Consolidated Financial Statements

– for the year 2016

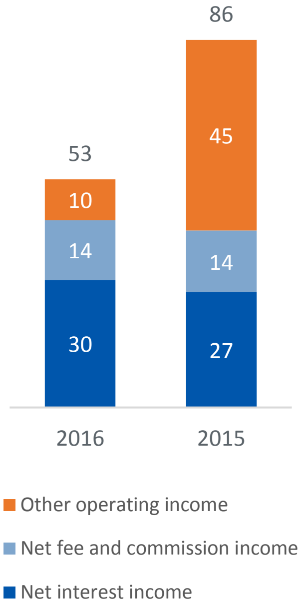
Arion Bank

Contents

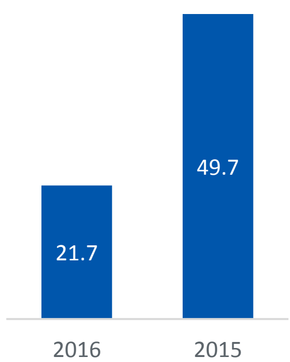
Key figures

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

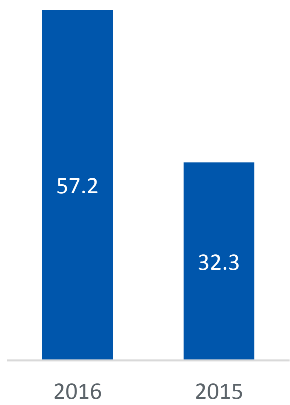
Operating income
(ISK billion)



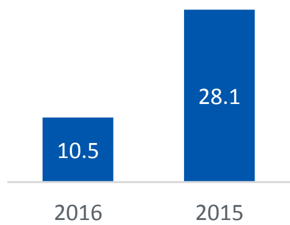
Net earnings
(ISK billion)



Cost to income
(%)

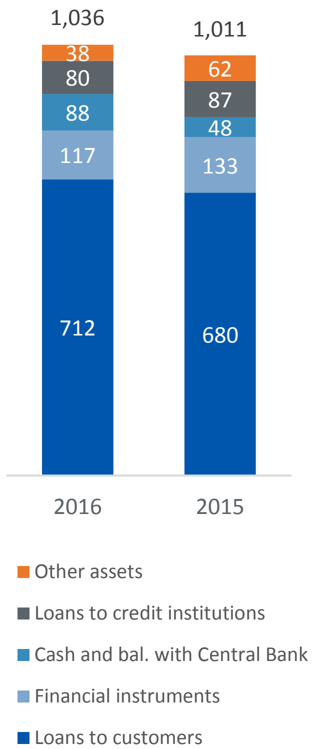


Return on equity
(%)

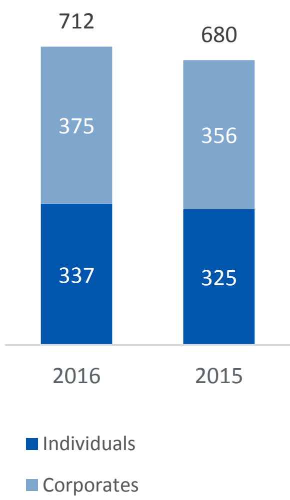


CONSOLIDATED STATEMENT OF FINANCIAL POSITION

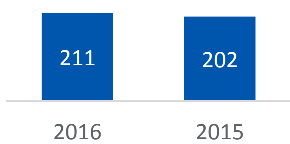
Total assets
(ISK billion)



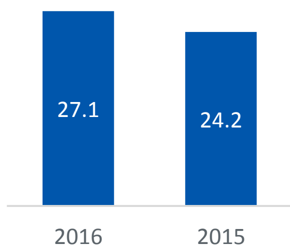
Loans to customers
(ISK billion)



Equity
(ISK billion)



Capital ratio
(%)



Endorsement and statement by the Board of Directors and the CEO

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

Outlook

2016 was an eventful year for the Icelandic economy. During the first nine months of the year gross domestic product grew by 6.2% from the previous year as a result of both investment and private consumption. Despite growing private consumption, national savings have also increased, which indicates that higher purchasing power does not entirely pass through to consumption but also results in higher savings. Robust economic growth can also be linked to the rapid growth of the tourist industry, as there was a 40% year-on-year increase in the number of tourists visiting Iceland. Tourism has firmly established itself and is now Iceland's main export sector. Foreign exchange earnings generated by increased exports have fuelled the appreciation of the nominal exchange rate of the króna, while the average exchange rate has strengthened by almost 11% between years. Unemployment averaged 3% in 2016, compared with 4% in 2015. Inflation was 1.7%, which is below the Central Bank of Iceland's target rate. Robust economic growth of 5% is still expected and most forecasts suggest that private consumption will be stronger this year than it was last year. Unemployment is expected to decrease slightly and inflation is forecast to remain low, averaging around 1.8%, owing to the further appreciation of the króna. The conditions are therefore excellent for Arion Bank, whose operations are primarily concentrated on the domestic market.

In October Standard & Poor's upgraded Arion Bank's credit rating from BBB- with a positive outlook to BBB with a positive outlook. The upgrade reflects Arion Bank's solid financial position and good liquidity position which builds on improving conditions in the Icelandic economy and the deleveraging of Icelandic households and corporations. It also takes into account Arion Bank's enhanced access to international funding markets.

Arion Bank is a leading, well balanced universal relationship bank operating on the Icelandic financial market. The Bank has moderate risk profile and enjoys a strong position in all its business segments: Retail Banking, Corporate Banking, Asset Management and Investment Banking. The Bank's subsidiaries further supplement its service offering and form an integral part of the Group. The main subsidiaries include Valitor hf., which is a market leader in Iceland in acquiring services and payment solutions and also has operations in Scandinavia and the United Kingdom. The Bank also owns Stefnir hf., Iceland's largest fund management company, Vörður tryggingar hf., the fourth largest insurance company in Iceland and Okkar líftryggingar hf., Iceland's second largest life insurance company. Work is under way to merge Okkar lítryggingar hf. into Vörður líftryggingar hf., which is a subsidary of Vörður tryggingar hf.

Arion Bank places great importance on innovation and efficiency in its operations. A key area of focus for many years has been developing online banking and in recent years mobile banking has been a priority. These new distribution channels have already had, and will continue to have, an impact on how the Bank meets the needs of its customers. As a result the number of branches has been substantially reduced in recent years and the Bank will continue to seek ways to bring greater efficiency to the branch network. Another area of focus at Arion Bank is digital future, which is critical in order to both onhance customer experience and reduce operating expenses across the Bank in the long term.

Arion Bank is financially robust as demonstrated by a leverage ratio of 18.0% (see Note 44). Its liquidity position is strong, with a liquidity coverage ratio of 171%, (see Note 42). All the ingredients are in place to enable Arion Bank to continue to offer its customers quality services in the areas which are important to them, whether in Retail Banking, Corporate Banking, Asset Management or Investment Banking. The Bank's financial strength enables it to grow alongside its customers and to pay competitive dividends to its owners.

Kaupthing ehf., now a holding company, has expressed its interest in exploring its options in respect to its 87% shareholding in Arion Bank, held by its subsidiary Kaupskil ehf. On 15 June Arion Bank and Kaupthing issued the following press release: "In the context of the continued strong development of the Icelandic economy, Arion Bank and Kaupthing, its majority owner, are currently assessing a range of strategic alternatives with regards to Kaupthing's shares held in the Bank. This may include a possible IPO; however, no decision has been made at this point in time with respect to any specific transaction and timing thereof".

Operations during the year

Net earnings amounted to ISK 21,739 million for 2016, and the Group's equity amounted to ISK 211,384 million at the end of the year. Return on equity was 10.5% for the year. The capital ratio of the Group, according to the Financial Undertakings Act No. 161/2002 was 27.1% and the corresponding Tier 1 ratio was 26.5%, which comfortably meets the requirements set by law and the Financial Supervisory Authority (FME). The liquidity position was also strong at year-end and well above the regulatory minimum.

The Board of Directors proposes that net earnings be added to equity and that no dividend be paid in 2017 for the fiscal year 2016, for now. The Board of Directors has a broad authority to suggest that the Bank pay dividends or other disbursement of equity and may convene a special shareholders' meeting later in the year to propose a payment.

Endorsement and statement by the Board of Directors and the CEO

On 30 September 2016 Arion Bank completed the acquisition of all shares in the insurance company Vörður tryggingar hf., which is classified as subsidiary of the Bank.

In June the Bank's subsidiary Valitor Holding hf. completed the sale of its shareholding in Visa Europe Ltd. to Visa Inc. The profit from the sale was ISK 5,291 million, after taking into account conditional payments to Landsbankinn hf. and two savings funds, which formed part of the agreement when Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014. The profit was recognized as Net financial income in the Statement of Comprehensive Income in the second quarter of 2016. The shareholding was classified as Financial assets available for sale at year-end 2015.

The main changes on the Balance Sheet from year-end 2015 relate to changes in the structure of funding, increased lending and increased liquidity. Loans to customers have increased by ISK 32.1 billion, or 4.7%, during the year. Approximately 17% of total loans to customers are in foreign currency. New lending is mainly to individuals, real estate and industry, energy and manufacturing.

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 1.6%.

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.

In May Arion Bank opened its first branch for several years with a new branch at Keflavík International Airport. It is a state-of-the-art branch which enables the Bank to provide a wide range of first-class services to the growing number of tourists visiting Iceland.

Arion Bank improved its funding during 2016. In January Arion Bank reached an agreement with Kaupthing under which Arion Bank issued a bond in the amount of USD 747 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. Arion Bank settled large share of the bond in 2016.

In April Arion Bank issued bonds for a total of EUR 300 million, or ISK 42 billion. It was the Bank's second issue in euros to a diverse group of investors. The bonds are 2-year instruments and bear a fixed 2.5% coupon and were sold at terms equivalent to 2.7% margin over interbank rates. In November Arion Bank held a second issue and issued a total of EUR 300 million (ISK 36 billion) in senior unsecured bonds. Orders totalling over EUR 400 million from more than 50 investors were received. The 5-year bonds have a fixed coupon of 1.625% and were sold at rates corresponding to a 1.65% margin over interbank rates. A significant proportion of the above issue was used to pay approximately 65% of the Bank's issue from January 2016 which is owned by Kaupthing.

In September Arion Bank settled the subordinated liabilities with the Ministry of Finance with a prepayment. The Bank partly used proceeds from the Bank's bond issues in foreign currencies to pay off these loans. Paying off subordinated loans significantly reduces the Bank's future interest expenses.

The Bank has also focused on several other sources of funding. A number of smaller private placements were completed in NOK, SEK and other currencies during the year, continued to issue covered bonds which are secured in accordance with the Covered Bond Act No. 11/2008. In 2016 the Bank issued a total of ISK 24.8 billion of covered bonds. The Bank has also continued to issue commercial paper on the domestic market and this has further diversified the Bank's funding. Commercial paper amounting to ISK 23.5 billion was issued in 2016.

The Group had 1,239 full-time equivalent positions at the end of the year, compared with 1,147 at the end of 2015; 869 of these positions were at Arion Bank, compared with 876 at the end of 2015. The number of employees increased by 30 in connection with the new branch at Keflavík International Airport. With the acquisition of Vörður tryggingar the number of full-time equivalent employees in the Group increased by 67. The number of employees at Valitor increased by 37 during the year. Arion Bank has invested heavily in Valitor's international operations which have grown rapidly in recent years. Salary increases in accordance with collective wage agreements, which came into effect on 1 January, raised the group's salary expenses substantially. As a consequence the Bank sought ways to reduce salary expenses and in September it reduced the number of employees by approximately 6%. Redundancies were made in all divisions of the Bank.

The tax environment did not change for Arion Bank during the year even though taxes paid by the main Icelandic banks are much higher than those paid by other companies. Most significant in this respect are the special 6% tax on earnings exceeding ISK 1 billion and the bank levy of 0.376% on liabilities exceeding ISK 50 billion.

Endorsement and statement
by the Board of Directors and the CEO

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

Risk management

The Group faces various risks arising from its day-to-day operations as a financial undertaking. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels. The Group's risk management, its structure and main risk factors are described in the notes, starting at Note 40.

Corporate governance

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

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

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

Endorsement and statement by the Board of Directors and the CEO

Sustainability

Arion Bank takes an active role in our society and its development. Financial institutions are one of the pillars of society and our role is to help our customers, both individuals and companies, reach their goals. The employees are guided by the Bank’s cornerstones: we make a difference, we say what we mean and we get things done. The Bank's code of ethics also serve as a key to responsible decision-making at Arion Bank. The code of ethics is approved by the Board of Directors.

Arion Bank has played an important role in the regeneration of the Icelandic economy, not least in the rebuilding of the Icelandic stock market. The Bank has played an active role in more than 60% of stock offerings in recent years, including all offerings in 2015 and 2016. The Bank is dedicated to supporting the Icelandic business sector. With this aim in mind it has actively supported innovation and it has helped to set up two business accelerators, Startup Reykjavík and Startup Energy Reykjavík, where entrepreneurs are given the opportunity to develop their business ideas. Startup Reykjavík is fully owned by Arion Bank, while Startup Energy Reykjavík is a joint project with several leading players on the Icelandic energy market. During the year Arion Bank invested in 17 startups which participated in the business accelerators and it has now invested in more than 70 such companies in the last few years. The Bank has also invested more than ISK 1 billion in the venture capital fund Eyrir Sprotar and supported innovation at primary and secondary level schools across Iceland.

Lean management has been introduced across the Bank with the aim of improving service and eliminating waste. Constant improvements are integral to the Bank’s culture. Improvements are recorded, targets set and then followed up on. During the year an average of eight improvements were made for each employee, exceeding the set goals. To this end there has been a strong focus on increasing digital services and five new digital solutions for customers were introduced during the year. Digital solutions reduce the ecological footprint of the Bank and its customers by reducing the number of trips made by customers to branches and cutting back on the use of paper. The Bank also places great importance on being able to provide quality advice at its branches and its employees also provide financial instruction to customers in order to help customers gain a better understanding of their own finances.

Since the Bank was founded one its key objectives has been to run an efficient and profitable business and to maintain the Bank's financial strength by meeting all capital and liquidity requirements. Internal control has been systematically reinforced and at the end of 2016 around 50 people worked in this area. Arion Bank has been recognized for good corporate governance. Arion Bank has been awarded equal pay certification by the labour union VR and has implemented a quality system which aims to eliminate the gender pay gap. In 2016 the unexplained gender pay gap measured 3.7% and the goal in 2017 is to reduce this to 3%.

In 2016 the Bank reviewed its policy on sustainability and in late 2016 a new policy was approved by the Board of Directors and presented to the employees. In 2015 Arion Bank signed the City of Reykjavík and Festa's Declaration on Climate Change and in collaboration with an Icelandic innovation company, Klappir Green Solutions, the Bank assessed its ecological footprint and set itself a target on how to reduce it. This will be discussed in more detail in the Bank's 2016 annual report. The Bank will also be guided by the list of non-financial factors highlighted by Nasdaq Iceland and the 10 principles in the UN Global Compact in which Arion Bank became a participant in 2016. Environmental and social issues will be covered in more depth in the 2016 annual report.

In 2017 the Bank will continue the good work carried out in 2016. The new policy on sustainable banking will be implemented, one of the objectives being to increase the number of non-financial performance indicators and to cement the role of sustainability in the Bank's procedures and management systems.

