Earnings release, 16 November 2016

ARION BANK’S 9M 2016 FINANCIAL RESULTS

Arion Bank reported net earnings of ISK 17.3 billion for the first nine months of 2016, compared with ISK 25.4 billion for the same period of 2015. Return on equity was 11.2%, compared with 19.8% for the first nine months of 2015. Adjusted earnings amounted to ISK 5.7 billion, compared with ISK 11.5 billion in the first nine months of 2015. Return on equity from adjusted operations was 3.7%, compared with 9.5% for the same period last year.

Total assets amounted to ISK 1,038.5 billion at the end of September, compared with ISK 1,011.0 billion at the end of 2015. Shareholders’ equity totalled ISK 206.9 billion at the end of September, compared with ISK 192.8 billion at the end of 2015. The Bank enjoys a strong financial position and has focused on maintaining good liquidity in the period leading up to the lifting of the capital controls.

The Bank’s capital ratio at the end of the period was 26.1%, compared with 24.2% at the end of 2015. Tier 1 Capital increased during the period to 25.5%, compared with 23.4% at the end of 2015.

Highlights of the income statement and key performance indicators:

In ISK million	**9M 2016**	**9M 2015**	**Q3 2016**	**Q3 2015**
Net interest income	22,058	20,287	7,432	7,112
Net commission income	10,213	10,726	3,466	3,292
Net financial income	4,339	10,176	844	453
Share of profit of associates	710	6,956	16	2,739
Other operating income	2,642	2,232	781	709
Operating income	**39,962**	**50,377**	**12,539**	**14,305**
Salaries and related expense	(12,252)	(10,320)	(3,826)	(3,153)
Other operating expenses	(10,393)	(9,016)	(3,425)	(3,012)
Bank levy	(2,190)	(2,168)	(705)	(779)
Net impairment	6,827	(114)	5,882	(33)
Net earnings before taxes	**21,954**	**28,759**	**10,467**	**7,328**
Income tax	(5,261)	(3,639)	(3,170)	(1,272)
Net gain from disc. operations	569	277	206	15
Net earnings	**17,262**	**25,397**	**7,503**	**6,071**
KPI's:				
Return on equity (ROE)	11.2%	19.8%	14.4%	14.2%
Net interest margin (int. bearing assets)	3.1%	3.0%	3.1%	3.1%
Cost-to-income ratio	56.7%	38.4%	57.8%	43.1%
Tier 1 ratio	25.5%	22.2%	25.5%	22.2%

HÖSKULDUR H. ÓLAFSSON, CEO OF ARION BANK:

"The financial results for the first nine months of 2016 are satisfactory. The Bank's core operations have performed slightly below expectations as external conditions have been challenging in many respects. The performance of the equities market had a negative impact on the financial results, as the Bank still has holdings in listed equities. Nevertheless the core operations remain solid and the Bank continues to consolidate its capital. Standard & Poor's cited Arion Bank's improving capital position, better access to foreign debt capital markets and greater resilience in the Icelandic economy as reasons for upgrading the Bank's credit rating to BBB/A-2 with a positive outlook. The spread on the Bank's international issues on the secondary market has decreased, clearly indicating that there is demand on the international credit markets for Arion Bank bonds.

At the end of September Arion Bank completed the acquisition of the insurance company Vörður, adding non-life insurance to our product range, which has already included life insurance for several years. As a subsidiary of Arion Bank, Vörður will form a close partnership with the Bank, bringing benefits to the customers of both companies."

CONFERENCE CALL IN ENGLISH

Arion Bank will be hosting a conference call in English on Thursday 17 November at 1:00 pm GMT, where Stefán Pétursson, Chief Financial Officer, will discuss the highlights of the Bank's financial results. People interested in participating can contact ir@arionbanki.is to obtain dial-in information.

For further information please contact Haraldur Gudni Eidsson of Arion Bank's Communications division at haraldur.eidsson@arionbanki.is, or tel. +354 444 7108.

