

# FINANCIAL STATEMENTS 30 SEPTEMBER 2016

INVESTOR PRESENTATION  
16 NOVEMBER 2016



# ARION BANK

ARION BANK PROVIDES COMPREHENSIVE FINANCIAL SERVICES

## Retail Banking

- ~ 30% market share
- Main provider of mortgages after HFF
- Wide range of financial services for individuals and SMEs
- Focus on digital services – app and ATMs

## Asset Management

- Market leader in asset management
- Assets under management almost same size as Bank's balance sheet
- Clients are institutional investors and high net worth individuals

## Investment Banking

- Comprehensive investment banking services
- Leader in capital markets and corporate finance
- Managed all IPOs in Iceland in 2015

## Corporate Banking

- Clients include many of Iceland's largest companies
- Provides customized solutions
- Lends to international companies in seafood industry and related sectors

# SUBSIDIARIES PERFORM VITAL ROLE

ARION BANK PROVIDES COMPREHENSIVE FINANCIAL SERVICES



- Largest fund management company in Iceland
- Clients are individuals and institutional investors
- Manages diverse range of UCITS, investment funds and institutional investors' funds

## VALITOR

- Market leader in acquiring services and card issuing
- Operations in Iceland, Denmark and the UK
- Member of VISA Europe and MasterCard International



- Vörður is the 4th largest non-life insurance company in Iceland with a 10% market share
- Arion Bank completed the acquisition at the end of September following the approval of the regulators



- Market leader in life insurance
- Focus on customized services
- Partnership with Arion Bank on sales

# HIGHLIGHTS OF THE FIRST 9 MONTHS OF 2016

## SOLID PERFORMANCE

### Increased demand for credit

- Interest income increased due to higher interest rates and more interest-bearing assets
- Lending to companies up 7% and strong demand for credit
- Valitor's sale of its share in Visa Europe Ltd. to Visa Inc. has positive impact on Bank's results
- Commission income decreased, particularly due to smaller number of IPOs
- Higher salary expenses after new collective wage agreements came into effect, increase in number of employees at Bank and subsidiaries and redundancies in September
- Arion Bank named the best investment bank in Iceland for 2016 by Euromoney

### Second major bond issue in euros

- Bond owned by Kaupthing issued in US dollars in January – equivalent of ISK 97 billion – in preparation for lifting capital controls
- Second bond issue in euros to broad group of investors was in April, €300 million or ISK 42 billion
- ISK 31 billion were subsequently paid into the Kaupthing bond from January
- ISK 20.4 billion in covered bonds issued during the period
- Subordinated loan from Central Bank was fully paid at the end of the period



# HIGHLIGHTS OF THE FIRST 9 MONTHS OF 2016

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## MORE DIVERSE PRODUCT OFFERING – CREDIT RATING CONTINUES TO IMPROVE

### Business accelerators moving at full speed

- Startup Reykjavík held for fifth time during the summer and Startup Energy Reykjavík is being held for third time
- Startup Reykjavík named best business accelerator in Iceland for 2016 by Nordic Startup Awards

### Vörður becomes subsidiary

- Arion Bank has acquired insurance company Vörður
- Fourth largest insurance company in Iceland with 10% market share
- Non-life insurance added to the Bank's product offering



### Credit rating upgraded

- Standard & Poor's upgraded Arion Bank's credit rating from BBB-/A-3 to BBB/A-2 with a positive outlook
- S&P cited the Bank's better capital position, enhanced access to international capital markets and the improving Icelandic economy as reasons behind the upgrade



# HIGHLIGHTS OF THE FIRST 9 MONTHS OF 2016

## NEW BRANCH AT KEFLAVÍK INTERNATIONAL AIRPORT

### New branch at Keflavík International Airport

- Branch opened at Keflavík International Airport, where the focus is on foreign currency and VAT reimbursement
- Three service points at the airport and 13 ATMs

### Borrowing fees for mortgages reduced

- Borrowing fees for mortgages will be fixed amount – represents substantial reduction for most borrowers
- Borrowing fee used to be percentage of loan
- 100% discount on borrowing fees for first mortgage remains in place

### Digital services

- New and quick way of becoming Arion Bank customer online was introduced
- Customers have received new contactless debit card – Visa Debit
- Announced that authentication tokens are being phased out and being replaced by electronic ID and SMS authentication



# HIGHLIGHTS OF Q3

## HEALTHY UNDERLYING PERFORMANCE IN Q3

Return on  
equity  
**14.4%**

Q3 2015:  
14.2%

Net interest  
income  
**ISK 7,432  
million**

Q3 2015:  
ISK 7,112 million

Net earnings  
**ISK 7,503  
million**

Q3 2015:  
ISK 6,071 million

Cost-to-  
income ratio  
**57.8%**

Q3 2015:  
43.1%

- Net change in valuation is positive due to revaluation of acquired mortgages
- Net financial income was positive due to more favorable market conditions for equities in the third quarter compared with the first half of 2016
- Operating expenses were high in the third quarter, mainly due to one-off professional expense and an expense relating to the redundancy of 46 full-time employees at the end of the quarter
- Net interest income and Net fee and commission income is increasing in third quarter compared with last year, despite changes in funding profile and more competitive environment

# HEADLINE FIGURES FOR 9M 2016

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## Profitability

Net earnings  
**ISK 17,262**  
million  
9M 2015:  
ISK 25,397 million

## Strength

Tier 1 ratio  
**25.5%**  
31.12.2015:  
23.4%

## Operation

Cost-to-  
income ratio  
**56.7%**  
9M 2015:  
38.4%

## Asset quality

Problem  
loans  
**2.0%**  
31.12.2015:  
2.5%

Return on  
equity  
**11.2%**  
9M 2015:  
19.8%

Leverage  
ratio  
**17.4%**  
31.12.2015:  
16.7%

Number of  
Employees  
**1,189**  
31.12.2015:  
1,147

Mortgages/  
Total loans  
**39.2%**  
31.12.2015:  
39.4%





# INCOME STATEMENT

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# INCOME STATEMENT

All amounts in ISK million

## POSITIVE NET IMPAIRMENT ON LOANS TO CUSTOMERS

- 9% increase in net interest income from 9M 2015
- Net commission income decreases mainly due to less IPO activity in investment banking
- Net financial income is positive in Q3 mainly due to listed equity holdings but below expectations for 9M
- Increase in salaries due to new wage agreements and redundancies. Increase in other expenses is partially due to one-off professional services
- Positive net impairment due to revaluation of acquired mortgages

	9M 2016	9M 2015	Diff	Q3 2016	Q2 2016	Diff
Net interest income	22,058	20,287	9%	7,432	7,353	1%
Net commission income	10,213	10,726	(5%)	3,466	3,527	(2%)
Net financial income	4,339	10,176	(57%)	844	3,796	(78%)
Share of profit of associates	710	6,956	(90%)	16	18	(11%)
Other income	2,642	2,232	18%	781	626	25%
<b>Operating income</b>	<b>39,962</b>	<b>50,377</b>	<b>(21%)</b>	<b>12,539</b>	<b>15,320</b>	<b>(18%)</b>
Salaries and related expense	(12,252)	(10,320)	19%	(3,826)	(4,318)	(11%)
Other operating expenses	(10,393)	(9,016)	15%	(3,423)	(3,736)	(8%)
Bank levy	(2,190)	(2,168)	1%	(705)	(743)	(5%)
Net impairment	6,827	(114)	-	5,882	1,448	306%
<b>Net earnings before taxes</b>	<b>21,954</b>	<b>28,759</b>	<b>(24%)</b>	<b>10,467</b>	<b>7,971</b>	<b>31%</b>
Income tax expense	(5,261)	(3,639)	45%	(3,170)	(1,354)	134%
Net gain from disc. operations	569	277	105%	206	259	(20%)
<b>Net earnings</b>	<b>17,262</b>	<b>25,397</b>	<b>(32%)</b>	<b>7,503</b>	<b>6,876</b>	<b>9%</b>