Endorsement and statement by the Board of Directors and the CEO

Endorsement of the Board of Directors and the Chief Executive Officer

The Financial Statements of Arion Bank for the year ended 31 December 2016 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

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

Furthermore, in our opinion the 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 Financial Statements of Arion Bank for the year 2016 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 13 February 2017

Board of Directors

Monica Caneman
Chairman

Benedikt Olgeirsson

Brynjólfur Bjarnason

Kirstín Þ. Flygenring

Måns Höglund

Þóra Hallgrímsdóttir

Guðrún Johnsen

John P. Madden

Chief Executive Officer

Höskuldur H. Ólafsson

Independent Auditor's report

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

Opinion

We have audited the Consolidated Financial Statements of Arion Bank hf. for the year ended December 31, 2016 which comprise the Consolidated Statement of Comprehensive Income, the Consolidated Statement of Financial Position, the Consolidated Statement of Changes in Equity, the Consolidated Statement of Cash Flows for the year then ended and the notes to the Consolidated Financial Statements, including a summary of significant accounting policies.

In our opinion, the accompanying Consolidated Financial Statements give a true and fair view of the consolidated financial position of Arion Bank hf. as at December 31, 2016, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act.

Basis for Opinion

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

Key Audit Matters

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

Key Audit Matters	***How the matter was addressed in the audit***
Loan valuation and loss provisioning	
Loans to customers is the largest class of asset on the Consolidated Statement of Financial Position. The management of the Bank exercise significant judgement when determining both when and how much to record as loan impairment provisions. Because of the significance of these judgements and the size of loans to customers, the audit of loan impairment provisions is a key audit matter. The basis of the provisions is summarized in the accounting policies in notes 53 and 55 to the Consolidated Financial Statements.	We have examined loan valuation policies and tested the relevant controls over the impairment process and assessed the technique management uses to estimate incurred but not reported losses. This includes testing of controls the Bank has in place for capturing loans that needs to be reviewed for impairment and their forbearance strategy. We selected a sample of loans from the full population, both performing and non-performing loans. For selected sample we have challenged the appropriateness of management's key processes and assumptions used in the calculations of impairment for loans and advances and assessed whether the provisions are in accordance with IFRS. This included the impaired accounts and valuation of underlying collateral.
Revenue recognition	
Interest income and fee and commission income are key elements to the core business of the Bank. Those are the largest items of the Statement of Comprehensive Income. Both revenue sources are subject to contractual terms and highly reliant on IT controls and other controls within the Bank's control environment. Therefore, we consider the interest income and fee and commission income as key audit matter. The basis for revenue recognition and accounting policies are presented in notes 49-51 to the Consolidated Financial Statements.	We reviewed the policies, processes and controls surrounding the revenue recognition. We have tested relevant controls related to accounting for interest income and fee and commission income. We have tested the appropriateness of the interest calculation in accordance with IAS 39. We tested interest income by select sample of loans and compare the underlying data to the loans system. We also tested the interest income and fee income using analytical procedures. We selected sample of loans to ensure that interest is being accrued correctly.

Independent Auditor's report

Key Audit Matters	*How the matter was addressed in the audit*
IT controls	
Arion Bank is significantly dependent on their IT-systems to, serve customers, support their business processes, ensure complete and accurate processing of financial transactions and support the overall internal control framework. Many of the Bank's internal controls over financial reporting are depending upon automated application controls and completeness and integrity of reports generated by the IT-systems. Given the high dependency on technology, we consider this to be a key audit matter for our audit.	We have reviewed the policies and processes related to IT applications. We have tested relevant controls related to change management, access rights and IT operation of material IT systems related to financial reporting. A large majority of controls were operating effectively and did not require further action. For the remaining few we performed additional testing in order to determine whether we could place reliance on the completeness and accuracy of system generated information.

Other information

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

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

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

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

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

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

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

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

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

Independent Auditor's report

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

- Identify and assess the risks of material misstatement of the Consolidated Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Arion Banks hf.'s internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the Consolidated Financial Statements, including the disclosures, and whether the Consolidated Financial Statements represent the underlying transactions and events in a manner that achieves fair presentation.

- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the Consolidated and Separate Financial Statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

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

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

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

Kópavogur, 13 February 2017

Deloitte ehf.

Páll Grétar Steingrímsson
State Authorised Public Accountant

Gunnar Þorvarðarson
State Authorised Public Accountant

Consolidated Statement of Comprehensive Income for the year 2016

INCOME STATEMENT

	Notes	2016	2015
Interest income		61,655	54,546
Interest expense		(31,755)	(27,554)
Net interest income	6	29,900	26,992
Fee and commission income		23,887	21,234
Fee and commission expense		(9,909)	(6,750)
Net fee and commission income	7	13,978	14,484
Net financial income	8	5,162	12,844
Net insurance income	9	1,395	760
Share of profit of associates	25	908	29,466
Other operating income	10	2,096	1,624
Operating income		53,439	86,170
Salaries and related expense	11	(16,659)	(14,892)
Other operating expense	12	(13,881)	(12,919)
Bank levy	13	(2,872)	(2,818)
Net impairment	14	7,236	(3,087)
Earnings before tax		27,263	52,454
Income tax expense	15	(6,410)	(3,135)
Net earnings from continuing operations		20,853	49,319
Net gain from discontinued operations, net of tax	16	886	360
Net earnings		21,739	49,679
Attributable to			
Shareholders of Arion Bank		21,147	41,968
Non-controlling interest	25	592	7,711
Net earnings		21,739	49,679
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	17	10.13	20.80

OTHER COMPREHENSIVE INCOME

	Notes	2016	2015
Net earnings		21,739	49,679
Net gain on AFS financial assets, net of tax		(2,903)	2,903
Exchange difference on translating foreign subsidiaries	33	182	13
Net other comprehensive income to be reclassified to profit or loss in subsequent periods		(2,721)	2,916
Total comprehensive income		19,018	52,595
Attributable to			
Shareholders of Arion Bank		18,426	44,884
Non-controlling interest		592	7,711
Total comprehensive income		19,018	52,595

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2016 12 Amounts are in ISK millions

Consolidated Statement of Financial Position
as at 31 Desember 2016

Assets	Notes	2016	2015
Cash and balances with Central Bank	18	87,634	48,102
Loans to credit institutions	19	80,116	87,491
Loans to customers	20	712,422	680,350
Financial instruments	21-23	117,456	133,191
Investment property	23	5,358	7,542
Investments in associates	25	839	27,299
Intangible assets	26	11,057	9,285
Tax assets	27	288	205
Other assets	28	20,854	17,578
Total Assets		1,036,024	1,011,043
Liabilities			
Due to credit institutions and Central Bank	22	7,987	11,387
Deposits	22	412,064	469,347
Financial liabilities at fair value	22	3,726	7,609
Tax liabilities	27	7,293	4,922
Other liabilities	29	54,094	49,461
Borrowings	22, 30	339,476	256,058
Subordinated liabilities	22, 31	-	10,365
Total Liabilities		824,640	809,149
Equity			
Share capital and share premium	33	75,861	75,861
Other reserves	33	19,761	4,548
Retained earnings		115,590	112,377
Total Shareholders' Equity		211,212	192,786
Non-controlling interest		172	9,108
Total Equity		211,384	201,894
Total Liabilities and Equity		1,036,024	1,011,043

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2016 13 Amounts are in ISK millions

Consolidated Statement of Changes in Equity for the year 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	-	-	21,147	21,147	592	21,739
Net gain on AFS financial assets	-	(2,903)	-	(2,903)	-	(2,903)
Translation difference	-	182	-	182	-	182
Total comprehensive income	-	(2,721)	21,147	18,426	592	19,018
Reserve for investments in subsidiaries	-	17,012	(17,012)	-	-	-
Reserve for investments in associates	-	23	(23)	-	-	-
Reserve for investments in securities	-	899	(899)	-	-	-
Decrease due to sale of subsidiary	-	-	-	-	(141)	(141)
Disbursement of share capital and dividend to non-controlling interest	-	-	-	-	(9,387)	(9,387)
Equity 31 December 2016	75,861	19,761	115,590	211,212	172	211,384
Equity 1 January 2015	75,861	1,632	83,218	160,711	1,501	162,212
Net earnings	-	-	41,968	41,968	7,711	49,679
Net gain on AFS financial assets	-	2,903		2,903	-	2,903
Translation difference	-	13		13	-	13
Total comprehensive income	-	2,916	41,968	44,884	7,711	52,595
Dividend paid	-	-	(12,809)	(12,809)	-	(12,809)
Acquisition of non-controlling interest	-	-	-	-	(104)	(104)
Equity 31 December 2015	75,861	4,548	112,377	192,786	9,108	201,894

In June 2016 the Icelandic Parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank. See Note 33.

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2016 14 Amounts are in ISK millions

Consolidated Statement of Cash flows for the year 2016

Operating activities	2016	2015
Net earnings	21,739	49,679
Non-cash items included in net earnings	(31,623)	(51,720)
Changes in operating assets and liabilities	5,625	16,109
Interest received	48,030	41,178
Interest paid*	(25,543)	(22,108)
Dividend received	2,280	7,954
Income tax paid	(3,032)	(4,499)
Net cash from operating activities	17,476	36,593
Investing activities		
Acquisition of associates	(76)	(262)
Proceeds from sale of associates	27,291	17,148
Dividends received from associates	153	611
Acquisition of subsidiary	(5,300)	-
Disposal of subsidiary	293	-
Acquisition of intangible assets	(1,247)	(790)
Acquisition of property and equipment	(1,040)	(711)
Proceeds from sale of property and equipment	224	30
Net cash from investing activities	20,298	16,026
Financing activities		
Payment of subordinated liabilities	(8,785)	(19,883)
Dividend paid to shareholders of Arion Bank	-	(12,809)
Disbursement of share capital and dividend to non-controlling interest	(9,386)	-
Acquisition of non-controlling interest	-	(118)
Net cash used in financing activities	(18,171)	(32,810)
Net increase in cash and cash equivalents	19,603	19,809
Cash and cash equivalents at beginning of the year	110,000	91,715
Cash and cash equivalents acquired through acquisitions of subsidiary	1,068	-
Effect of exchange rate changes on cash and cash equivalents	(6,738)	(1,524)
Cash and cash equivalents	123,933	110,000
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	1,830	2,768
Settlement of loans through foreclosure on collateral from customers with view to resale	(1,830)	(2,768)
Non-cash changes due to funding agreement with Kaupthing		
Deposits	41,409	-
Borrowings	(41,409)	-

Financial effects due to the acquisition of Vörður tryggingar hf. is described in Note 3.

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

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2016 15 Amounts are in ISK millions

Notes to the Consolidated Statement of Cash flows for the year 2016

Non-cash items included in net earnings	2016	2015
Net interest income	(29,900)	(26,992)
Net impairment	(7,236)	3,087
Income tax expense	6,410	3,135
Bank levy	2,872	2,818
Net foreign exchange loss	1,253	182
Net gain on financial instruments	(4,135)	(5,072)
Depreciation and amortisation	1,842	1,656
Share of profit of associates and fair value change	(908)	(29,466)
Investment property, fair value change	(290)	(422)
Net gain from discontinued operations, net of tax	(886)	(360)
Other changes	(645)	(286)
Non-cash items included in net earnings	(31,623)	(51,720)

Changes in operating assets and liabilities		
Mandatory reserve with Central Bank	3,303	(3,700)
Loans to credit institutions, excluding bank accounts	(22,698)	13,637
Loans to customers	(34,765)	(29,588)
Financial instruments and financial liabilities at fair value	13,100	(23,655)
Investment property	1,440	54
Other assets	1,804	2,660
Due to credit institutions and Central Bank	(3,151)	(11,266)
Deposits	(9,586)	19,704
Borrowings	62,638	53,070
Other liabilities	(6,460)	(4,807)
Changes in operating assets and liabilities	5,625	16,109

Cash and cash equivalents		
Cash and demand deposits	87,634	48,102
Due from credit institutions	45,631	74,533
Mandatory reserve with Central Bank	(9,332)	(12,635)
Cash and cash equivalents	123,933	110,000

The Notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Arion Bank Consolidated Financial Statements 2016 16 Amounts are in ISK millions

Notes to the Consolidated Financial Statements
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Notes to the Consolidated Financial Statements

GENERAL INFORMATION

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

1. Basis of preparation

Statement of compliance

The Financial Statements are consolidated and have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union and additional requirements in the Icelandic Annual Accounts Act, Financial Undertakings Act and rules on Accounting for Credit Institutions.

The Financial Statements were approved and authorized for issue by the Board of Directors of Arion Bank on 13 February 2017.

Basis of measurement

The 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 Financial Statements are presented in Icelandic krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the year the exchange rate of the ISK against the USD was 112.90 and 119.18 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 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 recognized 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.

3. The Group

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

			Equity interest	
	Operating activity	Currency	2016	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%
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%
Vörður tryggingar hf., Borgartún 25, Reykjavík, Iceland	Insurance	ISK	100.0%	-

In July 2016 Arion Bank sold majority of its shareholding in the subsidiary Kolufell ehf. The main asset of Kolufell ehf. is investment property. The profit from the sale and valuation change on the remaining shareholding amounted to ISK 493 million and is recognized in the Statement of Comprehensive Income. The remaining shareholding is classified as Financial instruments.

On 30 September 2016 Arion Bank acquired a 100% shareholding in the insurance company Vörður tryggingar hf. Vörður tryggingar hf. is classified as a subsidiary of Arion Bank from the day of acquisition. The transaction is as follows:

Purchase price, paid in cash	5,300
Fair value of asset and liabilities	
Loans to credit institutions (Bank accounts)	1,068
Financial instruments	8,773
Intangible assets, other than goodwill	2,045
Tax assets	147
Other assets	2,355
Tax liabilities	(409)
Other liabilities	(9,175)
Fair value of asset and liabilities	4,804
Calculated goodwill	496

The net impact of Vörður tryggingar hf. on the Statement of Comprehensive Income for the period 1 October to 31 December was ISK 384 million. For further information on intangible assets and goodwill, see Note 26.

Arion Bank Consolidated Financial Statements 2016 19 Amounts are in ISK millions

Notes to the Consolidated Financial Statements

OPERATING SEGMENT REPORTING

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

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

Operating segments

The Group comprises the following operating segments:

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

Corporate Banking provides comprehensive financial services and integrated solutions across the Bank's divisions, to larger corporate clients in Iceland. Corporate Banking provides a full range of lending products, deposit accounts, payment solutions as well as value-added electronic corporate solutions to meet the needs of each customer.

Investment Banking is divided into Corporate Finance, Capital Markets and Research. Corporate Finance arranges the buying and selling of companies and advises on all other major financial decisions undertaken by companies and investors such as financial restructuring, IPO's and stock market listings. Capital Markets buys and sells securities and FX on behalf of Arion Bank's clients. Capital Markets manages securities issuance for clients and advises on hedges used in business operations often in co-operation with Corporate Finance. Research is an independent research team covering the Icelandic economy and financial markets.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of services. This includes 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 24 branches all around Iceland have a total of more than 100,000 customers.

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

Other divisions and subsidiaries include market making in domestic securities and currencies. The subsidiaries are Valitor Holding hf., Vörður tryggingar hf., Okkar líftryggingar hf., Eignarhaldsfélagið Landey ehf., EAB 1 ehf., BG12 slhf. and other smaller entities of the Group.