INCOME STATEMENT

In ISK million	9M 2016	9M 2015	Diff	Diff%
Net interest income	22,058	20,287	1,771	9%
Net commission income	10,213	10,726	(513)	(5%)
Net financial income	4,339	10,176	(5,837)	(57%)
Share of profit of associates	710	6,956	(6,246)	(90%)
Other operating income	2,642	2,232	410	18%
Operating income	**39,962**	**50,377**	**(10,415)**	**-21%**
Salaries and related expense	(12,252)	(10,320)	(1,932)	19%
Other operating expenses	(10,393)	(9,016)	(1,377)	15%
Bank Levy	(2,190)	(2,168)	(22)	1%
Net change in valuation	6,827	(114)	6,941	-
Net earnings before taxes	**21,954**	**28,759**	**(6,805)**	**-24%**
Income tax	(5,261)	(3,639)	(1,622)	45%
Net earnings from continuing operation	**16,693**	**25,120**	**(8,427)**	**-34%**
Net gain from disc. operations	569	277	292	105%
Net earnings	**17,262**	**25,397**	**(8,135)**	**-32%**

Operating income amounted to ISK 40.0 billion, compared with ISK 50.4 billion in the first nine months of 2015. The main changes between years are in net financial income and the share of profit of associates which were significant in 2015 due to valuation changes and earnings from the sale of shareholdings in connection with the stock market listing and sale of the companies.

Net interest income increased by 9% from the previous year. The net interest margin as a percentage of average interest-bearing assets was 3.1% during the first nine months of 2016, compared with 3.0% for the same period in 2015. The growth of net interest income is mainly due to an increase in interest-bearing assets, new lending and cash for equity positions.

Net commission income decreased by 5% between years, primarily as a result of an exceptionally high level of activity in investment banking in 2015 following a number of IPOs. Approximately 80% of net commission income originates from corporate clients. Valitor has greatly expanded its business in the Nordic countries and the United Kingdom. The company is experiencing rapid growth but the positive impact on net commission income will not materialize until the next few financial periods, as is generally the case with growth companies. There was an increase in commission income in retail banking from the previous year, partly due to the opening of a branch at Keflavík International Airport in early 2016.

Net financial income amounted to ISK 4,339 million, compared with ISK 10,176 million for the first nine months of 2015. Realized gain on the sale of Valitor's shareholding in Visa Europe Ltd. to Visa Inc. amounted to ISK 5,291 million in the second quarter of 2016. Net financial income from other financial assets was satisfactory during the third quarter and partly offsets the loss generated in the first half of 2016 due to challenging market conditions, particularly on equities. The appreciation of the Icelandic króna resulted in a foreign exchange loss of ISK 829 million during the period.

Share in the profit of associates amounted to ISK 710 million during the first nine months of 2016, compared with ISK 6,956 million during the same period of 2015. Last year this item was heavily influenced by valuation changes and the sale of shareholdings in connection with the stock market listing of companies in 2015, whereas the main factor this year is the profit from sale of a shareholding in Bakkavor Group Ltd. in the first quarter of 2016.

Other operating income increased by ISK 410 million from the previous year and amounted to ISK 2,642 million in the first nine months of 2016. The increase is mainly related to profits from the sale of assets during the period.

Operating expenses amounted to ISK 22,645 million during the first nine months of 2016, compared with ISK 19,336 million during the same period of 2015. The Bank's cost-to-income ratio was 56.7% during the period, compared with 38.4% in 2015. This substantial increase in the cost-to-income ratio is partly attributable to high income from valuation changes in equities and profits from the sale of assets in the first nine months of 2015. The cost-to-assets ratio was 2.9%, compared with 2.6% for the first nine months of 2015.

Salaries and related expenses amounted to ISK 12,252 million during the period, an increase of 19% from the first nine months of 2015. The increase is mainly a result of renewed wage agreements, a rise in the number of employees as well as expenses in relation to the redundancy of 46 employees at the end of September. The average salary per employee increased by 15.5% from the same period in 2015, but at the same time the salary index rose by 11.9%. Full-time equivalent positions at the end of September totalled 1,189 at the Group, 38 more than at the end of September 2015. The increase is largely a result of investments in new business opportunities in Iceland and abroad. Most significant in this respect are the growth of Valitor internationally and the opening of a new branch at Keflavik International Airport.

Net valuation change was positive by ISK 6,827 million during the first nine months of 2016. The positive net impairment is in particular due to the revaluation of acquired mortgages.

Income tax amounted to ISK 5,261 million, compared with ISK 3,639 million during the first nine months of 2015. Income tax, as reported in the annual financial statements, comprises 20% income tax on earnings and a special 6% financial tax on the earnings of financial institutions in excess of ISK 1 billion. The effective income tax rate was 24.0% during the first nine months of 2016, compared with 12.7% in the same period of 2015. The unusually low effective income tax rate in 2015 is mainly explained by tax exempt earnings at corporates relating to valuation changes and profits on equity positions. Total taxes paid by financial institutions remain higher than those paid by other companies operating in Iceland. Taxes paid specifically by the Bank as a financial institution amount to ISK 3.9 billion.