# ADJUSTED EARNINGS

All amounts in ISK million

## SIGNIFICANT ONE-OFF INCOME AND EXPENSE

	9M 2016	Adjustment	Adjusted	
Net interest income	22,058	555	22,613	1)
Net commission income	10,213	69	10,282	
Net financial income	4,339	(4,839)	(500)	2)
Share of profit of associates	710	(498)	212	3)
Other operating income	2,642	(277)	2,365	4)
<b>Operating income</b>	<b>39,962</b>	<b>(4,990)</b>	<b>34,972</b>	
Salaries and related expense	(12,252)	320	(11,932)	5)
Other operating expenses	(10,393)	1,037	(9,356)	5)
Bank levy	(2,190)	0	(2,190)	
Net impairment	6,827	(9,864)	(3,037)	6)
<b>Earnings before tax</b>	<b>21,954</b>	<b>(13,497)</b>	<b>8,457</b>	
Income tax	(5,261)	1,938	(3,323)	7)
Net gain from disc. operations	569	0	569	
<b>Net earnings</b>	<b>17,262</b>	<b>(11,559)</b>	<b>5,703</b>	

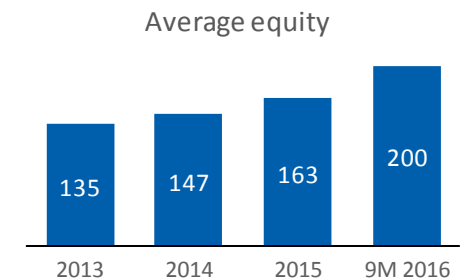
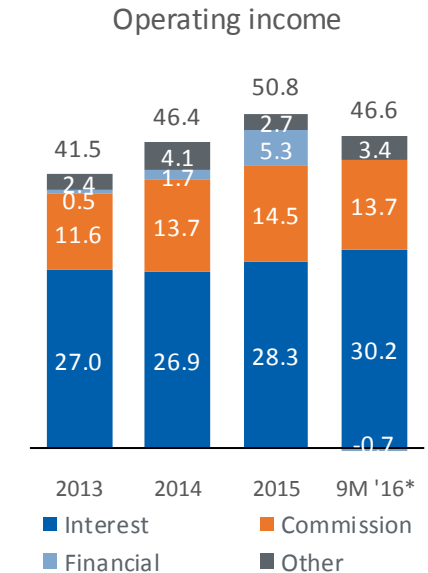
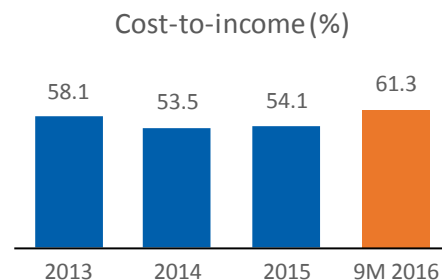
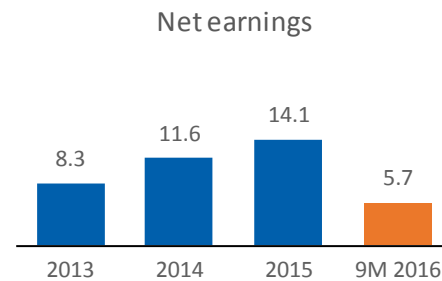
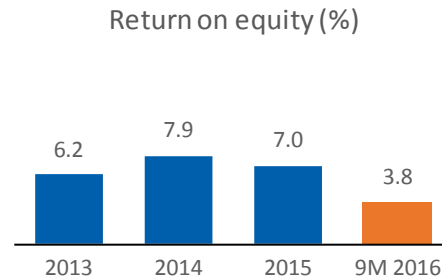
- 1) Interest income from non-core subsidiaries eliminated and interest income calculated on book value of other non-core assets
- 2) Profit from sale of Visa Europe and loss from fx trade with Central Bank
- 3) Profit from sale of Bakkavor Group
- 4) Profit from sale of asset at Landey
- 5) Expense due to redundancies, one-off professional services and calculated expense on non-core operation
- 6) Net impairment removed and 0.58% impairment calculated on total loans to customers
- 7) Calculated income tax effect on adjustments

# ADJUSTED EARNINGS

Amounts in ISK billion

## INCREASED EQUITY AFFECTING THE RETURN

- Average equity used for calculation in adjusted earnings has increased by 48% from 2013
- Lower Net earnings in 2016 is primarily due to lower financial income from financial instruments
- Net interest margin is very stable
- Positive development in Net interest income and Net fee and commission income reflects the strong platform at the Bank
- One-off expense is primarily related redundancies in September and professional services
- Bank levy is considered permanent, as the government has portended to collect the tax unchanged for the next four years

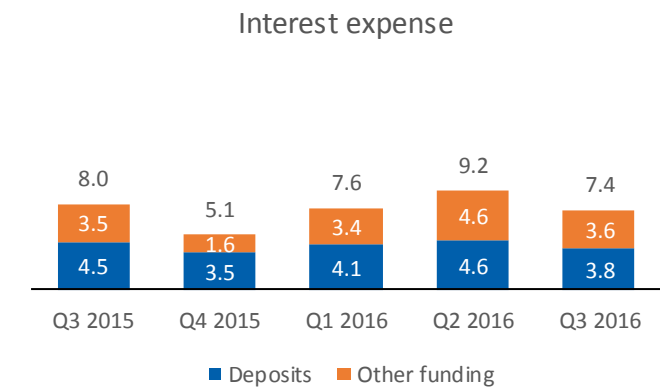
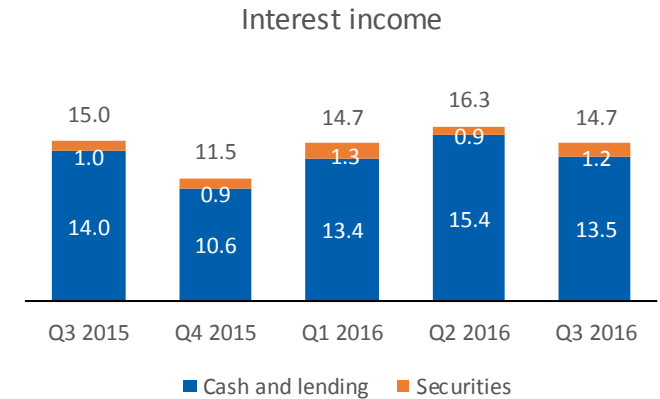
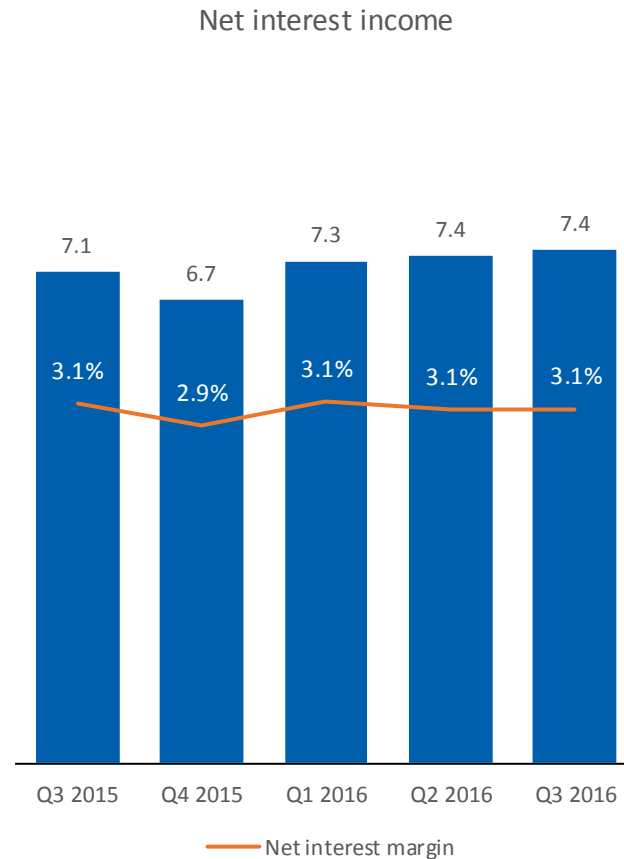