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

4. Operating segments

2016	Asset Manage-ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub-sidiaries	Head-quarters and Elimination	Total
Net interest income	535	6,436	1,104	14,992	6,093	1,233	(493)	29,900
Net fee and commission income	3,863	1,082	1,808	3,537	(345)	3,885	148	13,978
Net financial income	(67)	(12)	(100)	115	332	4,617	277	5,162
Net insurance income	-	-	-	-	-	1,395	-	1,395
Share of profit of associates	-	-	613	-	-	275	20	908
Other operating income	14	292	321	26	80	905	458	2,096
Operating income	4,345	7,798	3,746	18,670	6,160	12,310	410	53,439
Operating expense	(1,422)	(605)	(939)	(6,134)	(189)	(7,061)	(14,190)	(30,540)
Bank levy	-	-	-	-	-	-	(2,872)	(2,872)
Net impairment	-	33	1,704	5,557	7	(65)	-	7,236
Earnings before tax	2,923	7,226	4,511	18,093	5,978	5,184	(16,652)	27,263
Net seg. rev. from ext. customers	1,908	15,919	3,225	29,957	(11,647)	12,875	1,202	53,439
Net seg. rev. from other segments	2,437	(8,121)	521	(11,287)	17,807	(565)	(792)	-
Operating income	4,345	7,798	3,746	18,670	6,160	12,310	410	53,439
Depreciation and amortization	-	1	-	336	-	727	778	1,842
Total assets	5,302	251,822	16,835	476,369	190,418	68,750	26,528	1,036,024
Total liabilities	(272)	193,572	13,855	402,960	158,178	40,344	16,003	824,640
Allocated equity	5,574	58,250	2,980	73,409	32,240	28,406	10,525	211,384

2015	Asset Manage-ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other divisions and Sub-sidiaries	Head-quarters and Elimination	Total
Net interest income	462	6,023	101	13,877	5,803	708	18	26,992
Net fee and commission income	4,183	1,059	2,153	2,656	(313)	4,106	640	14,484
Net financial income	226	(37)	8,304	158	872	814	2,507	12,844
Net insurance income	-	-	-	-	-	760	-	760
Share of profit of associates	-	-	25,436	-	-	513	3,517	29,466
Other operating income	11	(33)	440	(345)	396	360	795	1,624
Operating income	4,882	7,012	36,434	16,346	6,758	7,261	7,477	86,170
Operating expense	(1,451)	(547)	(1,152)	(6,011)	(256)	(5,616)	(12,778)	(27,811)
Bank levy	-	-	-	-	-	-	(2,818)	(2,818)
Net impairment	-	(3,074)	3,030	(2,258)	11	(868)	72	(3,087)
Earnings before tax	3,431	3,391	38,312	8,077	6,513	777	(8,047)	52,454
Net seg. rev. from ext. customers	2,589	14,245	37,119	26,947	(9,809)	7,648	7,431	86,170
Net seg. rev. from other segments	2,293	(7,233)	(685)	(10,601)	16,567	(387)	46	-
Operating income	4,882	7,012	36,434	16,346	6,758	7,261	7,477	86,170
Depreciation and amortization	-	-	-	287	-	576	793	1,656
Total assets	5,884	236,621	62,904	448,547	179,375	50,166	27,546	1,011,043
Total liabilities	1,027	180,588	22,114	396,514	161,154	30,615	17,137	809,149
Allocated equity	4,857	56,033	40,790	52,033	18,221	19,551	10,409	201,894

Following the acquisition of Vörður tryggingar hf. the presentation of Insurance Income was changed and are presented in a separate line item in the Statement of Comprehensive income.

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

Arion Bank Consolidated Financial Statements 2016 21 Amounts are in ISK millions

Notes to the consolidated financial statements

4. Operating segments, continued

Geographic information

2016	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	32,302	1,079	114	(4,424)	791	38	29,900
Net fee and commission income	11,815	548	50	1,495	62	8	13,978
Net financial income	(500)	79	5,242	323	19	(1)	5,162
Net insurance income	1,395	-	-	-	-	-	1,395
Share of profit of associates	223	-	685	-	-	-	908
Other income	2,096	-	-	-	-	-	2,096
Operating income	47,331	1,706	6,091	(2,606)	872	45	53,439

2015	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	26,614	772	17	(851)	375	65	26,992
Net fee and commission income	8,376	1,731	605	3,672	95	5	14,484
Net financial income	10,315	(60)	(175)	2,850	(106)	20	12,844
Net insurance income	760	-	-	-	-	-	760
Share of profit of associates	8,621	-	20,845	-	-	-	29,466
Other income	1,624	-	-	-	-	-	1,624
Operating income	56,310	2,443	21,292	5,671	364	90	86,170

Arion Bank Consolidated Financial Statements 2016 22 Amounts are in ISK millions

Notes to the consolidated financial statements

QUARTERLY STATEMENTS

5. Operations by quarters, unaudited

2016	Q4	Q3	Q2	Q1	Total
Net interest income	7,842	7,432	7,353	7,273	29,900
Net fee and commission income	3,765	3,466	3,528	3,219	13,978
Net financial income	823	844	3,796	(301)	5,162
Net insurance income	731	272	247	145	1,395
Share of profit of associates	198	16	17	677	908
Other operating income	431	435	283	947	2,096
Operating income	13,790	12,465	15,224	11,960	53,439
Salaries and related expense	(4,407)	(3,826)	(4,318)	(4,108)	(16,659)
Other operating expense	(3,803)	(3,349)	(3,639)	(3,090)	(13,881)
Bank levy	(682)	(705)	(743)	(742)	(2,872)
Net impairment	409	5,882	1,448	(503)	7,236
Earnings before tax	5,307	10,467	7,972	3,517	27,263
Income tax expense	(1,149)	(3,170)	(1,354)	(737)	(6,410)
Net earnings from continuing operations	4,158	7,297	6,618	2,780	20,853
Net gain from discontinued operations, net of tax	317	206	259	104	886
Net earnings	4,475	7,503	6,877	2,884	21,739

2015	Q4	Q3	Q2	Q1	Total
Net interest income	6,705	7,112	7,392	5,783	26,992
Net fee and commission income	3,758	3,292	3,677	3,757	14,484
Net financial income	2,668	453	2,184	7,539	12,844
Net insurance income	216	156	218	170	760
Share of profit of associates	22,510	2,739	6	4,211	29,466
Other operating income	201	430	745	248	1,624
Operating income	36,058	14,182	14,222	21,708	86,170
Salaries and related expense	(4,572)	(3,153)	(3,675)	(3,492)	(14,892)
Other operating expense	(4,168)	(2,889)	(3,039)	(2,823)	(12,919)
Bank levy	(650)	(779)	(659)	(730)	(2,818)
Net impairment	(2,973)	(33)	(1,863)	1,782	(3,087)
Earnings before tax	23,695	7,328	4,986	16,445	52,454
Income tax expense	504	(1,272)	(647)	(1,720)	(3,135)
Net earnings from continuing operations	24,199	6,056	4,339	14,725	49,319
Net gain from discontinued operations, net of tax	83	15	79	183	360
Net earnings	24,282	6,071	4,418	14,908	49,679

Arion Bank Consolidated Financial Statements 2016 23 Amounts are in ISK millions

NOTES TO THE CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

6. Net interest income

	2016	2015
Interest income		
Cash and balances with Central Bank	4,584	2,757
Loans	51,910	47,393
Securities	4,347	3,532
Other	814	864
Interest income	61,655	54,546
Interest expense		
Deposits	(16,278)	(15,453)
Borrowings	(14,858)	(11,344)
Subordinated liabilities	(529)	(701)
Other	(90)	(56)
Interest expense	(31,755)	(27,554)
Net interest income	29,900	26,992
Net interest income from assets and liabilities at fair value	4,347	3,532
Interest income from assets not at fair value	57,308	51,014
Interest expense from liabilities not at fair value	(31,755)	(27,554)
Net interest income	29,900	26,992
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	3.1%	3.0%

Interest income from money market loans is classified as Cash and balances with Central Bank. Previously it was classified as Loans. Comparative figures have been adjusted accordingly.

7. Net fee and commission income

	2016			2015		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	4,225	(245)	3,980	4,463	(218)	4,245
Cards and payment solution	14,268	(8,975)	5,293	11,532	(5,945)	5,587
Collection and payment services	1,478	(80)	1,398	1,349	(93)	1,256
Investment banking	1,039	(46)	993	1,740	(56)	1,684
Lending and guarantees	1,685	-	1,685	1,431	-	1,431
Other	1,192	(563)	629	719	(438)	281
Net fee and commission income	23,887	(9,909)	13,978	21,234	(6,750)	14,484

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.

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Notes to the consolidated financial statements

8. Net financial income

	2016	2015
Dividend income	2,280	7,954
Net gain on financial assets and financial liabilities classified as held for trading	363	1,157
Net gain on financial assets and financial liabilities designated at fair value through profit or loss	(1,519)	3,915
Realised gain on financial assets available-for-sale	5,291	-
Net foreign exchange loss	(1,253)	(182)
Net financial income	5,162	12,844

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

	2016	2015
Equity instruments designated at fair value	(1,472)	3,692
Interest rate instruments designated at fair value	(47)	223
Net gain on financial assets and financial liabilities designated at fair value through profit or loss	(1,519)	3,915

In November 2015 Visa Inc. and Visa Europe Ltd. announced a definitive agreement on the acquisition by Visa Inc. of Visa Europe Ltd. Arion Bank was a member of Visa Europe Ltd. through its subsidiary Valitor Holding hf. In June 2016 the sale was formally completed, resulting in a total profit of ISK 5,291 million after taking into account conditional payments to Landsbankinn hf. and two savings funds, which formed part of the agreement when Arion Bank acquired a 39.21% shareholding in Valitor Holding hf. in 2014. The shareholding in Visa Europe Ltd. was classified as Financial assets available for sale.

9. Net insurance income

	2016	2015
Earned premiums, net of reinsurers' share		
Premiums written	2,927	1,314
Premiums written, reinsurers' shares	(196)	(139)
Change in provision for unearned premiums	330	(30)
Change in provision for unearned premiums, reinsurers' share	1	-
Earned premiums, net of reinsurers' share	3,061	1,145
Claims incurre, net of reinsurers' share		
Claims paid	(1,762)	(383)
Claims paid, reinsurers' share	66	67
Change in provision for claims	33	(59)
Changes in provision for claims, reinsurers' share	(3)	(10)
Claims incurred, net of reinsurers' share	(1,666)	(385)
Net insurance income	1,395	760

In the Financial Statements 2015 earned premium of the subsidiary Okkar was classified as Other operating income and claims incurred as Other operating expense. After the acquisition of the subsidiary Vörður Net insurance income is presented separately in the Statement of Comprehansive Income, due to increased weight in the operation of the Group. Comparison figures have been changed

10. Other operating income

	2016	2015
Fair value changes on investment property	290	422
Realized gain on investment property	400	286
Other income	1,406	916
Other operating income	2,096	1,624

Prior to the acquisition of Vörður tryggingar hf. earned premium was classified as Other operating income, see Note 9.

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Notes to the consolidated financial statements

11. Personnel and salaries

	2016	2015
Number of employees in the Group		
Average number of full-time equivalent positions during the year	1,201	1,139
Full-time equivalent positions at the end of the year	1,239	1,147
Number of employees at Arion Bank		
Average number of full-time equivalent positions during the year	889	885
Full-time equivalent positions at the end of the year	869	876
Salaries and related expense		
Salaries	13,274	11,811
Defined contribution pension plans	1,885	1,637
Salary-related expense	1,884	1,733
Capitalization of salaries, due to internally developed software	(384)	(289)
Salaries and related expense	16,659	14,892
Salaries and related expense for the Bank		
Salaries	9,690	8,780
Defined contribution pension plans	1,376	1,216
Salary-related expense	1,553	1,432
Salaries and related expense	12,619	11,428

During the year the Group made a provision of ISK 395 million (2015: ISK 599 million) for performance plan payments, including salary-related expense, of which the Bank made a provision of ISK 331 million (2015: ISK 461 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for Financial Undertakings. At the end of the year the Group's accrual for performance plan payments amounted to ISK 1,453 million (31.12.2015: ISK 1,056 million), of which the Bank's accrual amounts to ISK 1,177 million (31.12.2015: ISK 852 million).

	2016			2015		
Compensation of the Board of Directors	Fixed remuner-ation*	Additional remuner-ation**	Total	Fixed remuner-ation*	Additional remuner-ation**	Total
Monica Caneman, Chairman of the Board	19.0	2.5	21.4	18.4	2.4	20.7
Guðrún Johnsen, Vice Chairman of the Board	7.1	4.4	11.5	6.9	4.7	11.6
Benedikt Olgeirsson, Director	4.7	3.3	8.1	4.6	1.8	6.4
Brynjólfur Bjarnason, Director	4.7	3.8	8.5	4.6	1.4	6.0
Kirstín Þ. Flygenring, Director	4.7	3.3	8.1	4.6	1.8	6.4
Måns Höglund, Director	9.5	4.4	13.8	9.3	4.2	13.5
Þóra Hallgrímsdóttir, Director	4.7	3.8	8.5	4.6	3.7	8.3
Alternate directors of the Board	2.4	-	2.4	2.5	-	2.5
Total remuneration	56.9	25.4	82.3	55.4	20.0	75.4

John P. Madden became member of the Board of Directors 15 September 2016. He received no remunerations in 2016.

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Notes to the consolidated financial statements

11. Personnel and salaries, continued

Compensation of key management personnel	2016 Salaries	2016 Performance-based payments	2015 Salaries	2015 Performance-based payments
Höskuldur H. Ólafsson, CEO	58.2	7.1	55.9	7.2
Nine managing directors of the Bank's divisions who are members of the Bank's Executive Committee	262.7	30.3	254.7	26.4

Performance based payments in 2016 are based on the Group's performance in 2015.

Board Members receive remuneration for their involvement in board committees. In addition to 13 Board meetings (2015: 16) during the year 10 Board Credit Committee meetings (2015: 11), in all 15 Board Audit Committee and Board Risk Committee meetings (2015: 7) and 7 Board Remuneration Committee meetings (2015: 7) were held. Four committee meetings with alternate directors of the Board were held in 2016 (2015: 4).

The 2016 Annual General Meeting of the Bank held on 17 March 2016 approved the monthly salaries for 2016 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 796,950, ISK 597,700 and ISK 398,500 (2015: ISK 770,000; 577,500; 385,000) respectively. It was also approved that the salary of Alternate Board Members would be ISK 201,850 (2015: ISK 195,000) per meeting, up to a maximum of ISK 398,500 (2015: ISK 385,000) per month. For Board Members resident abroad, the aforementioned figures are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 159,400 (2015: ISK 154,000) per month for each committee they serve on and the Chairman of the board committees ISK 207,000 (2015: ISK 200,000).

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

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

12. Other operating expense

	2016	2015
Administration expense	11,186	10,330
Depositors' and investors' guarantee fund	804	836
Depreciation of property and equipment	865	849
Amortization of intangible assets	977	807
Other expense	49	97
Other operating expense	13,881	12,919

Prior to the acquisition of Vörður tryggingar hf. claims incurred of Okkar líftryggingar hf. was classified as Other operating expense, see Note 9.