Arion Bank's **adjusted earnings** in the first nine months of 2016 were lower than the same period in 2015. Net interest income and net commission income are relatively stable but income from shareholdings and bonds tends to fluctuate. There was a considerable year-on-year increase in operating expenses, which was mainly related to higher salaries under new wage agreements. In respect of adjusted operations Arion Bank makes adjustments for capital gains and valuation changes in acquired equity positions, the effect of subsidiaries engaged in unrelated operations, a one-off expense due to redundancies and professional services, and valuation changes in loans. Taking the above factors into account, net earnings for the first nine months of 2016 decreased by ISK 11,559 million to ISK 5,703 million. Return on equity from adjusted operations in the first nine months of 2016 was 3.7%, compared with 9.5% for the first nine months of 2015. The cost-to-income ratio for adjusted operations was 60.9% during the first nine months of 2016, compared with 49.1% for the same period in 2015.

Third quarter of 2016

The financial results for the third quarter of 2016 were good. Return on equity was 14.4%, compared with 14.2% in the same period of 2015.

In ISK million	**Q3 2016**	**Q3 2015**	**Diff**	**Diff%**
Net interest income	7,432	7,112	320	4%
Net commission income	3,466	3,293	173	5%
Net financial income	844	452	392	87%
Share of profit of associates	16	2,739	(2,723)	(99%)
Other operating income	781	709	72	10%
Operating income	**12,539**	**14,305**	**(1,766)**	**-12%**
Salaries and related expense	(3,826)	(3,152)	(674)	21%
Other operating expenses	(3,423)	(3,011)	(412)	14%
Bank Levy	(705)	(779)	74	(9%)
Net change in valuation	5,882	(32)	5,914	-18481%
Net earnings before taxes	**10,467**	**7,331**	**3,136**	**43%**
Income tax	(3,170)	(1,272)	(1,898)	149%
Net earnings from continuing operation	**7,297**	**6,059**	**1,238**	**20%**
Net gain from disc. operations	206	15	191	1273%
Net earnings	**7,503**	**6,074**	**1,429**	**24%**

Operating income in the third quarter decreased by 12% between years, mainly due to positive fair value changes of Síminn hf. in the third quarter last year in connection with the listing of the company on the stock market. Net interest income and net commission income both increased slightly. Net financial income was ISK 844 million as a result of strong returns on securities in general. Currency exchange difference was negative by ISK 143 million during the period.

Operating expenses increased between quarters, due to factors such as higher salary expenses as a result of renewed wage agreements, higher IT expenses and higher expenses on professional services.

Net change in valuation was positive in the third quarter and amounts to ISK 5,882 million. Positive net impairment is mainly due to the revaluation of the Bank's acquired mortgages.

BALANCE SHEET

Arion Bank's ***total assets*** increased by 3% from year end 2015. The main changes result from increases in balances with the Central Bank and loans to customers. Loans to credit institutions, investments in associates and financial assets decreased, however.

In ISK million	**30.09.2016**	**31.12.2015**	**Diff**	**Diff%**
Cash & balances with CB	85,645	48,102	37,543	78%
Loans to credit institutions	68,257	87,491	(19,234)	(22%)
Loans to customers	715,907	680,350	35,556	5%
Financial assets	128,357	133,191	(4,834)	(4%)
Investment property	5,113	7,542	(2,428)	(32%)
Investments in associates	869	27,299	(26,431)	(97%)
Intangible assets	11,077	9,285	1,792	19%
Other assets	23,255	17,783	5,471	31%
Total assets	**1,038,480**	**1,011,043**	**27,436**	**3%**

Loans to customers totalled ISK 715,907 million at the end of September, a 5% increase from year end 2015. Loans to corporates increased by 7%, or ISK 26 billion, during the first nine months of 2016. These new loans are mainly in real estate activities, industry, energy and manufacturing and wholesale and retail. Mortgage loans to individuals increased by 5% from year end 2015. The quality of loans to customers continues to improve. The ratio of problem loans decreased from 2.5% to 2.0% during the first nine months of 2016. The Bank defines problem loans as the ratio of the book value of loans 90 days or more in default and loans for which special impairment is required to the Bank's total loans to customers. The proportion of impaired loans decreased from 4.7% at the end of 2015 to 3.6% at the end of September 2016.