# NET INTEREST INCOME

All amounts in ISK billion

## INCREASE IN INTEREST BEARING ASSETS

- Responsible lending activities and active liquidity management have resulted in stable net interest income
- Fluctuations in both interest income and expenses during the year mostly due to changes in inflation
- Increase in interest bearing assets from year end 2015 of ISK 62 billion or 6% of total assets
- Sharp increase in interest expense from other funding due to new bonds issued both domestically and internationally



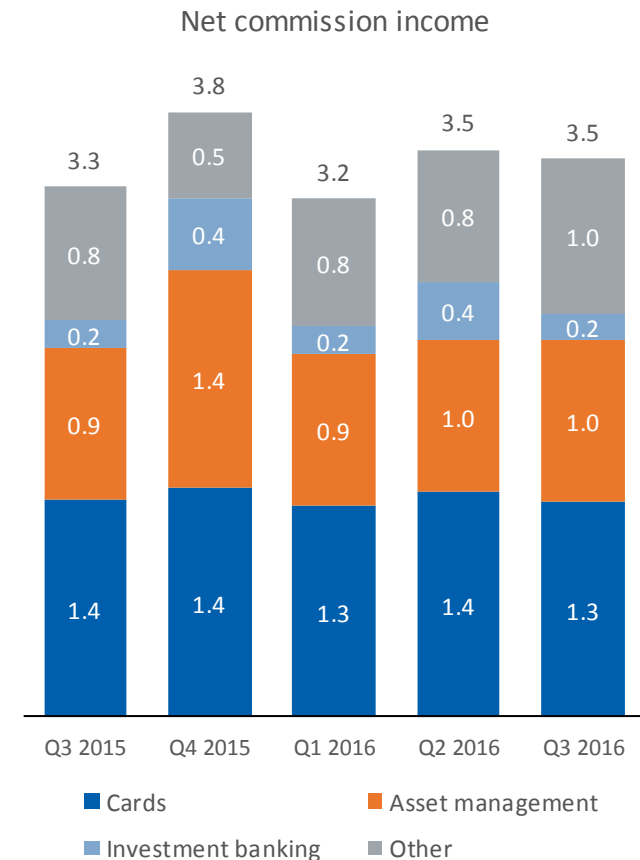
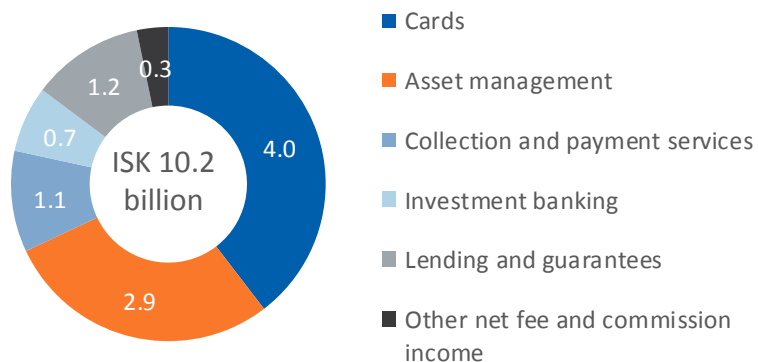
# NET COMMISSION INCOME

All amounts in ISK billion

## STRONG COMMISSION BASE IN ALL SEGMENTS

- Stable net commission income, small increase from Q3 2015
- Retail bank performing well and the effects of the new Keflavik airport branch are starting to impact other fee income in a positive way
- Revenue growth continues at Valitor but the company is affected by margin compression and FX volatility in European markets

Breakdown of Net commission income 9M 2016

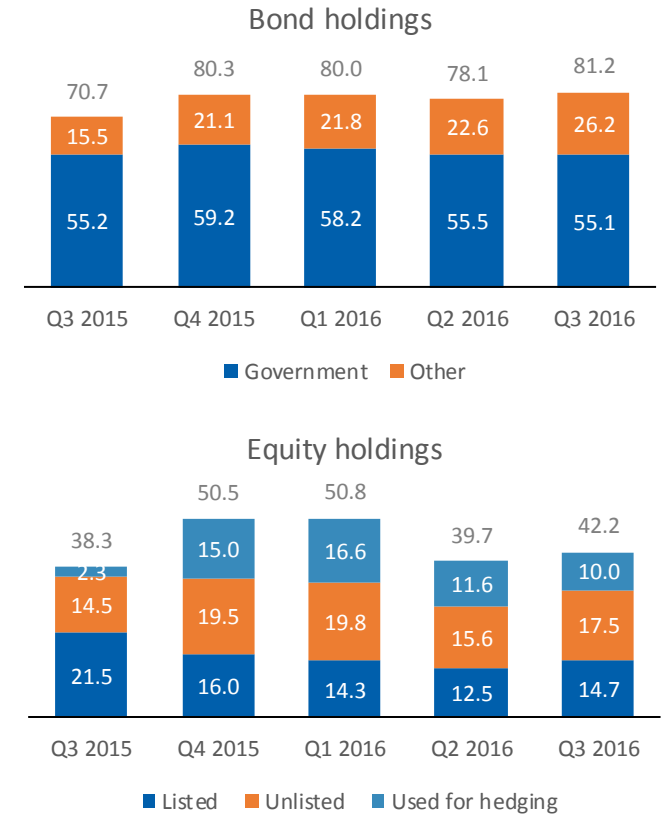
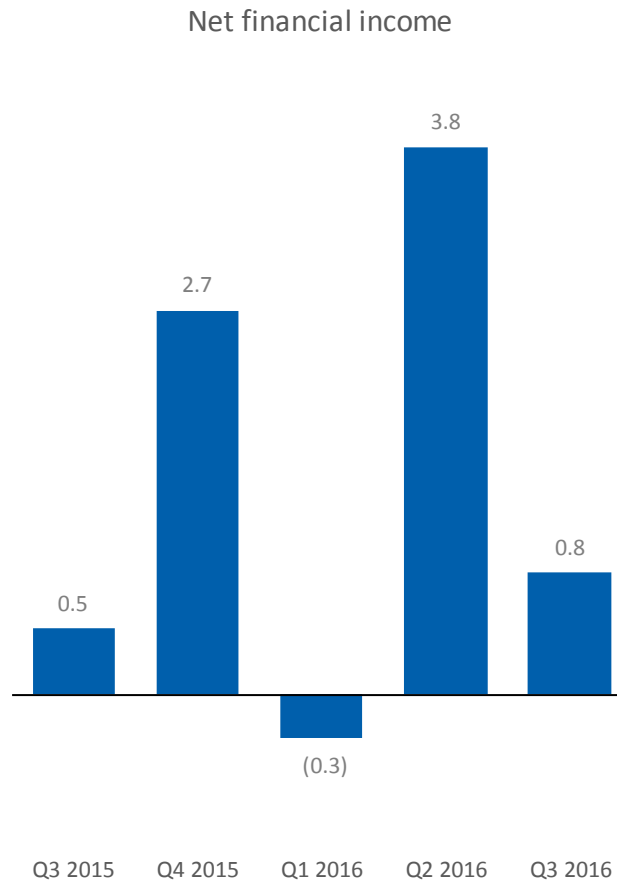