Auditor's fee	2016	2015
Audit and review of the Financial Statements for the relevant fiscal year	140	150
Other audit related services for the relevant fiscal year	11	3
Auditor's fee	151	153
Of which fee to others than the auditor of the Parent company	12	3

13. Bank levy

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

Arion Bank Consolidated Financial Statements 2016 27 Amounts are in ISK millions

14. Net impairment

	2016	2015
Increase in book value of loans to corporates	2,990	2,488
Increase in book value of loans to individuals	8,990	2,208
Net change in impairment of loans to corporates	(2,914)	(3,818)
Net change in impairment of loans to individuals	(2,248)	(3,421)
Net change in collective impairment on loans	427	(517)
Impairment of intangible assets	(9)	(27)
Net impairment	7,236	(3,087)

15. Income tax expense

	2016	2015
Current tax expense	6,563	1,659
Deferred tax expense	(153)	1,476
Income tax expense	6,410	3,135

Reconciliation of effective tax rate	2016		2015	
Earnings before tax		27,263		52,454
Income tax using the Icelandic corporation tax rate	20.0%	5,453	20.0%	10,491
Additional 6% tax on Financial Undertakings	5.1%	1,395	1.2%	628
Non-deductible expenses	0.0%	13	0.0%	13
Tax exempt revenue	(4.6%)	(1,247)	(16.4%)	(8,597)
Non-deductible taxes	2.1%	574	1.1%	564
Other changes	0.8%	222	0.1%	36
Effective tax rate	23.5%	6,410	6.0%	3,135

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

Tax exempt revenues consist mainly of profit from equity positions.

16. Net gain from discontinued operations, net of tax

	2016	2015
Income from real estates and other assets	1,335	709
Expense related to real estates and other assets	(449)	(349)
Net gain from discontinued operations, net of tax	886	360

17. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2016	2015	2016	2015
Net earnings attributable to the shareholders of Arion Bank	20,261	41,608	21,147	41,968
Weighted average number of outstanding shares for the year, million	2,000	2,000	2,000	2,000
Basic earnings per share	10.13	20.80	10.57	20.98

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

Arion Bank Consolidated Financial Statements 2016 28 Amounts are in ISK millions

Notes to the consolidated financial statements

NOTES TO THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

18. Cash and balances with Central Bank

	2016	2015
Cash on hand	7,448	4,921
Cash with Central Bank	70,854	30,546
Mandatory reserve deposit with Central Bank	9,332	12,635
Cash and balances with Central Bank	87,634	48,102

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

19. Loans to credit institutions

	2016	2015
Bank accounts	45,631	74,533
Money market loans	32,267	7,976
Other loans	2,218	4,982
Loans to credit institutions	80,116	87,491

20. Loans to customers

	Individuals		Corporates		Total	
2016	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	14,805	13,381	19,314	17,630	34,119	31,011
Credit cards	11,363	11,099	1,180	1,151	12,543	12,250
Mortgage loans	285,784	282,996	16,298	15,975	302,082	298,971
Other loans	34,777	29,940	351,739	340,250	386,516	370,190
Loans to customers	346,729	337,416	388,531	375,006	735,260	712,422
2015						
Overdrafts	16,840	14,833	24,248	22,387	41,088	37,220
Credit cards	10,842	10,560	1,054	997	11,896	11,557
Mortgage loans	271,895	268,048	12,889	12,601	284,784	280,649
Other loans	38,058	31,178	334,849	319,746	372,907	350,924
Loans to customers	337,635	324,619	373,040	355,731	710,675	680,350

The total book value of pledged loans that were pledged against amounts borrowed was ISK 165 billion at the end of the year (31.12.2015: ISK 199 billion). At the end of the year 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.

Arion Bank Consolidated Financial Statements 2016 29 Amounts are in ISK millions

20. Loans to customers, continued

Changes in the provision for losses on loans to customers

2016	Specific	Collective	Total
Balance at the beginning of the year	25,341	4,984	30,325
Provision for losses	5,162	(427)	4,735
Write-offs	(11,283)	-	(11,283)
Exchange difference	(1,138)	-	(1,138)
Payment of loans previously written off	199	-	199
Balance at the end of the year	18,281	4,557	22,838

2015	Specific	Collective	Total
Balance at the beginning of the year	22,214	4,467	26,681
Provision for losses	7,239	517	7,756
Write-offs	(6,547)	-	(6,547)
Exchange difference	1,055	-	1,055
Payment of loans previously written off	1,380	-	1,380
Balance at the end of the year	25,341	4,984	30,325

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 53. 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 realizable 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.

21. Financial instruments

	2016	2015
Bonds and debt instruments	69,565	78,794
Shares and equity instruments with variable income	27,035	35,504
Derivatives	5,159	2,401
Securities used for hedging	15,697	16,492
Financial instruments	117,456	133,191

Arion Bank Consolidated Financial Statements 2016 30 Amounts are in ISK millions

22. Financial assets and financial liabilities

2016	Amortised cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	87,634	-	-	87,634
Loans to credit institutions	80,116	-	-	80,116
Loans to customers	712,422	-	-	712,422
Loans	880,172	-	-	880,172
Bonds and debt instruments				
Listed	-	5,284	61,055	66,339
Unlisted	-	102	3,124	3,226
Bonds and debt instruments	-	5,386	64,179	69,565
Shares and equity instruments with variable income				
Listed	-	2,949	9,125	12,074
Unlisted	-	1,348	10,579	11,927
Bond funds with variable income, unlisted	-	1,027	2,007	3,034
Shares and equity instruments with variable income	-	5,324	21,711	27,035
Derivatives				
OTC derivatives	-	5,159	-	5,159
Derivatives	-	5,159	-	5,159
Securities used for hedging				
Bonds and debt instruments, listed	-	7,318	-	7,318
Shares and equity instruments with variable income, listed	-	8,365	-	8,365
Shares and equity instruments with variable income, unlisted	-	14	-	14
Securities used for hedging	-	15,697	-	15,697
Other financial assets	8,617	-	-	8,617
Financial assets	888,789	31,566	85,890	1,006,245
Liabilities at amortized cost				
Due to credit institutions and Central Bank	7,987	-	-	7,987
Deposits	412,064	-	-	412,064
Borrowings	339,476	-	-	339,476
Liabilities at amortized cost	759,527	-	-	759,527
Financial liabilities at fair value				
Short position in bonds	-	1,884	-	1,884
Derivatives	-	1,842	-	1,842
Financial liabilities at fair value	-	3,726	-	3,726
Other financial liabilities	36,350	-	-	36,350
Financial liabilities	795,877	3,726	-	799,603

Financial assets classified as available for sale at year-end 2015 were sold in June 2016, see Note 8.

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Notes to the consolidated financial statements

22. Financial assets and financial liabilities, continued

2015	Amortised cost	Trading	Designated at fair value	Available for sale	Total
Loans					
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
Bonds and debt instruments					
Listed	-	2,526	74,757	-	77,283
Unlisted	-	99	1,412	-	1,511
Bonds and debt instruments	-	2,625	76,169	-	78,794
Shares and equity instruments with variable income					
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
Derivatives					
OTC derivatives	-	2,401	-	-	2,401
Derivatives	-	2,401	-	-	2,401
Securities used for hedging					
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
Liabilities at amortized cost					
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 amortized cost	747,157	-	-	-	747,157
Financial liabilities at fair value					
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

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22. Financial assets and financial liabilities, continued

	2016	2015
Bonds and debt instruments designated at fair value specified by issuer		
Financial and insurance activities	5,564	9,258
Public sector	51,860	59,246
Corporates	6,755	7,665
Bonds and debt instruments designated at fair value	64,179	76,169

The total amount of pledged bonds was ISK 15.6 billion at the end of the year (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.

23. Fair value hierarchy

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

Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;
Level 2: valuation techniques for which all significant inputs are market observable, either directly or indirectly; and
Level 3: valuation techniques which include significant inputs that are not based on observable market data.

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

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

2016

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	22,787	46,689	89	69,565
Shares and equity instruments with variable income	11,863	15,154	18	27,035
Derivatives	-	5,159	-	5,159
Securities used for hedging	15,659	38	-	15,697
Investment property	-	-	5,358	5,358
Assets at fair value	50,309	67,040	5,465	122,814
Liabilities at fair value				
Short position in bonds	1,884	-	-	1,884
Derivatives	-	1,842	-	1,842
Liabilities at fair value	1,884	1,842	-	3,726

Arion Bank Consolidated Financial Statements 2016 33 Amounts are in ISK millions

23. Fair value hierarchy, continued

2015

Assets at fair value	Level 1	Level 2	Level 3	Total
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
Liabilities at fair value				
Short position in bonds	4,616	-	-	4,616
Derivatives	-	2,993	-	2,993
Liabilities at fair value	4,616	2,993	-	7,609

There was no transfer between Level 1 and Level 2 during the year (2015: Transfers from Level 2 to Level 1 ISK 8,106 million. No transfers from Level 1 to Level 2).

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

Fair value of assets and liabilities

The fair value of asset and liabilities is the amount at which the asset and liability could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Group to measure assets and liabilities. If quoted prices for an asset fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

Methods for establishing fair value

Level 1: Fair value established from quoted market prices

The best evidence of the fair value of an asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of an asset in Note 22 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from the market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

Level 2: Fair value established using valuation techniques with observable market information

For assets and liabilities, for which the market is not active, the Group applies specific working procedures and valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent arm's length market transactions between knowledgeable and willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

For assets and liabilities for which quoted prices on active markets are not available, the fair value is derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

Arion Bank Consolidated Financial Statements 2016 34 Amounts are in ISK millions

23. Fair value hierarchy, continued

In most cases the valuation is based on theoretical financial models, such as the Black Scholes model or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

The fair value for deposits with stated maturities is calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Statement of Financial Position.

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

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

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organizations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

The Group applies management valuation for determining fair value of investment properties. Management valuation is either based on recent transactions and offers for similar assets or present value calculations which involve estimation of future cash flow and the assessment of appropriate discount rate.

Movements in Level 3 assets measured at fair value	Investment property		Financial assets		Total	
	2016	2015	2016	2015	2016	2015
Balance at the beginning of the year	7,542	6,842	6,056	1,276	13,598	8,118
Net fair value changes	290	422	2,828	5,857	3,118	6,279
Additions	618	1,026	-	77	618	1,103
Disposal	(1,684)	(843)	(8,778)	(1,154)	(10,462)	(1,997)
Disposals through the sale of a subsidiary	(1,408)	-	-	-	(1,408)	-
Transfers into Level 3	-	95	13	-	13	95
Transfers out of Level 3	-	-	(12)	-	(12)	-
Balance at the end of the year	5,358	7,542	107	6,056	5,465	13,598

Line items where effects of Level 3 assets are recognized in the Statement of Comprehensive Income	2016	2015
Net interest income	2	25
Net financial income	5,255	(20)
Other operating income	690	708
Net loss on AFS financial assets, net of tax	(2,903)	2,903
Effects recognized in the Statement of Comprehensive Income	3,044	3,616

Arion Bank Consolidated Financial Statements 2016 35 Amounts are in ISK millions

23. Fair value hierarchy, continued

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

2016	Carrying value	Fair value	Unrealised gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	87,634	87,634	-
Loans to credit institutions	80,116	80,116	-
Loans to customers	712,422	717,220	4,798
Other financial assets	8,617	8,617	-
Financial assets not carried at fair value	888,789	893,587	4,798
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,987	7,987	-
Deposits	412,064	412,064	-
Borrowings	339,476	348,412	(8,936)
Other financial liabilities	36,350	36,350	-
Financial liabilities not carried at fair value	795,877	804,813	(8,936)

2015			
Financial assets not carried at fair value			
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
Financial liabilities not carried at fair value			
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.

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Notes to the consolidated financial statements

23. Fair value hierarchy, continued

Derivatives	Notional	Fair value	
2016	value	Assets	Liabilities
Forward exchange rate agreements, unlisted	31,921	266	247
Interest rate and exchange rate agreements, unlisted	210,143	4,288	1,104
Bond swap agreements, unlisted	2,995	1	8
Share swap agreements, unlisted	8,138	597	457
Options - purchased agreements, unlisted	1,218	7	26
Derivatives	254,415	5,159	1,842

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	30	1	34
Derivatives	169,744	2,401	2,993

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24. 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				
2016	Gross assets before balance sheet nettings	Balance sheet nettings with gross liabilities	Assets recognized on balance sheet, net	Financial liabilities	Collateral received	Assets after consideration of netting potential	Assets not subject to enforceable netting arr-angements	Total assets recognized on balance sheet
Reverse repurchase agreements	15,644	(80)	15,564	(1,884)	-	13,680	-	15,564
Derivatives	4,100	-	4,100	(629)	-	3,471	1,059	5,159
Total assets	19,744	(80)	19,664	(2,513)	-	17,151	1,059	20,723
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				
2016	Gross liabilities before balance sheet nettings	Balance sheet nettings with gross assets	Liabilities recognized on balance sheet, net	Financial assets	Collateral pledged	Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arr-angements	Total liabilities recognized on balance sheet
Repurchase agreements	1,884	-	1,884	(1,884)	-	-	-	1,884
Derivatives	629	-	629	(629)	-	-	1,213	1,842
Total liabilities	2,513	-	2,513	(2,513)	-	-	1,213	3,726
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

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25. Investments in associates

The Group's interest in its principal associates	2016	2015
Auðkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	22.4%
Bakkavor Group Ltd., West Marsh Road, Spalding, Lincolnshire, United Kingdom	-	46.0%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	38.4%	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	34.9%	38.5%

Investments in associates		
Carrying amount at the beginning of the year	27,299	21,966
Additions	76	262
Dividend received	(153)	(611)
Transfers	-	(6,458)
Disposals	(27,291)	(17,148)
Exchange difference	-	(178)
Share of profit of associates and reversal of impairment	908	29,466
Investment in associates	839	27,299

In January 2016 the Bank's subsidiary BG12 slhf. sold its 46% shareholding in Bakkavor Group Ltd. The main effect related to the sale was a valuation change recognized in the Statement of Comprehensive Income in 2015. During the year the total effects from the sale through the Statement of Comprehensive Income was ISK 685 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.

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26. 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.

On 30 September 2016 Arion Bank acquired the insurance company Vörður tryggingar hf. The purchase price of the shareholding in Vörður totalled ISK 5,300 million, paid in full with cash. A total of ISK 2,541 million in intangible assets were recognized, of which ISK 904 million is customer relationship and related agreements, ISK 684 million as trade name included in infrastructure, ISK 424 million as software and ISK 496 million as goodwill. When allocating the purchase price to separate assets the free cash flow method and management forecasts on the operations of Vörður were used. The allocation of purchase price was close to be completed at year-end 2016 and Arion Bank will complete it within the 12 months permitted timeframe from acquisition date.

At the end of 2014 Valitor Holding hf. acquired the Danish group AltaPay A/S, to support operation in the Nordic region. A total of ISK 4,217 million in intangible assets were recognized, mainly relating to the expertise of the employees of AltaPay A/S and the business opportunities inherent in a rapidly growing market and the synergy with Valitor hf. in the future. When allocating the purchase price to separate assets the free cash flow method and management forecasts on the operations of AltaPay A/S were used. The original allocation of purchase price was revisited in 2015 and 2016, and thus within the 12 months permitted timeframe from the acquisition date. Following this revisit there was a transfer of ISK 376 million to goodwill and ISK 20 million to software from customer relationship and related agreements.

Infrastructure, which is capitalized as an intangible asset, is related to Asset Management in the parent company and in the Bank’s subsidiary Stefnir, payment solution and credit card operation at the Bank's subsidiary Valitor Holding and branding of the newly acquired subsidiary Vörður. The business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as described below.

Customer relationships and related agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries and agreements bought. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationships related to individual customers through SPRON and the subsidiaries Okkar and Vörður. The customer relationship is tested for impairment and related agreements are amortized over a period of five years, with two years left of the period.