Financial assets amounted to ISK 128,357 million at the end of September, compared with ISK 133,191 million at the end of 2015. Financial assets decreased due to the sale of assets, including the sale of holdings in Visa Europe Ltd. as well as due to a decrease in market value. Financial assets decreased despite the acquisition of the subsidiary Vörður tryggingar hf. Financial assets at Vörður tryggingar hf. at the end of September totalled ISK 4.3 billion.

Shareholdings in associates decreased significantly from year end 2015, mainly due to the sale of shareholdings in Bakkavor Group Ltd. in January 2016.

Liabilities increased slightly between years, which is primarily a result of new borrowings. ***Equity*** increased as a result of the first nine months 2016 financial results. ***Non-controlling interest*** decreased due to the disbursement of share capital and dividend payment of the subsidiary BG12 and due to the sale of a large shareholding in the subsidiary Kolufell in August.

In ISK million	**30.09.2016**	**31.12.2015**	**Diff**	**Diff%**
Due to credit institutions & CB	9,375	11,387	(2,012)	(18%)
Deposits from customers	431,929	469,347	(37,418)	(8%)
Financial liabilities at fair value	5,097	7,609	(2,512)	(33%)
Other liabilities	58,319	54,383	3,936	7%
Borrowings	326,754	256,058	70,696	28%
Subordinated loans	-	10,365	(10,365)	(100%)
Shareholders equity	206,940	192,786	14,154	7%
Non-controlling interest	66	9,108	(9,042)	(99%)
Total liabilities and equity	**1,038,480**	**1,011,043**	**27,436**	**3%**

Borrowings amounted to ISK 326,754 million at the end of September. In January Arion Bank reached an agreement with Kaupthing under which Arion Bank issued a bond in the amount of $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 offset loans in foreign currency taken by Arion Bank from the Central Bank of Iceland, owned by Kaupthing, and Kaupthing deposits in foreign currency at Arion Bank and explains the decrease in Deposits from customers from year end 2015. The bond issue forms part of the capital controls liberalization process relating to Kaupthing, first announced by the Ministry of Finance and Economic Affairs on 8 June 2015. In April the Bank issued €300 million in 3-year instruments under its EMTN programme. The bonds were issued with a 2.7% premium on interbank rates. The Bank has continued to issue covered bonds to finance new mortgages and issued ISK 20.4 billion in such bonds in the first nine months 2016.

Shareholders' equity amounted to ISK 206,940 million at the end of September 2016, compared with ISK 192,786 million at the end of 2015. The increase is explained by the financial results for the period. The Tier 1 ratio was 25.5% at the end of September 2016, compared with 23.4% at the end of 2015. According to the FME's rules on calculating capital ratios, it is not permitted to take financial results into account unless they are endorsed by an auditor. The capital ratio according to the FME's rules was 24.0% at the end of September, compared with 24.2% at the end of 2015.

KEY PERFORMANCE INDICATORS

	9M 2016	2015	9M 2015
Return on equity (ROE)	11.2%	28.1%	19.8%
Return on total assets (ROA)	2.2%	5.0%	3.5%
Net interest margin (int. bearing assets)	3.1%	3.0%	3.0%
Net interest margin (total assets)	2.9%	2.7%	2.8%
Cost-to-income ratio	56.7%	32.6%	38.4%
Cost-to-Total assets ratio	2.9%	2.9%	2.6%
Effective tax rate	24.0%	6.0%	12.7%
CAD ratio	26.1%	24.2%	23.5%
Tier 1 ratio	25.5%	23.4%	22.2%
Problem loans	2.0%	2.5%	3.2%
Gross impaired loans/Gross loans	3.6%	4.7%	4.4%
RWA/Total assets	73.2%	79.9%	73.3%
Loans to deposit ratio	165.7%	145.0%	134.9%
The Group's average number of employees	1,186	1,139	1,131
The Group's employees at the end of the period	1,189	1,147	1,151
The Parent's average number of employees	894	885	849
The Parent's employees at the end of the period	887	876	850

FINANCIAL CALENDAR FOR 2016 AND 2017

The Bank's interim financial statements are scheduled for publication as stated below.

Financial statements for 2016	13 February 2017
Annual general meeting 2017	16 March 2017
First quarter 2017	16 May 2017
Second quarter 2017	30 August 2017
Third quarter 2017	15 November 2017

This calendar may be subject to change.