# NET FINANCIAL INCOME

All amounts in ISK billion

## PROFIT FROM SALE OF VISA EUROPE HAS SIGNIFICANT EFFECT

- Listed bonds and equity holdings increased, mainly due to assets from the acquisition of Vörður at period end
- The Icelandic stock market sub performed during 9M 2016 with OMXI8 decreasing by 12.4%
- The ISK continued to strengthen during the period resulting in a some FX loss at subsidiary level

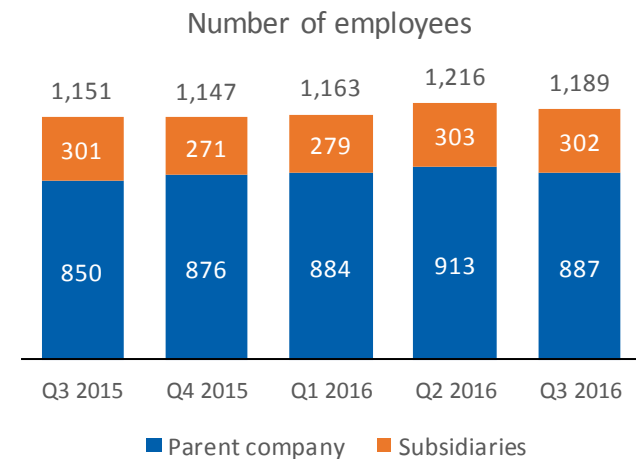
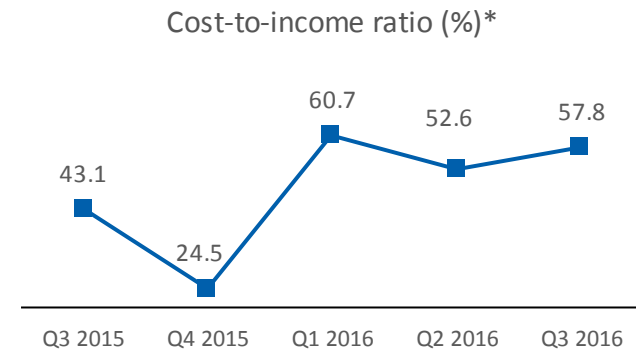
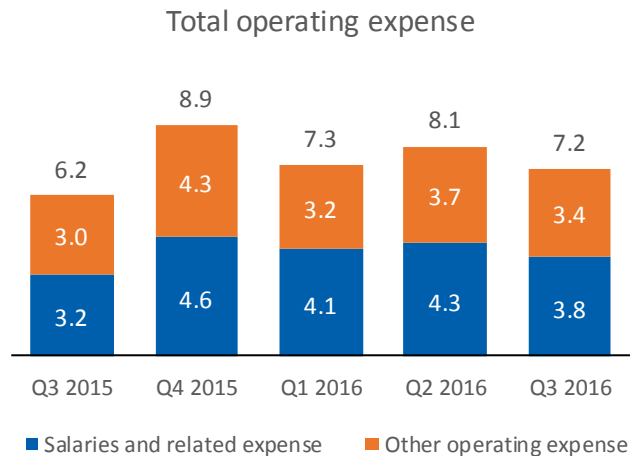


# TOTAL OPERATING EXPENSE

All amounts in ISK billion

## INCREASED EXPENSE FOLLOWING NEW WAGE AGREEMENTS

- Increase in salaries greatly affected by new wage agreements and expense in relation to redundancies
- Increase in professional services, marketing expenses and IT expenditures compared with prior year
- Cost-to-income ratio volatile mainly due to large one-off income items





## BALANCE SHEET

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# BALANCE SHEET

All amounts in ISK billion

## STRONG BALANCE SHEET

- Increase in loans to customers, partially offset by strengthening of the ISK
- Increase in financial assets largely due to acquisition of Vörður
- Deposit base stabilising following the funding agreement with Kaupthing in January
- Subordinated loan from the Icelandic State prepaid in Q3
- Strong liquidity and equity position

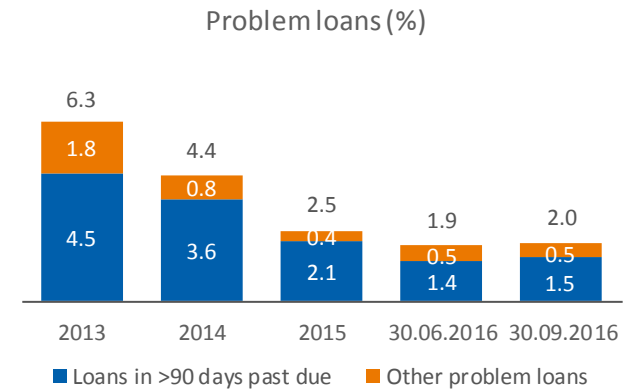
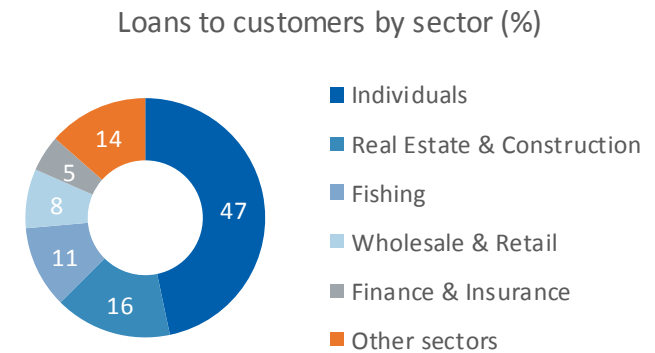
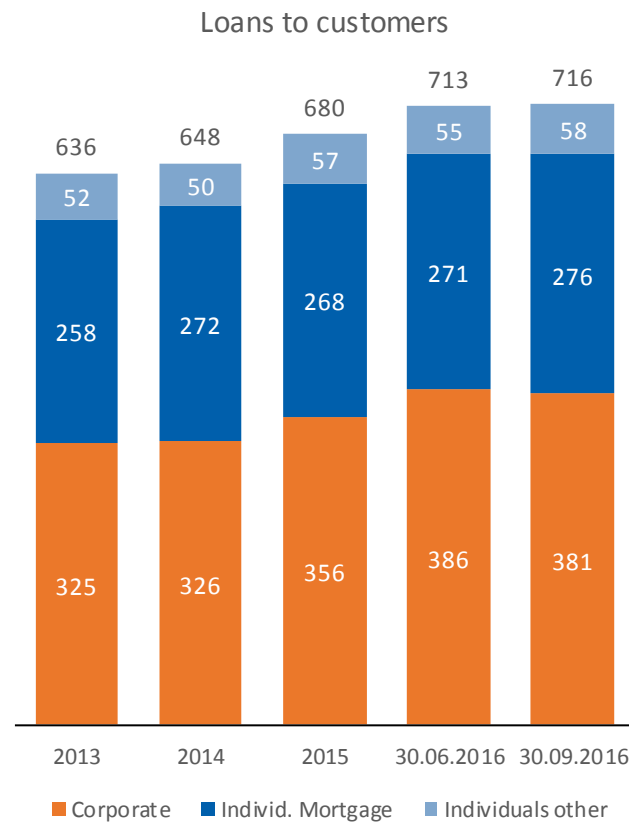
<b>Assets</b>	<b>30.09.2016</b>	<b>30.06.2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>
Cash & balances with CB	86	77	48	21	38
Loans to credit institutions	68	86	87	109	102
Loans to customers	716	713	680	648	636
Financial assets	128	121	133	102	87
Investment property	5	6	8	7	29
Investments in associates	1	1	27	22	18
Other assets	34	31	27	26	30
<b>Total Assets</b>	<b>1,038</b>	<b>1,035</b>	<b>1,011</b>	<b>934</b>	<b>939</b>
<b>Liabilities and Equity</b>					
Due to credit institutions & CB	9	8	11	23	28
Deposits from customers	432	423	469	455	472
Other liabilities	63	56	62	61	58
Borrowings	327	330	256	201	205
Subordinated loans	-	10	10	32	32
Shareholders Equity	207	199	193	161	140
Non-controlling interest	0	10	9	2	5
<b>Total Liabilities and Equity</b>	<b>1,038</b>	<b>1,035</b>	<b>1,011</b>	<b>934</b>	<b>939</b>