Acquired software and internally developed software is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

26. Intangible assets, continued

2016	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,407	3,021	854	3,003	9,285
Acquisition through business combination	496	684	904	457	2,541
Additions and transfers	(271)	-	110	638	477
Additions, internally developed	-	-	-	384	384
Exchange difference	(430)	-	(32)	(182)	(644)
Impairment	-	-	(9)	-	(9)
Amortization	-	-	(219)	(758)	(977)
Intangible assets	2,202	3,705	1,608	3,542	11,057

2015	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
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)
Amortization	-	-	(208)	(599)	(807)
Intangible assets	2,407	3,021	854	3,003	9,285

Impairment testing

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

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis impairment of ISK 9 million was recognized in 2016 (2015: ISK 27 million).

	2016		2015	
Discount and growth rates	Discount rates	Growth rates	Discount rates	Growth rates
Asset Management operation	15.1%	2.5%	12.6%	2.5%
Payment solution and Credit card operation	15.1%	2-37%	12.6%	3-25%
Insurance operation	14.6%	2,5%	-	-

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27. Tax assets and tax liabilities

	2016		2015	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	6,630	-	3,272
Deferred tax	288	663	205	1,650
Tax assets and tax liabilities	288	7,293	205	4,922

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

	2016 Assets	2016 Liabilities	2015 Assets	2015 Liabilities
Foreign currency denominated assets and liabilities	1	(225)	4	(222)
Investment property and property and equipment	40	(689)	101	(271)
Financial assets	475	-	494	(1,171)
Other assets and liabilities	266	(407)	256	(495)
Deferred tax related to foreign exchange gain	-	(103)	-	(141)
Tax loss carry forward	267	-	-	-
	1,049	(1,424)	855	(2,300)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(761)	761	(650)	650
Deferred tax assets and tax liabilities	288	(663)	205	(1,650)

Subsidiaries own tax loss carry forward with asset value of the amount of ISK 464 million (31.12.2015: ISK 546 million) that is not recognized in the Financial Statements, due to uncertainty about the utilization possibilities of the loss.

Changes in deferred tax assets and tax liabilities	At 1 Jan.	Addition related to Vörður	Recognized through equity	Recognized in profit or loss	At 31 Dec.
2016					
Foreign currency denominated assets and liabilities	(218)	-	-	(6)	(224)
Investment property and property and equipment	(170)	(409)	-	(70)	(649)
Financial assets	(677)	8	1,171	(27)	475
Other assets and liabilities	(239)	-	-	98	(141)
Deferred foreign exchange differences	(141)	-	-	38	(103)
Tax loss carry forward	-	147	-	120	267
Change in deferred tax assets and tax liabilities	(1,445)	(254)	1,171	153	(375)
2015					
Foreign currency denominated assets and liabilities	(198)	-	-	(20)	(218)
Investment property and property and equipment	(238)	-	-	68	(170)
Financial assets	564	-	(1,171)	(70)	(677)
Other assets and liabilities	(341)	-	-	102	(239)
Deferred foreign exchange differences	(78)	-	-	(63)	(141)
Tax loss carry forward	322	-	-	(322)	-
Change in deferred tax assets and tax liabilities	31	-	(1,171)	(305)	(1,445)

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28. Other assets

	2016	2015
Non-current assets and disposal groups held for sale	4,418	5,082
Property and equipment	6,723	6,766
Accounts receivable	5,373	2,433
Unsettled securities trading	712	685
Investment for life assurance policyholders where risk is held by the policyholder	820	914
Sundry assets	2,808	1,698
Other assets	20,854	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.

Property and equipment	Real estate	Equip-ment	Total 2016	Total 2015
Gross carrying amount at the beginning of the year	6,151	6,752	12,903	12,425
Additions	166	844	1,010	711
Acquisition through business combination	-	62	62	-
Disposals and transfers	(203)	(56)	(259)	(233)
Translation difference	-	(15)	(15)	-
Gross carrying amount at the end of the year	6,114	7,587	13,701	12,903
Accumulated depreciation at the beginning of the year	(1,545)	(4,592)	(6,137)	(5,355)
Depreciation	(198)	(667)	(865)	(849)
Disposals and transfers	15	9	24	67
Accumulated depreciation at the end of the year	(1,728)	(5,250)	(6,978)	(6,137)
Property and equipment	4,386	2,337	6,723	6,766

The official real estate value (Registers Iceland) amounts to ISK 4,905 million at the end of the year (31.12.2015: ISK 4,603 million) and the insurance value amounts to ISK 8,818 million (31.12.2015: ISK 9,597 million).

29. Other liabilities

	2016	2015
Accounts payable	22,627	23,296
Provision for settled FX loans	-	2,882
Unsettled securities trading	668	754
Depositors' and investors' guarantee fund	2,870	2,873
Technical provision	10,243	1,660
Technical provision for life assurance policyholders investment risk by policyholder	820	914
Withholding tax	1,745	1,643
Bank levy	2,872	2,811
Sundry liabilities	12,249	12,628
Other liabilities	54,094	49,461

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29. Other liabilities, continued

Technical provision	Technical provision	Reinsurers' share	Total 2016	Technical provision	Reinsurers' share	Total 2015
Claims reported and loss adjustment expenses	4,842	(167)	4,675	406	(94)	313
Claims incurred but not reported	1,352	(99)	1,253	274	(56)	218
Claims outstanding	6,194	(266)	5,928	680	(150)	531
Provision for unearned premiums	4,049	(18)	4,031	979	-	979
Own technical provision	10,243	(284)	9,959	1,659	(150)	1,510

Insurance claim consists of claims outstanding and provision for unearned premiums. Claims outstanding present unsettled claims incurred. Claims outstanding is the total of claims reported and actuarial estimation of claims incurred but not reported. Provision for unearned premiums presents the current insurance risk that will be conditional to future fiscal years.

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Notes to the consolidated financial statements

30. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	2016	2015
ISK 4,500 million	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,502	4,483
ISK 1,540 million	2016	2019	At maturity	Fixed, 5.50%	580	-
ISK 10,220 million	2014	2021	At maturity	Fixed, CPI linked, 3.50%	9,696	5,096
ISK 20,160 million	2015	2022	At maturity	Fixed, 6.50%	19,596	7,737
ISK 23,080 million	2014	2029	At maturity	Fixed, CPI linked, 3.50%	23,524	15,279
ISK 2,500 million	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	2,207	2,249
Statutory covered bonds					60,105	34,844
ISK 21,877 million	2006	2033	Amortizing	Fixed, CPI linked, 3.75%	16,734	17,108
ISK 15,500 million	2008	2045	Amortizing	Fixed, CPI linked, 4.00%	6,199	6,182
ISK 51,125 million	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	78,239	77,916
Structured Covered bonds					101,172	101,206
Total Covered bonds					161,277	136,050
NOK 500 million	2013	2016	At maturity	Floating, NIBOR +5.00%	-	1,547
USD 30 million	2016	2017	At maturity	Floating, 3 month LIBOR +1.93%	3,406	-
EUR 21 million	2009	2018	Amortizing	Floating, EURIBOR +1.00%	662	1,177
ISK 3,835 million	2010	2018	Amortizing	Floating, REIBOR +1.00%	1,063	1,600
EUR 300 million	2015	2018	At maturity	Fixed, 3.125%	36,610	43,350
SEK 250 million	2016	2018	At maturity	Floating, 3 month STIBOR + 1.09%	3,113	-
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	36,307	-
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	951	-
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	3,422	-
NOK 300 million	2015	2020	At maturity	Floating, NIBOR +2.95%	10,617	11,900
NOK 220 million	2016	2020	At maturity	Floating, NIBOR +1.95%	2,902	-
EUR 300 million	2016	2021	At maturity	Fixed, 1.625%	35,639	-
USD 747 million	2016	2023	At maturity	Floating, 3 month LIBOR +2.60%	29,317	-
Senior unsecured bonds					164,009	59,574
Central Bank, secured, various curr.	2010	2022	At maturity	Floating, LIBOR + 3.00%	-	56,024
Bills issued					13,854	4,081
Other					336	329
Other loans/bills					14,190	60,434
Borrowings					339,476	256,058

Book value of listed bonds was ISK 283,871 million at the end of the year (31.12.2015: ISK 196,927 million). Market value of those bonds was ISK 290,196 million (31.12.2015: ISK 205,720 million).

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

In January 2016 the Bank reached an agreement with Kaupthing regarding FX deposits held at Arion Bank to be converted into issued EMTN bond in USD and that Kaupthing would prepay Arion Bank's Central Bank secured loan, in various currencies, of ISK 56 billion at year-end 2015. The total issue was ISK 97 billion (USD 747 million) with mandatory prepayment requirement if the Bank should issue bonds in excess of USD 165 million. In 2016 Arion Bank's issue exceeded this benchmark twice and therefore a prepayment of ISK 57 billion (USD 490 million) was made in 2016. At year-end outstanding bonds held by Kaupthing amounted to ISK 29.3 billion (USD 258 million).

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31. Subordinated liabilities

	Issued	Maturity	Maturity type	Terms of interest	2016	2015
Tier II capital in various currencies	2010	2020	At maturity	Floating, EURIBOR/LIBOR + 5.00% .	-	10,365
Subordinated liabilities					-	10,365

Arion Bank settled the subordinated liabilities with the Ministry of Finance with a prepayment in September.

32. Pledged assets

Pledged assets against liabilities

Assets, pledged as collateral against borrowings	196,901	222,046
Assets, pledged as collateral against loans from credit institutions and short positions	15,644	21,611
Pledged assets against liabilities	212,545	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 197 billion at the end of the year (31.12.2015: ISK 222 billion). At the end of the year 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 161 billion at the end of the year (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.

33. 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)	2016	Number (million)	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.

Other reserves	2016	2015
Statutory reserve	1,637	1,637
Reserve for investments in subsidiaries	17,012	-
Reserve for investments in associates	23	-
Reserve for investments in securities	899	-
Available for sale reserve	-	2,903
Foreign currency translation reserve	190	8
Other reserves	19,761	4,548

In June 2016 the Icelandic Parliament approved amendments to the Financial Statements Act including new requirements on equity reserves in relation to unrealized profit from financial assets. The amendments may affect future dividend payments to the shareholders of Arion Bank. See Note 65.

There is some uncertainty over the interpretation and implementation of the amendments and thus the Note may be subject to change in the near term.

OTHER INFORMATION

34. 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 ICA has sent the Bank a letter proposing concluding the matter with an agreement. The Bank is looking into the conditions of the proposed agreement.

With a writ issued in June 2013, Kortaþjónustan ehf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and the Bank's subsidiary Valitor hf. to the amount of ISK 1.2 billion plus interest, due to damage Kortaþjónustan 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 Kortaþjónustan's claims. Kortaþjónustan's court-appointed evaluator has given a report on Kortaþjónustan's alleged loss. The Bank and other defendants in the case have demanded that a reassessment be carried out.

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 January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed suit against Valitor hf. for compensatory damages relating to Valitor hf.'s cessation of Datacell's vendor agreement. The Icelandic Supreme Court ruled on 24 April 2013 in case no. 612/2012 that Valitor hf. did not have a premise to rescind the agreement. The plaintiffs had court appointed appraisers evaluate their alleged losses. The appraisers returned their report in March 2016. Valitor disagreed with the assessment stated in the report and filed a motion for appointing three court appraisers to re-evaluate plaintiffs' alleged losses. The district court approved the motion and they have been appointed. Conclusion is pending.

Other legal matters

Mortgage documents

Courts cases are being prosecuted against the Bank in which it is demanded that the mortgaging of part of a property be invalidated on the basis that the signature of the mortgagor on the mortgage documents was not correct. Recently the district court, in respect of a case which did not involve the Bank, invalidated a mortgage under similar circumstances to these. The Bank is assessing the possible impact of a negative outcome on the Bank's loan portfolio.

34. Legal matters, continued

The uncertainty regarding the book value of foreign currency loans

Some uncertainty over the legality of FX loans has continued in 2016 and the Group constantly monitors judgements involving itself and others to refine its provisions on foreign currency loans. Although there is much more clarity in the matters of FX loans there still remains some uncertainty regarding foreign currency linked loans in certain respects, such as regarding the recalculation of particular loans and compensations on account of enforcement actions that have been made on the basis of currency-linked 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. The Supreme Court ruled in April 2016 on upholding the ICA‘s decision from April 2013. Valitor paid the fine in 2013.

Notes to the consolidated financial statements

OFF BALANCE SHEET INFORMATION

35. Obligations

	2016	2015
Financial guarantees, unused overdraft and loan commitments the Group has granted its customers		
Financial guarantees	15,270	19,162
Unused overdrafts	46,379	42,100
Loan commitments	82,268	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 banks have made quarterly payments to a separate division within the fund since 2010. Despite this change in execution and due to uncertainty over the shape of future legislation the liability brought forward from previous years has 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. Operating lease commitments

Group as a lessee

The Group has concluded lease agreements on some of the real estate it uses for its operations. These lease agreements are for a period of up to 10 years. The majority of the contracts include renewal options for various periods of time.

	2016	2015
Less than one year	507	279
Over 1 year and up to 5 years	1,371	684
Over 5 years	368	346
Future minimum lease payments under non-cancellable leases	2,246	1,309

Group as a lessor

The Group has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 10 years, with the majority being non-cancellable agreements.

	2016	2015
Less than one year	68	120
Over 1 year and up to 5 years	147	127
Over 5 years	55	25
Future minimum lease payments under non-cancellable leases	270	272

37. Assets under management and under custody

Assets under management	1,054,759	996,648
Assets under custody	1,356,997	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.

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38. Events after Balance Sheet date

In January 2017 Arion Bank issued an additional 200 million Euro tap of the Euro benchmark bond issued December 2016. The Bank previously issued 300 million Euro bringing the total to 500 million Euro, or approximately ISK 60 billion. As before, part of the issue will be used to pay down existing loans. The bonds have a 2021 maturity and bear a fixed 1.625% coupon.

Notes to the consolidated financial statements

RELATED PARTY

39. 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 an 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 year. 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.

2016

Balances with related parties	Assets	Liabilities	Net balance
Shareholders with control over the Group	192	(7,255)	(7,063)
Board of Directors and key Management personnel	255	(242)	13
Associates and other related parties	181	(369)	(188)
Balances with related parties	628	(7,866)	(7,238)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	1	(89)	4	-
Shareholders with influence over the Group	-	-	6	-
Board of Directors and key Management personnel	15	(7)	-	-
Associates and other related parties	28	(4)	2	(216)
Transactions with related parties	44	(100)	12	(216)

2015

Balances with related parties	Assets	Liabilities	Net balance
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)

Transactions with related parties	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(762)	16	-
Shareholders with influence over the Group	-	(4)	15	(13)
Board of Directors and key Management personnel	12	(2)	5	-
Associates and other related parties	1,288	(617)	344	(276)
Transactions with related parties	1,300	(1,385)	380	(289)

Through the ownership of ISFI the Group has a related party relationship with Landsbankinn hf. and Íslandsbanki hf. but they provide banking services to the Bank's subsidiary Valitor hf. and have a traditional bank to bank relationship with Arion Bank hf. The Group holds assets amounting to ISK 5,832 million (31.12.2015: ISK 14,038 million) by these aforementioned Financial Undertakings and liabilities amounting to ISK 791 million at the end of the year (31.12.2015: ISK 1,499 million). Total interest income was ISK 632 million in 2016 (2015: ISK 120 million) and interest expense ISK 42 million (2015: ISK 48 million). Other income was ISK 954 million during the year (2015: ISK 500 million) and other expense was ISK 1,845 million (2015: ISK 1,192 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 29,317 million at the end of the year. This amount is not included in the table above.

