22,359	36,264	213,612
31.12.2015					
Cash and balances with Central Bank	47,357	167	252	326	48,102
Short term deposits in other banks	3,768	16,741	20,824	20,316	61,649
Domestic bonds eligible as collateral at the Central Bank	22,614	-	-	-	22,614
Foreign government bonds	-	10,658	8,700	3,984	23,342
Government liquidity facility	29,513	-	-	-	29,513
Covered bonds with a minimum rating of AA-	-	-	2,122	4,783	6,905
Total liquidity reserve	103,252	27,566	31,898	29,409	192,125

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

41. Liquidity and Funding risk, continued

LCR deposit categorization

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

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

LCR categorization - amounts and LCR outflow weights

	Deposits maturing within 30 days				Term deposits*	Total deposits
	Less Stable	Weight (%)	Stable	Weight (%)		
31.3.2016						
Retail	87,123	10%	36,402	5%	55,840	179,365
SME	38,887	10%	3,924	5%	4,920	47,731
Operational relationship	-	25%	-	5%	-	-
Corporations	43,881	40%	889	20%	4,312	49,082
Sovereigns, central-banks and PSE	20,762	40%	-	-	1,069	21,831
Financial entities being wound up	17,211	100%	-	-	8,412	25,623
Pension funds	30,206	100%	-	-	31,766	61,972
Domestic financial entities	31,635	100%	-	-	14,508	46,143
Foreign financial entities	3,697	100%	-	-	-	3,697
Other foreign parties	3,806	100%	3,208	25%	2,058	9,072
Total	277,208		44,423		122,885	444,516
31.12.2015						
Retail	86,095	10%	39,598	5%	53,599	179,292
SME	37,884	10%	3,928	5%	4,327	46,139
Operational relationship	-	25%	-	5%	-	-
Corporations	36,300	40%	823	20%	4,945	42,068
Sovereigns, central-banks and PSE	11,900	40%	-	-	1,304	13,204
Financial entities being wound up	16,948	100%	-	-	47,062	64,010
Pension funds	41,609	100%	-	-	35,104	76,713
Domestic financial entities	32,727	100%	-	-	11,016	43,743
Foreign financial entities	5,193	100%	-	-	-	5,193
Other foreign parties	3,707	100%	3,260	25%	1,923	8,890
Total	272,363		47,609		159,280	479,252

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

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

42. Capital management

The capital base amounts to ISK 198,323 million at the end of the period. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 27,0%, exceeding the minimum legal requirement of 8%. As of 1 April 2016, the Bank must additionally hold a combined capital buffer of approx. 6% (the 3% systemic risk buffer only applies to domestic exposures), resulting in a legal requirement of approx. 14% for the Bank. When the capital buffers are fully implemented, on 1 March 2017, the legal capital requirement will reach 16,5%.

The Group uses the standardised approach to calculate the capital requirements for credit risk, market risk, and operational risk.

The Bank carries out an on-going process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank's total risk exposure. The ICAAP is aimed at identifying and measuring the Groups risk across all risk types and ensure that the Group has sufficient capital in accordance to its risk profile. FME supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole following the Supervisory Review and Evaluation Process (SREP). The Group's capital base exceeds the FME's SREP requirements.

<i>Capital Base</i>	31.3.2016	31.12.2015
Total equity	204,661	201,894
Non-controlling interest not eligible for inclusion in CET1 capital*	(9,507)	(9,108)
Intangible assets	(9,153)	(9,285)
Tax assets	(209)	(205)
Other statutory deductions	(2,921)	(3,151)
Common equity Tier 1 capital*	<u>182,871</u>	<u>180,145</u>
Non-controlling interest not eligible for inclusion in CET1 capital*	9,507	9,108
Tier 1 capital	<u>192,378</u>	<u>189,253</u>
Subordinated liabilities	9,921	10,365
Regulatory adjustments to Tier 2 capital**	(1,055)	(771)
Other statutory deductions	(2,921)	(3,118)
Tier 2 capital	<u>5,945</u>	<u>6,476</u>
Total capital base	<u>198,323</u>	<u>195,729</u>

* CET1 capital according to CRR definition while Tier 1, capital base and RWA are calculated according to The Act on Icelandic Undertakings No. 161/2002. Capital ratios according to CRR are generally lower than the ratios shown here.

** Straight-line amortization for maturities within five years.

<i>Risk weighted assets</i>	31.3.2016	31.12.2015
Credit risk	635,499	681,034
Market risk FX	10,649	38,401
Market risk other	7,994	7,035
Operational risk	81,441	81,441
Total risk weighted assets	<u>735,583</u>	<u>807,911</u>

<i>Capital ratios</i>	31.3.2016	31.12.2015
CET1 ratio using current RWA *	24.9%	22.3%
Tier 1 ratio	26.2%	23.4%
Capital adequacy ratio	27.0%	24.2%
Official Tier 1 ratio**	25.8%	23.4%
Official Capital adequacy ratio**	26.6%	24.2%

* CET1 capital according to CRR definition while Tier 1, capital base and RWA are calculated according to The Act on Icelandic Undertakings No. 161/2002. Capital ratios according to CRR are generally lower than the ratios shown here.

** Official capital ratios are based on audited earnings at 31 December 2015.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

42. Capital management, continued

Leverage ratio

As part of the Basel III regulatory framework, the leverage ratio is seen as a complementary measure to the risk-based Capital adequacy ratio.

	31.3.2016	31.12.2015
On-balance sheet exposures	999,855	982,348
Derivative exposures	3,996	3,789
Securities financing transaction exposures	16,590	16,287
Off-balance sheet exposures	90,814	127,675
Total exposure	1,111,255	1,130,099
Tier 1 capital	192,378	189,253
Leverage ratio	17.3%	16.7%

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SIGNIFICANT ACCOUNTING POLICIES

The accounting policies adopted in the preparation of these Interim Financial Statements are consistent with those followed in the preparation of the Annual Financial Statements for the year 2015.

43. Going concern assumption

The Group's management has made an assessment of the ability to continue as a going concern and is satisfied that the Group has the resources to continue. In making this assessment, management has taken into consideration the risk exposures facing the Group which are further described in the Risk Management Disclosures. The Interim Financial Statements are prepared on a going concern basis.