# LOANS TO CUSTOMERS

All amounts in ISK billion

## INCREASED QUALITY IN THE LOAN PORTFOLIO

- Continued good balance in loans to corporates and individuals
- Increase in loans to customers during the first nine months, mostly to corporate customers in Real estate, industry, energy and manufacturing and wholesale and retail
- Increase in loans to corporates partially dampened by FX development
- Strong pipeline for corporate loans
- Good diversification in the corporate loan book

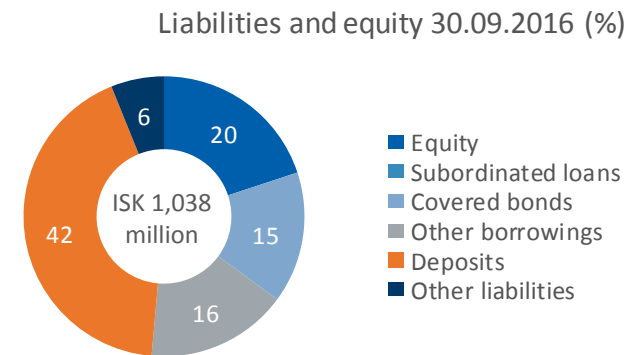
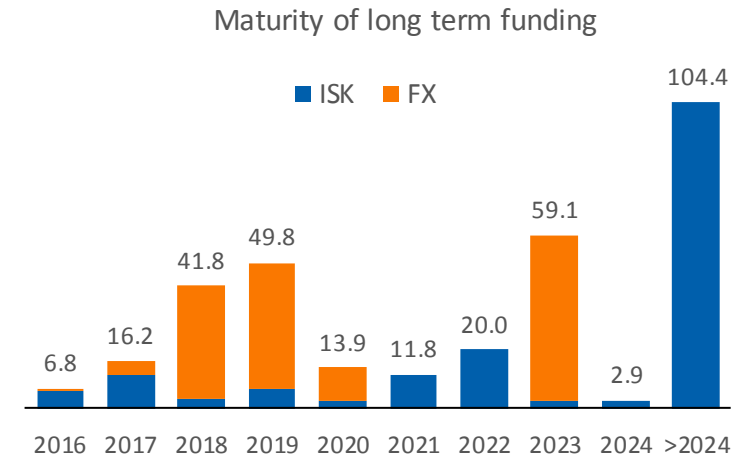
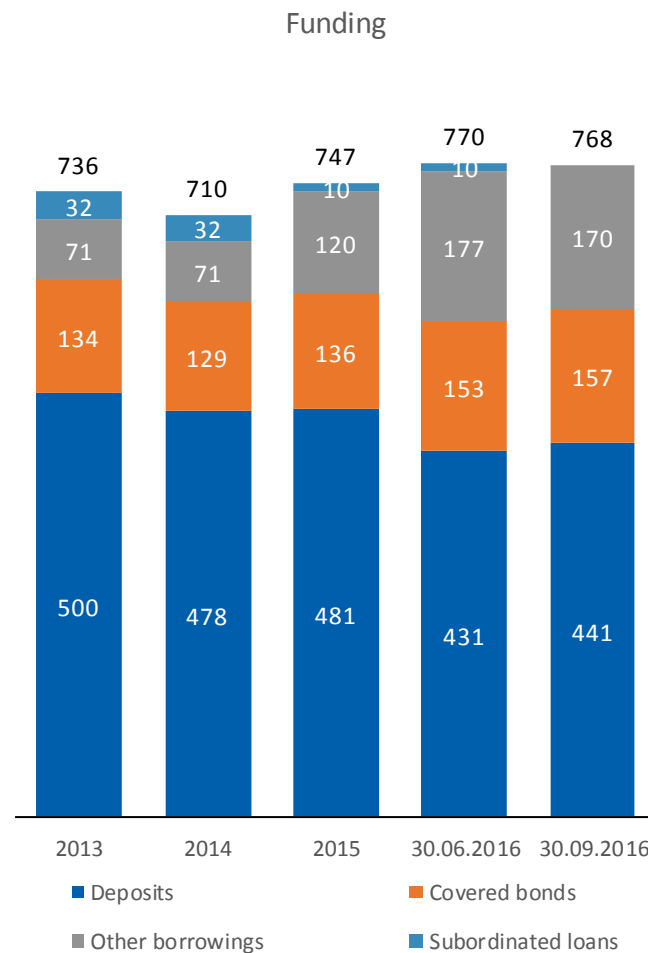


# LIABILITIES AND EQUITY

All amounts in ISK billion

## SUBORDINATED LOAN FULLY PREPAID

- In January the Bank and Kaupthing reached a funding agreement with deposits in foreign currency at Arion Bank and foreign currency loan at Central Bank changed to EMTN 7 year USD bonds. The total amount was USD 748 million but USD 252 million was prepaid in April
- In April the Bank issued a new 3 year EUR 300 million bond, which is trading favourably on the market, as are other bonds issued by Arion Bank
- The Bank continues to issue Covered Bonds in the Icelandic market, total of ISK 20.4 billion during 9M 2016