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RISK MANAGEMENT DISCLOSURES

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

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

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

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

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

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

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

The Bank has no large exposure at the end of the year. The total sum of large exposures is therefore 0% compared to 11% in the previous year. A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's eligible capital.

The Group is exposed to currency risk due to a net currency position on the balance sheet. The Group's operations are subject to interest rate risk associated with a mismatch between interest bearing assets and interest bearing liabilities.

Liquidity risk is a large risk factor in the Group's operation due to maturity mismatch between assets and liabilities. The maturity of loans exceeds the maturity of deposits, of which 75% is on-demand or with less than 30 day term.

Further information on risk management and capital adequacy is provided in the annual Financial Statements for 2016 and in the Pillar 3 Risk Disclosures for 2016. The Pillar 3 Risk Disclosures 2016 will be published in March 2017 and be available on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures will not be subject to external audit.

40. 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 guarantees.

Managing and analysing the Group's loan portfolio is of utmost importance. Great emphasis is placed on the quality of the credit portfolio, by maintaining a strict credit process, critically inspecting loan applications, actively monitoring the credit portfolio and identifying and reacting to possible problem loans at an early stage as well as restructuring of impaired credits.

The Group grants credit based on well informed lending decisions and seeks business with strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in the pricing.

Credit risk is managed and controlled by setting limits on the amount of risk the Group is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits. The Group seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to group of connected clients.

40. Credit risk, continued

Exposure to credit risk

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the year before the effect of mitigation due to collateral agreements or other credit enhancements. The Group uses an internal industry classification which is based on the ISAT08 standard classification. ISAT08 is based on the NACE Rev. 2 classification standard.

2016

Maximum exposure to credit risk related to on-balance sheet assets

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Cash and balances with Central Bank	-	-	-	-	-	87,634	-	-	-	-	-	87,634
Loans to credit institutions	-	-	-	-	-	80,116	-	-	-	-	-	80,116
Loans to customers	337,417	114,895	76,475	28,647	52,719	34,939	28,633	6,519	17,308	8,711	6,159	712,422
Financial instruments	307	1,106	261	-	7	18,865	10,942	3	557	59,253	-	91,301
Other assets with credit risk	443	779	14	19	22	6,708	10	7	540	72	3	8,617
Total on-balance sheet maximum exposure to credit risk	338,167	116,780	76,750	28,666	52,748	228,262	39,585	6,529	18,405	68,036	6,162	980,090

Maximum exposure to credit risk related to off-balance sheet items

	Individuals	Real estate activities and construction	Fishing industry	Information and communication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manufacturing	Transportation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	1,394	1,967	1,573	1,039	2,416	1,333	1,880	978	2,643	35	12	15,270
Unused overdrafts	27,609	2,226	640	574	5,951	1,546	2,363	381	2,845	1,895	349	46,379
Loan commitments	33	15,276	16,756	540	24,249	7,154	13,155	2,399	2,659	38	9	82,268
Total off-balance sheet maximum exposure to credit risk	29,036	19,469	18,969	2,153	32,616	10,033	17,398	3,758	8,147	1,968	370	143,917
Maximum exposure to credit risk	367,203	136,249	95,719	30,819	85,364	238,295	56,983	10,287	26,552	70,004	6,532	1,124,007

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40. Credit risk, continued

2015

Maximum exposure to credit risk related to on-balance sheet assets

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Cash and balances with Central Bank	-	-	-	-	-	48,102	-	-	-	-	-	48,102
Loans to credit institutions	-	-	-	-	-	87,491	-	-	-	-	-	87,491
Loans to customers	324,629	102,624	75,850	30,802	51,784	33,460	21,384	6,001	19,864	8,193	5,759	680,350
Financial instruments	135	175	72	11	-	14,894	9,430	29	400	61,624	-	86,770
Other assets with credit risk	289	564	29	80	67	3,018	3	1	455	65	10	4,581
Total on-balance sheet maximum exposure to credit risk	325,053	103,363	75,951	30,893	51,851	186,965	30,817	6,031	20,719	69,882	5,769	907,294

Maximum exposure to credit risk related to off-balance sheet items

	Individuals	Real estate activities and construction	Fishing industry	Information and com-munication technology	Wholesale and retail trade	Financial and insurance activities	Industry, energy and manu-facturing	Transpor-tation	Services	Public sector	Agriculture and forestry	Total
Financial guarantees	1,352	3,032	1,253	1,225	4,145	729	3,299	2,244	1,855	22	6	19,162
Unused overdrafts	24,373	1,977	596	632	5,093	1,622	2,013	377	2,403	2,639	375	42,100
Loan commitments	188	39,196	27,711	11,463	14,083	3,544	14,017	10,618	2,183	3,000	65	126,068
Total off-balance sheet maximum exposure to credit risk	25,913	44,205	29,560	13,320	23,321	5,895	19,329	13,239	6,441	5,661	446	187,330
Maximum exposure to credit risk	350,966	147,568	105,511	44,213	75,172	192,860	50,146	19,270	27,160	75,543	6,215	1,094,624

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40. Credit risk, continued

Loans to customers specified by sectors	2016	2015
Individuals	47.4%	47.7%
Real estate activities and construction	16.1%	15.1%
Fishing industry	10.7%	11.1%
Information and communication technology	4.1%	4.7%
Wholesale and retail trade	7.4%	7.6%
Financial and insurance activities	4.9%	4.9%
Industry, energy and manufacturing	4.0%	3.1%
Transportation	0.9%	0.9%
Services	2.4%	2.9%
Public sector	1.2%	1.2%
Agriculture and forestry	0.9%	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 quotas.

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

2016	Cash and securities	Real estate	Fishing vessels	Other collateral	Total
Cash and balances with Central Bank	-	-	-	-	-
Loans to credit institutions	-	-	-	-	-
Loans to customers					
Individuals	481	297,974	5	7,419	305,879
Real estate activities and construction	581	106,770	34	1,444	108,829
Fishing industry	564	8,100	57,092	8,041	73,797
Information and communication technology	27	2,598	-	18,363	20,988
Wholesale and retail trade	410	26,570	8	19,988	46,976
Financial and insurance activities	14,826	7,620	-	807	23,253
Industry, energy and manufacturing	3,287	15,332	-	6,875	25,494
Transportation	73	892	278	3,622	4,865
Services	20	7,221	71	3,650	10,962
Public sector	7	3,811	-	179	3,997
Agriculture and forestry	5	5,128	-	327	5,460
Financial instruments	5,953	-	-	-	5,953
Financial guarantees	1,038	3,871	1,249	2,375	8,533
Collateral held against different types of financial assets	27,272	485,887	58,737	73,090	644,986

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40. Credit risk, continued

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 year the Group took possession of assets due to foreclosures. The total amount of real estates the Group took possession of during the year and still holds at year-end amount to ISK 1,817 million (31.12.2015: ISK 2,761 million) and other assets ISK 13 million (31.12.2015: ISK 7 million). The assets are held for sale, see Note 28.

Credit quality

Credit quality by class of financial assets

2016	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Cash and balances with Central Bank	87,634	-	-	87,634
Loans to credit institutions	80,116	-	-	80,116
Loans to customers				
Loans to corporates	358,709	14,251	2,046	375,006
Loans to individuals	312,259	21,854	3,303	337,416
Financial instruments	82,042	-	-	82,042
Other assets with credit risk	8,617	-	-	8,617
Credit quality by class of financial assets	929,377	36,105	5,349	970,831

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

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40. 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.

	Risk classification						
2016	1	2	3	4	5	Not rated	Total
Individuals	68,538	162,930	55,500	17,036	4,331	3,924	312,259
Real estate activities and construction	43,172	33,819	24,557	5,679	348	3,184	110,759
Fishing industry	24,480	36,143	9,700	2,579	604	79	73,585
Information and communication technology	18,372	3,207	966	5,476	-	12	28,033
Wholesale and retail trade	11,342	19,302	16,890	2,244	208	-	49,986
Financial and insurance activities	9,669	2,210	15,623	207	-	5,730	33,439
Industry, energy and manufacturing	7,908	7,854	10,101	719	635	351	27,568
Transportation	958	3,753	989	433	20	-	6,153
Services	2,303	5,312	7,263	847	28	3	15,756
Public sector	377	4,425	1,874	1,146	53	656	8,531
Agriculture and forestry	478	1,147	2,029	1,227	18	-	4,899
Neither past due nor impaired loans	187,597	280,102	145,492	37,593	6,245	13,939	670,968
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.

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40. Credit risk, continued

Past due but not impaired loans by class of loans 2016	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	5,388	4,282	1,589	1,211	1,781	14,251
Loans to individuals	3,196	8,708	4,989	391	4,570	21,854
Past due but not impaired loans	8,584	12,990	6,578	1,602	6,351	36,105
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 aquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

	2016		2015	
Impaired loans to customers specified by sector	Impair-ment amount	Gross carrying amount	Impair-ment amount	Gross carrying amount
Individuals	7,069	10,372	10,593	17,403
Real estate activities and construction	770	1,056	1,515	1,867
Fishing industry	966	1,648	257	373
Information and communication technology	179	182	308	332
Wholesale and retail trade	540	868	681	893
Financial and insurance activities	261	298	5,953	6,011
Industry, energy and manufacturing	786	878	828	1,025
Transportation	4,301	4,307	4,433	4,440
Services	3,145	3,624	504	682
Public sector	89	113	143	215
Agriculture and forestry	175	284	126	186
Impaired loans to customers specified by sector	18,281	23,630	25,341	33,427

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40. Credit risk, continued

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Group's eligible capital according to Act. No. 161/2002 on Financial Undertakings and FME Rules No. 625/2013. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible collateral.

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

	2016		2015	
No.	Gross	Net	Gross	Net
1	<10%	<10%	11%	11%
Sum of large exposure gross and net > 10%	0%	0%	11%	11%

41. 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.

The Group keeps close track of market risk and separates its exposures for the trading book and the banking book. Market risk in the trading book arises from proprietary trading activities and non-strategic derivatives positions arising from the Bank's operations of meeting customers' investment and risk management needs. Market risk in the banking book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. Market risk in the trading book and in the banking book is managed separately.

Market risk allowance is set by the Board in the Bank's risk appetite and limit frameworks are in place for each trading desk. The Asset and Liability Committee (ALCO) is responsible for managing the Bank's overall market risk. Risk Management is responsible for measuring and monitoring market risk exposure, and reporting the exposure, usage and limit breaches.

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

Interest rate risk

Interest rate risk arises from the possibility that changes in 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.

The Group's strategy for managing its interest rate risk is to strive to contain interest rate mismatches within acceptable levels by maintaining partly matched funding for its loans to customers, offering deposit incentives and by targeted lending practices.

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41. Market risk, continued

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 23, and are therefore different from the amounts shown in these 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.

2016	Up to 3	3-12	1-5	5-10	Over 10	
Assets	months	months	years	years	years	Total
Balances with Central Bank	80,186	-	-	-	-	80,186
Loans to credit institutions	80,116	-	-	-	-	80,116
Loans to customers	382,928	63,694	138,540	4,457	127,601	717,220
Financial instruments	41,495	1,695	5,182	6,349	1,897	56,618
Assets	584,725	65,389	143,722	10,806	129,498	934,140
Liabilities						
Due to credit institutions and Central Bank	7,962	25	-	-	-	7,987
Deposits	376,424	21,111	12,450	1,263	816	412,064
Borrowings	62,830	8,653	126,836	20,670	129,423	348,412
Liabilities	447,216	29,789	139,286	21,933	130,239	768,463
Derivatives and other off-balance sheet items (net position)	(107,799)	(916)	111,083	(146)	-	2,222
Net interest gap	29,710	34,684	115,519	(11,273)	(741)	167,899

2015						
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	126,633	264,839
Subordinated liabilities	10,365	-	-	-	-	10,365
Liabilities	558,760	8,010	49,553	12,982	126,633	755,938
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	16,478	134,655

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41. Market risk, continued

Sensitivity analysis of interest rate risk in the banking book

The following table shows the sensitivity of the Group's net present value of interest-bearing assets and liabilities to changes in interest rates by currencies. Sensitivity is quantified as the net change in value of interest-bearing assets and liabilities when assuming a simultaneous parallel shift upwards and downwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income and is not an estimate of risk. The calculations are based on contractual interest fixing periods, not taking into account the expected behavior of non-maturing deposits.

	2016		2015	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	414	(63)	1,850	(1,763)
ISK, Non index-linked	348	(508)	751	(735)
EUR	87	(147)	185	(178)
Other	162	(148)	522	(494)

Interest rate risk in the trading book

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

	2016			2015		
Trading financial instruments, long positions	MV	Duration	BPV	MV	Duration	BPV
ISK, CPI index-linked	8,084	2.2	(1.8)	4,544	3.6	(1.6)
ISK, Non index-linked	10,992	1.0	(1.1)	5,849	(1.8)	1.1
FX	37,399	(0.5)	2.0	64,226	(0.6)	3.9
Total	56,475	0.2	(0.9)	74,619	(0.5)	3.4
Trading financial instruments, short positions						
ISK, CPI index-linked	518	4.7	(0.2)	393	9.7	(0.4)
ISK, Non index-linked	15,680	0.3	(0.4)	7,953	0.3	(0.3)
FX	29,847	(0.8)	2.4	64,172	(0.5)	2.9
Total	46,045	(0.4)	1.8	72,518	(0.3)	2.3

Sensitivity analysis of interest rate risk in the trading book

The following table shows the interest sensitivity of the Group's net positions in the trading book by currencies. Sensitivity is quantified as the net change in value when assuming a simultaneous parallel shift upwards and downwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income and is not an estimate of risk. The calculations are based on duration and convexity in this table.