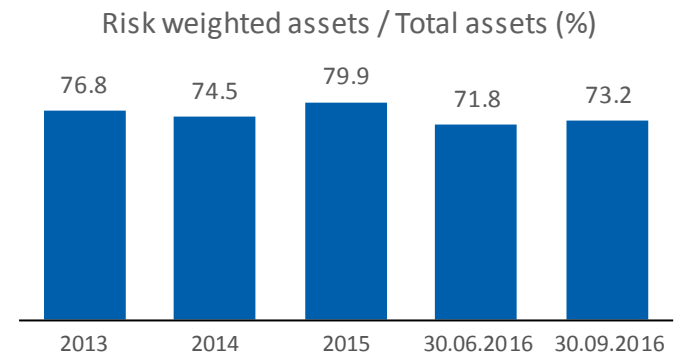
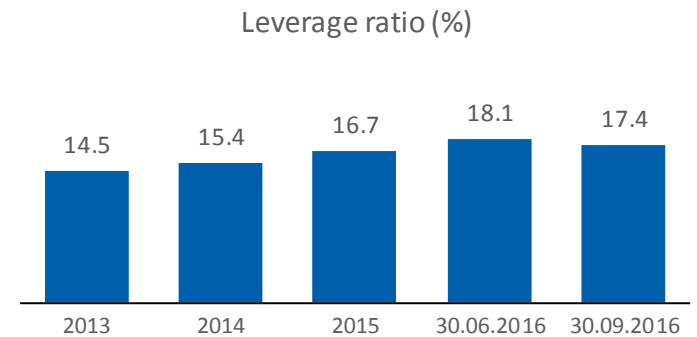
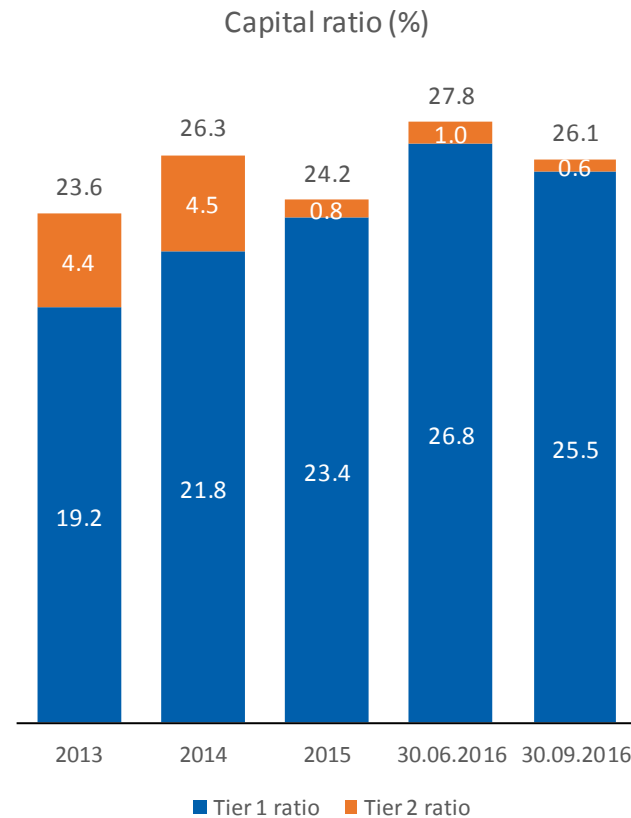


# CAPITAL BASE

All amounts in ISK billion

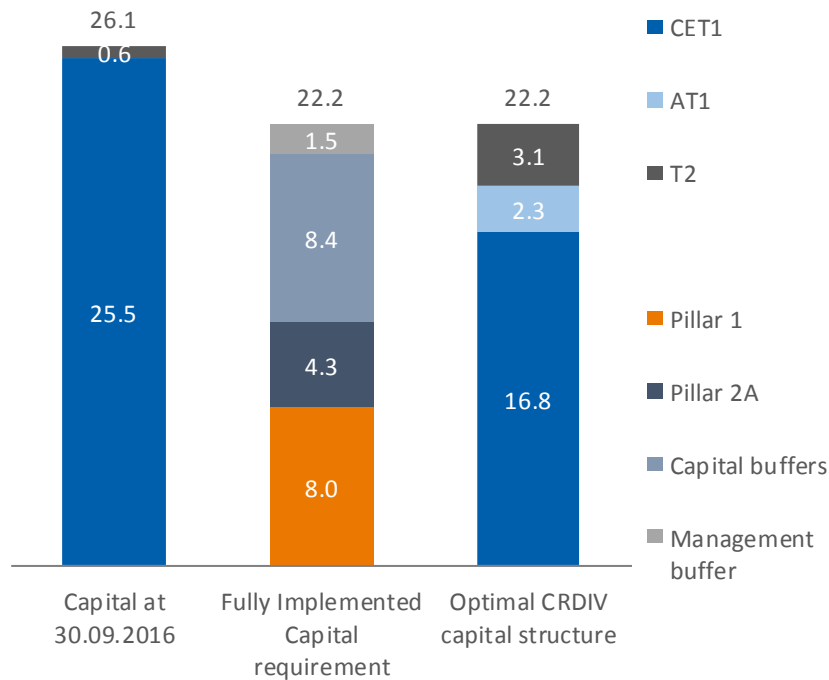
## STRONG EQUITY POSITION

- Solid level of capitalization due to strong profit generation
- Decline in Tier 1 ratio due to reduction of non-controlling interest
- Reduction in risk weighted assets from year end due to decrease in loan commitments and lower FX imbalance
- Tier 2 capital consisted only of subordinated liabilities from 2013 till 30 June 2016.
- With the implementation of Basel III as at 30 September 2016, the Bank's general provisions count as Tier 2 capital.



# CAPITAL BASE

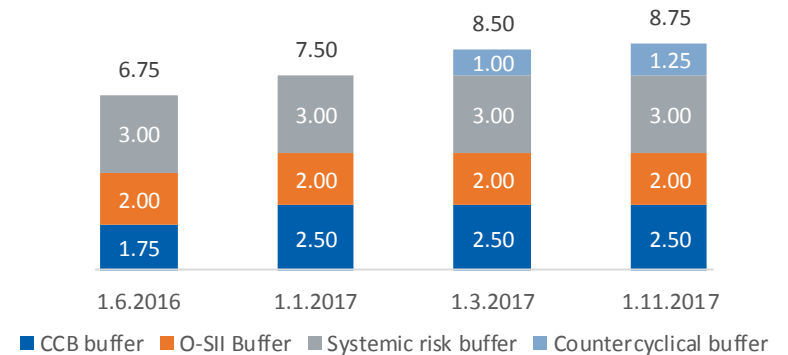
## CAPITAL STRUCTURE AND CAPITAL NEEDS (%)



- The final adoption of CRDIV/CRR into Icelandic law has been finalized. The main effect is the inclusion of the Bank's general provisions as Tier 2 capital.

- At Q4 of 2017, the combined capital buffer requirement reaches 8.4%. The Financial Stability Board has recommended to the regulator that the countercyclical capital buffer be increased from 1.00% to 1.25%, taking effect in 12 months' time
- FME's SREP results indicate a regulatory capital requirement of 20.7%, including fully-implemented buffers
- Assuming a management buffer of 1.5%, the Bank had a surplus capital of ISK 30 billion at 30 September 2016

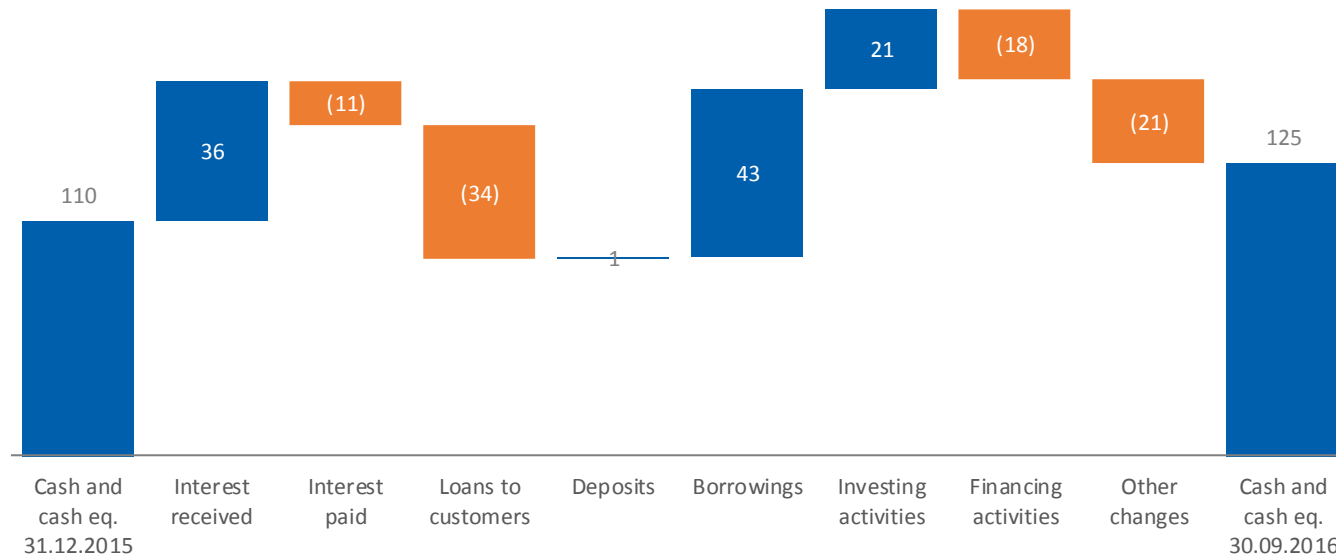
Capital Buffer Implementation for systemically important banks in Iceland (%)



# CASH FLOW

All amounts in ISK billion

## GOOD SOURCE OF FUNDING CONTRIBUTE INCREASED LENDING



- Insurance company Vörður was acquired in Q3 for ISK 5.3 billion, included in investing activities
- Large non-cash changes due to funding agreement with Kaupthing in deposits and borrowings

- Financing activities consist of ISK 9 billion settlement of subordinated loan and ISK 9 billion disbursement to minority shareholders in BG 12



## OUTLOOK AND KEY FINANCIAL INDICATORS

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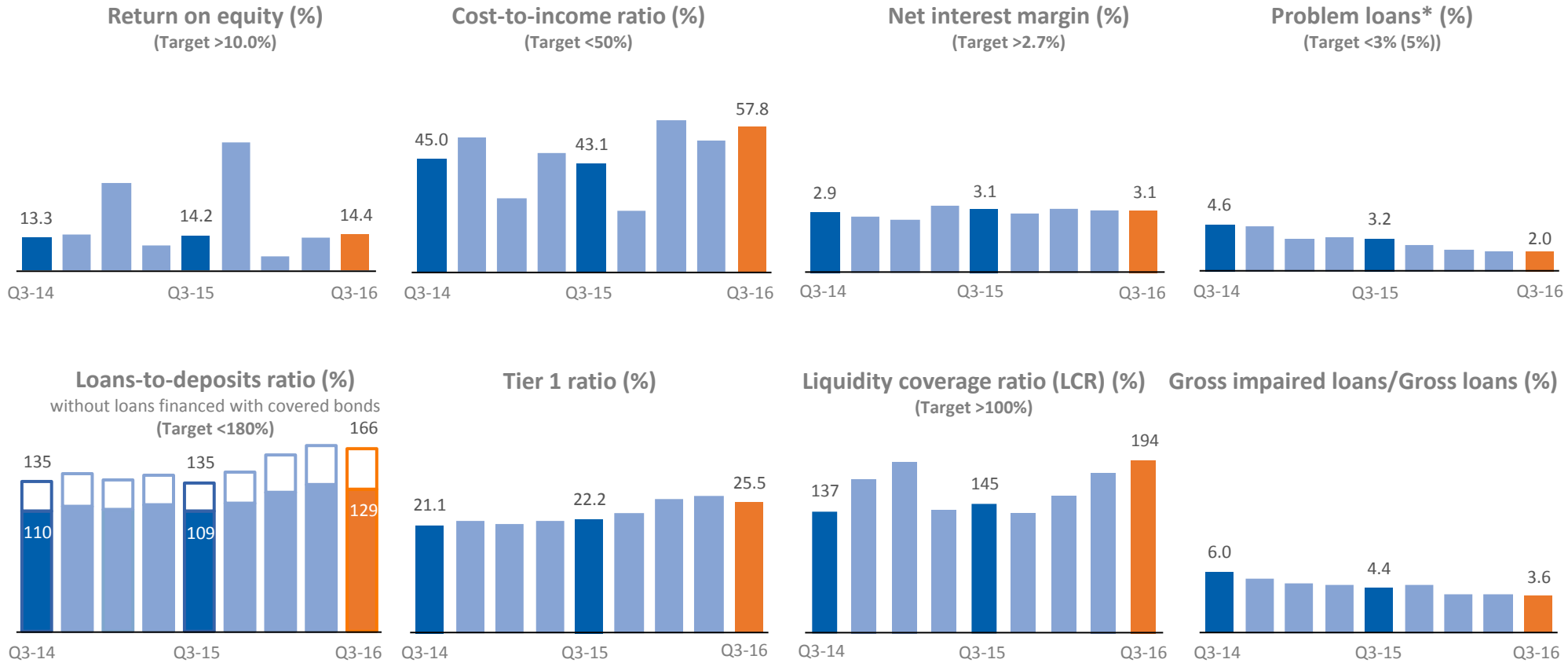


# OUTLOOK

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- Exciting yet challenging times ahead in a positive economic environment
- Following the acquisition of the insurance company Vörður, the Arion Bank group has the most diverse product range in the Icelandic financial services sector
  - Integrating the product ranges of the two companies will be a key task in the future
- Strong liquidity position
  - Strong demand for corporate loans and new lending up from last year
  - Fierce competition on the mortgage market after the pension funds stepped up its activities, leading to a decrease in the percentage of retail loans in the Bank's loan portfolio.
- Arion Bank is continuing its efforts to diversify its sources of funding. Upgraded credit rating in October has a highly positive impact
- Arion Bank's solid capital position makes it well placed to tackle future challenges
- Increased focus on digital future with the goal of generating higher income and reducing operating expenses
- In light of the improving performance of the Icelandic economy, Arion Bank and Kaupthing, the majority shareholder in Arion Bank, are now assessing the options concerning Kaupthing's interest in the Bank
  - An IPO is one of the options on the table, although it should be stressed that no decision has been taken with regard to any specific transactions or timing