	2016		2015	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	156	(152)	126	(121)
ISK, Non index-linked	127	(64)	(142)	130
EUR	2	(20)	19	(20)
Other	-	(13)	(122)	115

Arion Bank Consolidated Financial Statements 2016 62 Amounts are in ISK millions

41. 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

2016	Up to 1	1 to 5	Over 5	
Assets, CPI index-linked	year	years	years	Total
Loans to customers	12,911	97,225	218,981	329,117
Financial instruments	7,100	-	-	7,100
Off-balance sheet position	851	6,619	-	7,470
Assets, CPI index-linked	20,862	103,844	218,981	343,687
Liabilities, CPI index-linked				
Deposits	69,621	12,121	2,050	83,792
Borrowings	2,253	24,437	114,747	141,437
Off-balance sheet position	-	518	-	518
Other	395	692	893	1,980
Liabilities, CPI index-linked	72,269	37,768	117,690	227,727
Net on-balance sheet position	(52,258)	59,975	101,291	109,008
Net off-balance sheet position	851	6,101	-	6,952
CPI Balance	(51,407)	66,076	101,291	115,960

2015				
Assets, CPI index-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 index-linked	17,790	84,333	209,485	311,608
Liabilities, CPI index-linked				
Deposits	72,352	12,899	1,916	87,167
Borrowings	2,128	14,164	112,350	128,642
Other	-	-	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

Arion Bank Consolidated Financial Statements 2016 63 Amounts are in ISK millions

41. 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

2016

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with Central Bank	85,052	775	627	364	197	108	511	87,634
Loans to credit institutions	18,946	16,963	17,444	8,522	1,826	10,064	6,351	80,116
Loans to customers	593,185	66,242	34,012	2,857	7,378	7	8,741	712,422
Financial instruments	91,566	13,403	9,572	311	244	2,245	115	117,456
Investment property	5,358	-	-	-	-	-	-	5,358
Investments in associates	831	8	-	-	-	-	-	839
Intangible assets	6,978	-	-	-	4,079	-	-	11,057
Tax assets	272	-	-	-	16	-	-	288
Other assets	19,356	650	556	142	135	13	2	20,854
Assets	821,544	98,041	62,211	12,196	13,875	12,437	15,720	1,036,024
Liabilities and equity								
Due to credit inst. and Central Bank ..	6,857	978	84	3	-	1	64	7,987
Deposits	377,195	15,762	12,038	4,186	844	1,301	738	412,064
Financial liabilities at fair value	3,020	408	272	-	-	16	10	3,726
Tax liabilities	7,075	-	-	-	218	-	-	7,293
Other liabilities	44,625	2,660	1,160	4,255	756	229	409	54,094
Borrowings	176,530	109,217	32,723	-	-	13,520	7,486	339,476
Subordinated liabilities	-	-	-	-	-	-	-	-
Shareholders' equity	211,212	-	-	-	-	-	-	211,212
Non-controlling interest	172	-	-	-	-	-	-	172
Liabilities and equity	826,686	129,025	46,277	8,444	1,818	15,067	8,707	1,036,024
Net on-balance sheet position	(5,142)	(30,984)	15,934	3,752	12,057	(2,630)	7,013	
Net off-balance sheet position	279	31,775	(15,315)	(3,232)	(8,579)	2,335	(7,263)	
Net position	(4,863)	791	619	520	3,478	(295)	(250)	

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41. Market risk, continued

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	6,791	584	104	10	4	-	116	7,609
Tax liabilities	4,500	-	-	-	422	-	-	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)	

Sensitivity analysis on currency risk

The table below indicates the currencies to which the Group had significant exposure at the end of the year. The analysis calculates the effect of a reasonably possible movement of the currency rate against the ISK, with all other variables held constant, on the Statement of Comprehensive income (due to the fair value of currency sensitive non-trading monetary assets and liabilities). A negative amount in the table reflects a potential net reduction in the Statement of Comprehensive income or equity, while a positive amount reflects a net potential increase. An equivalent decrease in each of the below currencies against the ISK would have resulted in an equivalent but opposite impact (+10% denotes a depreciation of the ISK).

	2016		2015	
Currency	-10%	+10%	-10%	+10%
EUR	(79)	79	(1,105)	1,105
USD	(62)	62	(209)	209
GBP	(52)	52	(2,425)	2,425
DKK	(348)	348	221	(221)
NOK	30	(30)	304	(304)
Other	25	(25)	3	(3)

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41. Market risk, continued

Equity risk

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. For information on assets seized and held for sale and equity exposures, see Notes 28 and 22 respectively.

Sensitivity analysis of equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices on the Statement of Comprehensive Income. A negative amount in the table reflects a potential net reduction in the Statement of Comprehensive income or equity, while a positive amount reflects a potential net increase. Investments in associates are excluded.

	2016		2015	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(295)	295	(214)	214
Banking book - listed	(913)	913	(1,387)	1,387
Banking book - unlisted	(1,193)	1,193	(1,819)	1,819

Derivatives

Customers can enter into derivatives contracts with the Bank. The types of derivatives currently offered by the Group are forward contracts for foreign exchange, securities and commodities, foreign exchange and interest rate swaps and options for foreign exchange, securities and commodities. Eligible underlying instruments, limits on exposures and required collateral are determined in accordance with the Group's risk appetite. The Group also uses derivatives to reduce market risk on its balance sheet. Note 23 shows a breakdown of the Group's derivative positions by type.

Prepayment risk

Prepayment risk is the risk that the Group will incur a financial loss because its customers and counterparties repay or request repayment earlier or later than expected, such as fixed rate mortgages when interest rates fall. The Group is not materially exposed to prepayment risk at year-end 2016.

42. 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.

The Group's primary source of funding is deposits from individuals, businesses and Financial Undertakings. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 70% is on-demand.

Liquidity risk is one of the Group's most significant risk factors and a great deal of emphasis is placed on managing it. The Asset and Liability Committee (ALCO) is responsible for managing liquidity and funding risk within the risk appetite the Board sets. The Bank's Treasury manages liquidity positions on a day-to-day basis. Risk Management measures, monitors and reports the Bank's liquidity and funding risk.

The Group's strategy is to always maintain sufficient liquidity by maintaining a high ratio of liquid assets and available funding to near term liabilities and possible payment outflows. Uncertainties in relation to the capital controls have been significantly reduced and in January 2016 Kaupthing's deposits in foreign currency with the Group were termed out into EMTN funding. As a result, liquidity risk due to entities in winding-up has been reduced.

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42. Liquidity and Funding risk, continued

Maturity gap analysis

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

2016 *Assets*	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	87,634	78,302	-	9,332	-	-	-
Loans to credit institutions	80,116	54,104	26,012	-	-	-	-
Loans to customers	712,422	9,051	54,203	79,205	253,938	316,025	-
Financial instruments	117,456	12,715	2,100	3,670	51,729	11,828	35,414
Derivatives - assets leg	*75,527*	-	*28,038*	*19,179*	*27,825*	*485*	-
Derivatives - liabilities leg	*(70,368)*	-	*(27,300)*	*(17,927)*	*(24,886)*	*(255)*	-
Investment property	5,358	-	-	-	-	-	5,358
Investments in associates	839	-	-	-	-	-	839
Intangible assets	11,057	-	-	-	-	-	11,057
Tax assets	288	-	-	-	288	-	-
Other assets	20,854	2,687	3,883	1,303	745	-	12,236
Assets	1,036,024	156,859	86,198	93,510	306,700	327,853	64,904
Liabilities							
Due to credit institutions and Central Bank	7,987	7,636	-	326	25	-	-
Deposits	412,064	288,390	74,202	37,769	10,088	1,615	-
Financial liabilities at fair value	3,726	-	2,400	127	895	304	-
Derivatives - assets leg	*(57,923)*	-	*(13,857)*	*(3,960)*	*(39,388)*	*(718)*	-
Derivatives - liabilities leg	*59,766*	-	*14,374*	*4,087*	*40,283*	*1,022*	-
Short position securities used for hedging	*1,884*	-	*1,884*	-	-	-	-
Tax liabilities	7,293	-	-	6,626	667	-	-
Other liabilities	54,094	21,837	7,414	3,446	3,660	6	17,731
Borrowings	339,476	-	10,293	13,371	153,607	162,205	-
Liabilities	824,640	317,863	94,309	61,665	168,942	164,130	17,731
Off-balance sheet items							
Financial guarantees	15,270	2,893	4,032	4,136	2,538	1,671	-
Unused overdraft	46,379	1,460	9,098	18,305	17,516	-	-
Loan commitments	82,268	1,348	38,757	17,075	21,088	4,000	-
Off-balance sheet items	143,917	5,701	51,887	39,516	41,142	5,671	-
Net assets (liabilities)	67,467	(166,705)	(59,998)	(7,671)	96,616	158,052	47,173

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Notes to the consolidated financial statements

42. Liquidity and Funding risk, continued

2015 *Assets*	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
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
Derivatives - assets leg	*56,171*	-	*24,671*	*1,478*	*29,509*	*513*	-
Derivatives - liabilities leg	*(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	-
Derivatives - assets leg	*(49,199)*	-	*(36,552)*	*(5,662)*	*(6,518)*	*(467)*	-
Derivatives - liabilities leg	*52,192*	-	*38,282*	*6,198*	*7,149*	*563*	-
Short position bonds and derivatives	*1,309*	-	*1,309*	-	-	-	-
Short position bonds used for hedging	*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

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42. Liquidity and Funding risk, continued

Net Stable Funding Ratio

The net stable funding ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per the definition of the Central Bank of Iceland rules No. 1032. 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.

2016	ISK	FX	Total
Available stable funding	612,964	169,821	782,785
Required stable funding	544,854	87,010	631,864
FX imbalance		(4,019)	
Net stable funding ratio	113%	191%	124%

2015	ISK	FX	Total
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%

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42. 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.

2016	ISK	FX	Total
Liquid assets level 1 *	112,770	13,026	125,796
Liquid assets level 2 **	-	2,932	2,932
Liquid Assets	112,770	15,958	128,728
Deposits	93,584	16,885	110,469
Market Borrowing	3,192	371	3,563
Other Cash outflows	12,426	7,013	19,439
Cash outflows	109,202	24,269	133,471
Short-term deposits with other banks ***	1,688	51,779	53,467
Other Cash inflows	3,843	1,011	4,854
Cash inflows	5,531	52,790	58,321
Liquidity coverage ratio (LCR) ****	109%	263%	171%

2015	ISK	FX	Total
Liquid assets level 1 *	99,483	24,088	123,571
Liquid assets level 2 **	-	5,869	5,869
Liquid Assets	99,483	29,957	129,440
Deposits	122,275	21,640	143,915
Market Borrowing	1,502	122	1,624
Other Cash outflows	16,296	34,749	51,045
Cash outflows	140,073	56,511	196,584
Short-term deposits with other banks ***	3,768	57,881	61,649
Other Cash inflows	9,193	29,457	38,650
Cash inflows	12,961	87,338	100,299
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 and foreign government bonds.

** 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 = Weighted liquid assets / (weighted cash outflows - weighted cash inflows) where weighted cash inflows are capped at 75% of weighted cash outflows.

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Notes to the consolidated financial statements

42. Liquidity and Funding risk, continued

Composition of liquid assets

The following table shows the composition of the Bank's liquidity buffer. At 1 January 2017 the Bank's liquidity facility with the Icelandic government expired, and is not included in the composition of liquid assets for 31 December 2016.

2016	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	85,053	627	775	1,179	87,634
Short-term deposits in other banks	1,688	16,018	14,090	21,671	53,467
Domestic bonds eligible as collateral at the Central Bank	27,718	-	-	-	27,718
Foreign government bonds	-	5,536	4,908	-	10,444
Covered bonds with a minimum rating of AA-	-	-	1,202	2,247	3,449
Liquidity reserve	114,459	22,181	20,975	25,097	182,712

2015	ISK	USD	EUR	Other	Total
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
Liquidity reserve	103,252	27,566	31,898	29,409	192,125

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42. 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					
2016	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Individuals	97,232	10%	40,376	5%	59,344	196,952
SME	39,823	10%	3,955	5%	3,762	47,540
Corporations	55,094	40%	921	20%	5,850	61,865
Sovereigns, central banks and PSE	11,653	40%	-	-	1,379	13,032
Pension funds	31,157	100%	-	-	15,959	47,116
Domestic financial entities	24,310	100%	-	-	16,730	41,040
Foreign financial entities	2,150	100%	-	-	-	2,150
Other foreign parties	4,466	100%	3,276	25%	2,288	10,030
Total	265,885		48,528		105,312	419,725
2015						
Individuals	86,095	10%	39,598	5%	53,599	179,292
SME	37,884	10%	3,928	5%	4,327	46,139
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.

43. Operational risk

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

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

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

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44. Capital management

Capital ratio

The focus of capital management at the Group is to optimize the capital structure in the medium term and consequently maintain the Group's capitalization comfortably above the regulatory minimum, including capital buffers and Pillar 2 requirements.

The Group's capital ratios are calculated in accordance with Act No. 161/2002 on Financial Undertakings. In September 2016, amendments were made to the Act, effectively adopting parts of CRR into law. The regulation had not been fully implemented at 31 December 2016 and as a result, the legal framework is not entirely aligned with CRR. The Group however assumes a full adoption of CRR in the capital calculations for 31 December 2016. Capital ratios for 31 December 2015 are based on the the preceding Basel II definitions. The Group uses the standardized approach to calculate the capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

Capital Base	2016	2015
Total equity	211,384	201,894
Non-controlling interest not eligible for inclusion in CET1 capital	(172)	(9,108)
Intangible assets	(11,057)	(9,285)
Tax assets	(288)	(205)
Cash flow hedges	(22)	-
Additional value adjustments	(127)	-
Equity holdings in financial sector entities *	-	(3,151)
Common equity Tier 1 capital	199,718	180,145
Non-controlling interest not eligible for inclusion in CET1 capital	172	9,108
Tier 1 capital	199,890	189,253
Subordinated liabilities	-	10,365
Regulatory adjustments to Tier 2 capital **	-	(771)
Equity holdings in financial sector entities *	-	(3,118)
General credit risk adjustments	4,557	-
Tier 2 capital	4,557	6,476
Total capital base	204,447	195,729

Risk-weighted assets		
Credit risk, loans	577,661	567,242
Credit risk, securities and other	68,074	113,791
Market risk due to currency imbalance	5,449	38,401
Market risk other	12,966	7,035
Credit valuation adjustment	2,678	-
Operational risk	86,490	81,441
Total risk-weighted assets	753,318	807,910
Of which domestic	687,921	694,803

Capital ratios		
CET1 ratio	26.5%	22.3%
Tier 1 ratio	26.5%	23.4%
Capital adequacy ratio	27.1%	24.2%

* In CRR (Basel III), a 10% threshold criteria applies to deduction of such holdings. At 31 December 2015 such deductions were split between Tier 1 and Tier 2 capital without any threshold criteria.

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

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44. Capital management, continued

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

Capital buffer requirement, % of RWA	1.6.2016	1.1.2017	1.3.2017	1.11.2017
Capital conservation buffer	1.75%	2.50%	2.50%	2.50%
Capital buffer for systematically important institutions	2.00%	2.00%	2.00%	2.00%
Systemic risk buffer *	3.00%	3.00%	3.00%	3.00%
Countercyclical capital buffer *	-	-	1.00%	1.25%
Combined capital buffer requirement	6.75%	7.50%	8.50%	8.75%

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

The Bank's Pillar 2R capital add-on, which is the result of the ICAAP/SREP, may comprise 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital. With the current capital structure, the Pillar 2R requirement is solely met with CET1 capital.

2016		Fully implemented
Total capital requirement, % of RWA	Current	1.11.2017
Pillar 1 capital requirement	8.0%	8.0%
Pillar 2R capital requirement **	4.3%	4.3%
Combined buffer requirement	6.5%	8.4%
Total regulatory capital requirement	18.8%	20.7%
Available capital	27.1%	27.1%
CET1 requirement, % of RWA		
Pillar 1 CET1 requirement	4.5%	4.5%
Pillar 2R CET1 requirement **	2.4%	2.4%
Combined buffer requirement	6.5%	8.4%
CET1 regulatory capital requirement	13.4%	15.3%
Available CET1 capital	26.5%	26.5%

*The capital buffers for systemic risk and countercyclical effects only apply to the part of RWA that is calculated on domestic exposures. The precise meaning of what constitutes the domestic part has not been defined. Here, the domestic part of RWA is assumed to be the portion of credit risk and market risk RWA that is calculated on domestic exposures, in addition to 100% of operational risk RWA. With the FME's expected recognition of countercyclical buffers in foreign countries, these will apply to the portion of RWA that is calculated on exposures from the corresponding countries.

** The SREP result based on the Group's financial statement of 31.12.2015.

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44. Capital management, continued

Leverage ratio

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The minimum leverage ratio requirement is 3% as stated in Act No. 161/2002 on Financial Undertakings.

	2016	2015
On-balance sheet exposures	1,011,735	982,348
Derivative exposures	8,226	3,789
Securities financing transaction exposures	9,330	16,287
Off-balance sheet exposures	83,156	127,675
Total exposure	1,112,447	1,130,099
Tier 1 capital	199,890	189,253
Leverage ratio	18.0%	16.7%

Solvency II

At the end of the year the Group held the insurance companies Vörður and Okkar.

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vörður was ISK 2,489 million at the end of the year and Okkar ISK574 million and calculated solvency of Vörður ISK 3,609 million and Okkar ISK 1,236 million. The solvency ratio, which is the ratio of calculated solvency to the solvency requirements, of Vörður was 145.0% and Okkar 215,0% at the end of the year.