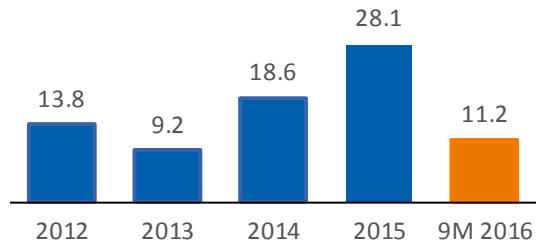
# KEY FINANCIAL INDICATORS



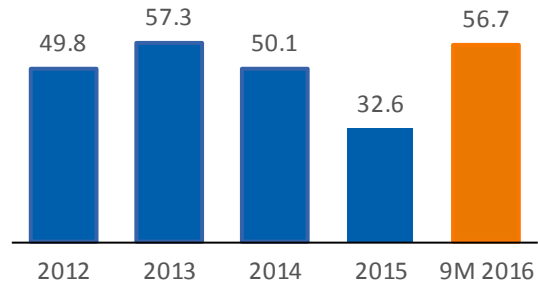
\* Problem loans (past due but not impaired loans over 90 days + individually impaired loans) as % of loans to customers

# KEY FINANCIAL INDICATORS

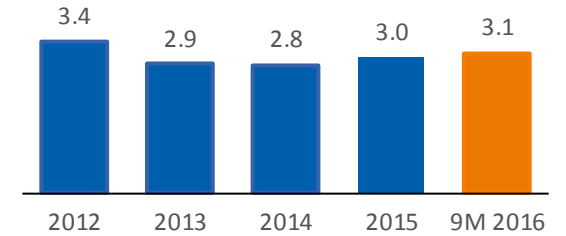
Return on equity (%)



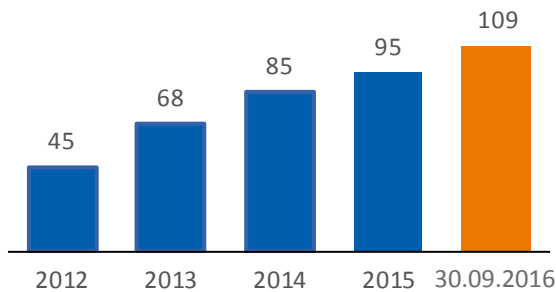
Cost-to-income ratio (%)



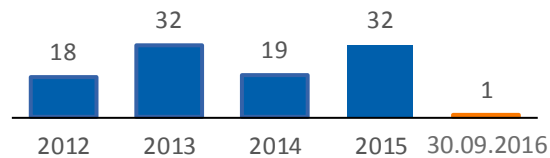
Net interest margin (%)



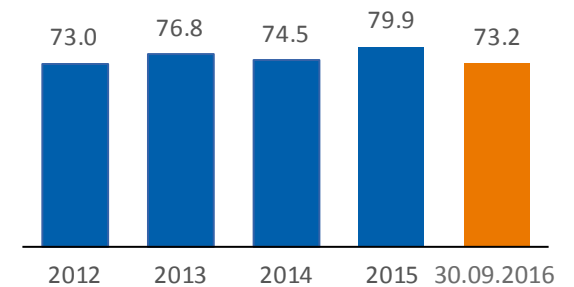
CPI Imbalance – ISK bn.



FX Imbalance – ISK bn.



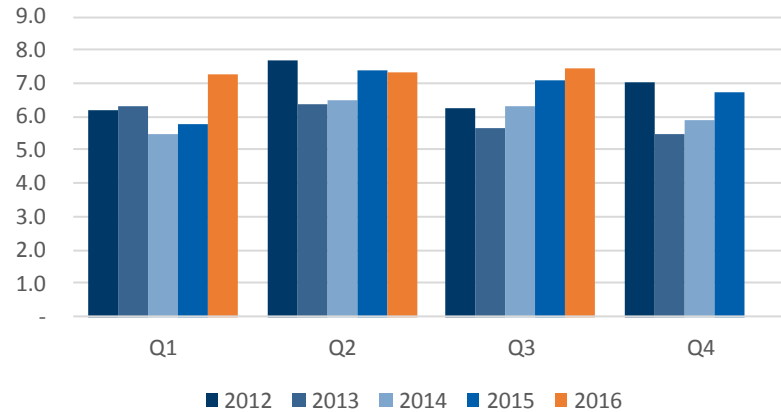
Risk weighted assets/Total assets (%)



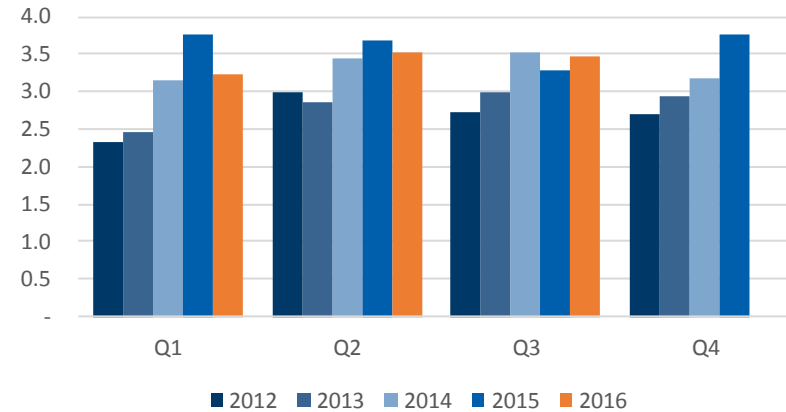
# DEVELOPMENT OF KEY FIGURES

All amounts in ISK billion

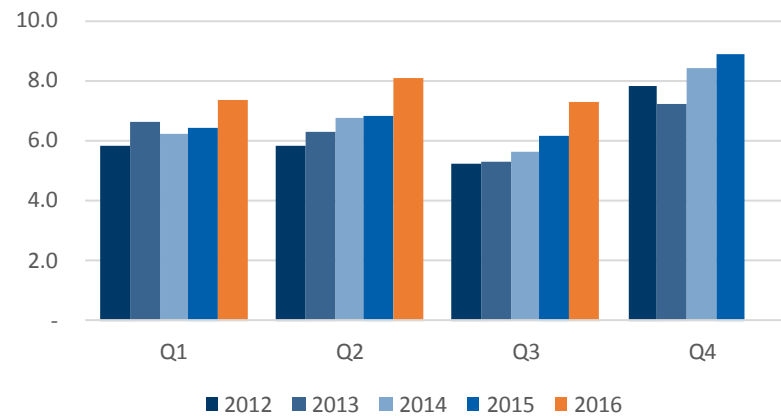
### Net interest income



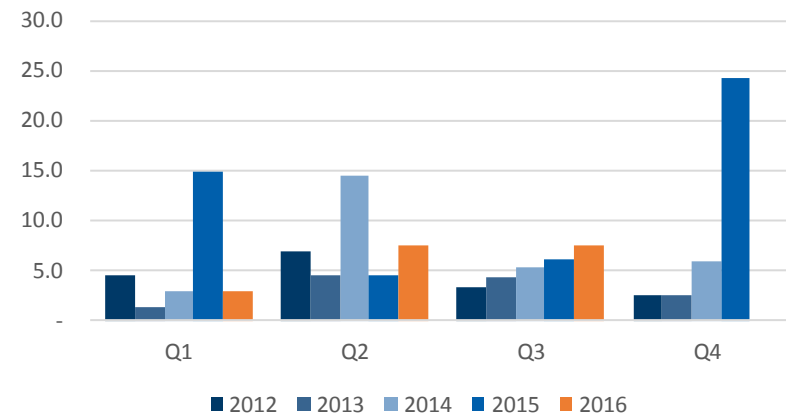
### Net commission income



### Total operating expenses



### Net earnings





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