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Notes to the Consolidated Financial Statements

SIGNIFICANT ACCOUNTING POLICIES

The accounting policies adopted in the preparation of these Consolidated Financial Statements are consistent with those followed in the preparation of the Group's Consolidated Financial Statements for the year ended 31 December 2015 except for new and amended IFRS adopted by the European Union, that became effective as of 1 January 2016, see Note 70, and amendments to Icelandic Annual Accounts Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

45. 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.

46. Principles underlying the consolidation

Subsidiaries

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

Business combinations

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. Control is achieved when the Group is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Group controls an investee if, and only if, the Group has:

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

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

The Group measures goodwill at the acquisition date as:

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

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

Transaction costs incurred are expensed and included in administration expense.

Non-controlling interests

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

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:

- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

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

46. Principles underlying the consolidation, continued

Loss of control

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

Transactions eliminated on consolidation

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Financial Statements.

If an investment in a subsidiary is classified as held for sale the investment is accounted for as non-current asset and disposal groups held for sale from the date of classification.

Funds management

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

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

47. Associates

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

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

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

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

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

Impairment on investments in associates

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

Notes to the Consolidated Financial Statements

48. Foreign currency

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

Foreign currency transactions

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

49. Interest

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

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

Interest income and expense presented in the Statement of Comprehensive Income include:

- interest on financial assets and liabilities at amortized cost on an effective interest rate basis;
- interest on financial assets and liabilities held for trading; and
- interest on financial assets designated at fair value through profit or loss.

50. Fee and commission

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

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

51. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and financial liabilities classified as held for trading, Net gain on financial assets and liabilities at fair value, Net foreign exchange gain.

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

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

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

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

52. Income tax expense

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

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

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

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

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

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realized.

53. Financial assets and financial liabilities

Recognition

The Group initially recognizes loans, deposits, debt securities issued and subordinated liabilities on the date that they are originated. Regular way purchases and sales of financial assets are recognized on the trade date at which the Group commits to purchase or sell the asset. All other financial assets and liabilities are recognized on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

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

Classification

The Group classifies its financial assets in one of the following categories:

- amortized cost;
- at fair value through profit or loss and within the category as:
  - held for trading; or
  - designated at fair value through profit or loss; or
- AFS financial assets at fair value through other comprehensive income.

The Group classifies its financial liabilities, other than financial guarantees and loan commitments, as measured at amortized cost or held for trading.

Designation at fair value through profit or loss

The Group has designated financial assets and liabilities at fair value through profit or loss in either of the following circumstances:

- the assets or liabilities are managed, evaluated and reported internally on a fair value basis;
- the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- the asset or liability contains an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

53. Financial assets and financial liabilities, continued

Derecognition

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

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

Offsetting

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

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

Amortized cost measurement

The amortized cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the initial amount recognized and the maturity amount, minus any reduction for impairment.

All consumer price indexed assets and liabilities are revalued based on the index rate at the end of the year.

Fair value measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the Group measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis.

If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties (if available), reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses, and option pricing models. The Group uses widely recognized valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

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

Identification and measurement of impairment

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

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, default or delinquency by a borrower, restructuring of a loan or advance by the Group on terms that the Group would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, the disappearance of an active market for a security, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group. In addition, for an investment in an equity security, a significant or prolonged decline in its fair value below its cost is objective evidence of impairment.

53. Financial assets and financial liabilities, continued

The Group considers evidence of impairment for loans at both a borrower-specific and a collective level. Borrowers for specific assessment are sampled based on a combination of the borrowers' exposure, days in default and an internal classification where customers are classified according to financial position, defaults and credit rating. In determining specific provisions for impairment on individually assessed borrowers, the following factors are considered:

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

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow.

Collective provisions are taken for all loans other than those that have been specifically impaired. Also exempt from collective provisions are loans that are more than 90 days in default, but have been determined not to require specific impairment.

In assessing collective impairment, two deciding, quantitative components need to be addressed in order to perform the calculation i.e. probability of default (PD) and loss given default (LGD). The Group uses internally developed probability-of-default models, which are regularly benchmarked against actual outcomes to ensure the predictive power of the models. For loss given default the Group uses internally developed models as well.

Impairment losses are recognized in profit or loss and reflected in an allowance account against loans. When an event occurring after the impairment was recognized causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through profit or loss.

In some cases, financial assets are acquired at a deep discount that reflects incurred credit losses. The Group includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the financial asset to reflect actual and revised estimated cash flows. The Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognized as an increase in value of loans in profit or loss when recalculation results in an increase in carrying amount and impairment when there is a decrease in carrying amount.

Loans are written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralized loans, when the proceeds from the realization of collateral have been received.

54. Cash and cash equivalents

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

55. Loans

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

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

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

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

56. Financial instruments

Trading assets and liabilities

Trading assets and liabilities are financial instruments acquired principally for the purpose of generating profits from short term price fluctuations or from a dealer's margin, and derivative financial instruments.

Securities used for hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts. Those assets are not subject to hedge accounting.

Financial assets designated at fair value through profit or loss

Assets classified designated at fair value through profit or loss consist of equity and debt instruments which are acquired by the Group with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial instruments and trading liabilities are initially and subsequently measured at fair value in the Statement of Financial position, with transaction costs recognized in profit or loss. All changes in fair value are recognized as part of net financial income in profit or loss.

Interest and dividend income that arises from these assets are included in Interest income and Net financial income, respectively.

Available-for-sale financial assets designated at fair value through Other comprehensive income

AFS financial assets include equity investments. Equity investments classified as AFS are those that are neither classified as held for trading nor designated at fair value through profit or loss. After initial measurement, AFS financial assets are subsequently measured at fair value with unrealized gains or losses recognized in OCI and credited in the AFS reserve until the investment is derecognized, at which time, the cumulative gain or loss is recognized in other operating income, or the investment is determined to be impaired, when the cumulative loss is reclassified from the AFS reserve to the statement of profit or loss in finance costs.

57. Derivatives

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

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

58. Intangible assets

Goodwill

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

Infrastucture and customer relationship

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

Software

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

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

Amortization of intangible assets

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

Notes to the Consolidated Financial Statements

59. Investment property

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

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

60. Impairment of non-financial assets

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

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

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

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

61. Deposits

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

62. Borrowings

Some of the borrowings of the Group are classified as other financial liabilities and are initially recognized at fair value less attributable transaction costs. Subsequent to initial recognition, borrowings are measured at amortized cost with any difference between cost and redemption amount being recognized in the Statement of Comprehensive Income over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

63. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within Tier II, as shown in Note 44. The Group may only retire subordinated liabilities with the permission of the Icelandic Financial Supervisory Authority.

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

64. Other assets and other liabilities

Property and equipment

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

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

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

Buildings	33-50 years
Equipment	3-7 years

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

Non-current assets and disposal groups held for sale

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

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

Other assets and other liabilities

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

Insurance claim

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

65. Equity

Dividends

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

Statutory reserve

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

65. Equity, continued

Reserve for investments in subsidiaries and associates

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

Reserve for investments in securities

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

Available-for-sale reserve

AFS reserve comprises all unrealized gain or losses related to fair value measurements of AFS financial assets.

Foreign currency translation reserve

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

66. Earnings per share

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

67. Financial guarantees

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

68. Fiduciary activities

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

69. Employee benefits

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

70. New standards and amendments to standards

The Consolidated Financial Statements are presented in accordance with the new and revised IFRS standards and new interpretations (IFRIC), applicable in the year 2016. These new and revised IFRSs did not have material effect on amounts nor information reported in the Consolidated Financial Statements.

Amendments to IAS 27 Equity Method in Separate Financial Statements allows entities to use the equity method to account for investments in subsidiaries, joint ventures and associates in their separate Financial Statements. Entities already applying IFRS and electing to change to the equity method in their separate financial statements have to apply that change retrospectively. These amendments do not have any impact on the Bank's Consolidated Financial Statements. The amendment is effective from 1 January 2017 but will not have any impact on the Bank's Consolidated Financial Statements.

A number of new standards, amendments to standards and interpretations have been issued but are not yet effective for the year ended 31 December 2016, and have not been applied in preparing these Financial Statements. Relevant to the Group's reporting are:

IFRS 9 Financial Instruments

In July 2014, the IASB issued IFRS 9 Financial Instruments, the standard that will replace IAS 39 for annual periods on or after 1 January 2018, with early adoption permitted. The Group has set up a multidisciplinary implementation team ('the Team') with members from Risk, Finance and other relevant divisions to prepare for IFRS 9 implementation ('the Project'). IFRS 9 steering committee consists of Chief Risk and Finance officers as well as senior managers from Corporate banking and Retail banking, who regularly report to the Bank's Audit committee (BAC). The Project has six key phases: the initial assessment and analysis, design, build and test the system, parallel running in the second half of 2017, and go live in 2018. At year-end 2016 the Project is on time and the Group will be able to meet the set timeline in this project. The Group is currently evaluating the impats of IFRS 9 on the Financial Statements.

Classification and measurement

From a classification and measurement perspective, the new standard will require all financial assets, except equity instruments and derivatives, to be assessed based on a combination of the entity’s business model for managing the assets and the instruments’ contractual cash flow characteristics. The IAS 39 measurement categories will be replaced by: fair value through profit or loss (FVPL), fair value through other comprehensive income (FVOCI), and amortised cost. IFRS 9 will also allow entities to continue to irrevocably designate instruments that qualify for amortised cost or fair value through OCI instruments as FVPL, if doing so eliminates or significantly reduces a measurement or recognition inconsistency. Equity instruments that are not held for trading may be irrevocably designated as FVOCI, with no subsequent reclassification of gains or losses to the Statement of Comprehensive Income.

The accounting for financial liabilities will largely be the same as the requirements of IAS 39, except for the treatment of gains or losses arising from an entity’s own credit risk relating to liabilities designated at FVPL. Such movements will be presented in OCI with no subsequent reclassification to the Statement of Comprehensive income , unless an accounting mismatch in profit or loss would arise.

Having completed its initial assessment, the Group has concluded that:

• The majority of loans to credit institutions and loans to customers that are classified as loans and receivables under IAS 39 are expected to be measured at amortised cost under IFRS 9.

• Financial assets and liabilities held for trading and financial assets and liabilities designated at FVPL are expected to be continue to be measured at FVPL.

Arion Bank has finalised majority of the work on business models setup for each division and each classes of assets. The estimated outcome will not change the setup of the Balance Sheet significantly from IAS 39 classification.

Impairment of financial assets

IFRS 9 will also fundamentally change the loan loss impairment methodology. The standard will replace IAS 39’s incurred loss approach with a forward-looking expected loss (ECL) approach. The Group will be required to record an allowance for expected losses for all loans and other debt financial assets not held at FVPL, together with loan commitments and financial guarantee contracts. The allowance is based on the expected credit losses associated with the probability of default in the next twelve months unless there has been a significant increase in credit risk since origination, in which case, the allowance is based on the expected loss over the life of the asset - lifetime expected credit loss (LECL).

70. New standards and amendments to standards, continued

The Group has established a policy to perform an assessment at the end of each reporting period of whether credit risk has increased significantly since initial recognition by considering the change in the risk of default occurring over the remaining life of the financial instrument.

• To calculate ECL, the Group will estimates the risk of a default occurring on the financial instrument during its expected life. ECLs are estimated based on the present value of all cash shortfalls over the remaining expected life of the financial asset, i.e., the difference between: the contractual cash flows that are due to the Group under the contract, and

• The cash flows that the Group expects to receive,

• discounted at the effective interest rate of the loan.

In comparison to IAS 39, the Group expects the impairment charge under IFRS 9 to be more volatile than under IAS 39 and to result in an increase in the total level of current impairment allowances.

The Group will group its loans into Stage 1, Stage 2 and Stage 3, based on the applied impairment methodology, as described below:

• Stage 1 – Performing loans: when loans are first recognised, the Group recognises an allowance based on 12-month expected credit losses.

• Stage 2 – Underperforming loans: when a loan shows a significant increase in credit risk, the Group records an allowance for the lifetime expected credit loss.

• Stage 3 – Impaired loans: the Group recognises the lifetime expected credit losses for these loans. In addition, in Stage 3 the Group accrues interest income on the amortised cost of the loan net of allowances.

The Group will record impairment for FVOCI debt securities, depending on whether they are classified as Stage 1, 2, or 3, as explained above. However, the expected credit losses will not reduce the carrying amount of these financial assets in the statement of financial position, which will remain at fair value. Instead, an amount equal to the allowance that would arise if the asset were measured at amortised cost will be recognised in OCI as an accumulated impairment amount, with a corresponding charge to profit or loss.

For 'low risk' FVOCI debt securities, the Group intends to apply a policy which assumes that the credit risk on the instrument has not increased significantly since initial recognition and will calculate ECL as explained in Stage 1. Such instruments will generally include traded, investment grade securities where the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. The Group will not consider instruments to have low credit risk simply because of the value of collateral. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the Group's other financial instruments.

Forward looking information

The Group will incorporate forward-looking information in both the assessment of significant increase in credit risk and the measurement of ECLs.

The Group considers forward-looking information such as macroeconomic factors and economic forecasts. To evaluate a range of possible outcomes, the Group intends to formulate three scenarios: a base case, a worse case and a better case. The base case scenario represents the more likely outcome resulting from the Group’s normal financial planning and budgeting process, while the better and worse case scenarios represent more optimistic or pessimistic outcomes. For each scenario, the Group will derive an ECL and apply a probability weighted approach to determine the impairment allowance.

The Group will use internal information coming from internal economic experts, combined with published external information from government and private economic forecasting services. Both the Risk and Finance management teams will need to approve the forward-looking assumptions before they are applied for different scenarios.

70. New standards and amendments to standards, continued

Limitation of estimation techniques

The models applied by the Group may not always capture all characteristics of the market at a point in time as they cannot be recalibrated at the same pace as changes in market conditions. Interim adjustments are expected to need to be made until the base models are updated. Although the Group will use data that is as current as possible, models used to calculate ECLs will be based on data that is one month in arrears and adjustments will be made for significant events occurring prior to the reporting date. The governance over such adjustments is still in development.

Capital management

The impact on capital adequacy is not possible to determine as it is expected the Basel committee will issue new rules for the transition to IFRS 9, but these are not yet final.

Presentation of the operating model

The steering committee will present the proposed operating model to BAC in second quarter of 2017.

IFRS 15 Revenue from Contracts with Customers

The standard was issued in 2014 and defines principles for recognizing revenue and will be applicable to all contracts with customers. However, interest and fee income integral to financial instruments and leases will continue to fall outside the scope of IFRS 15 and will be regulated by the other applicable standards. Revenue under IFRS 15 will need to be recognized as goods and services are transferred, to the extent that the transfer anticipates entitlement to goods and services. The standard specifies a comprehensive set of disclosure requirements. The standard will be effective for periods beginning on 1 January 2018 with early adoption permitted. The Group does not expect IFRS 15 to be adopted early and is currently evaluating its impacts.

IFRS 16 Leases

The standard issued in January 2016 does not significantly change the accounting for leases for lessors. However, it does require lessees to recognize most leases on their balance sheet as lease liabilities, with the corresponding right-to-use assets. Lessees must apply a single model for all recognized leases, but will have the option not to recognize short-term leases and leases of low-value assets. The standard is effective for annual periods beginning 1 January 2019. The Group is currently assessing the impact of the new standard.

Amendments to IAS 12 Income Taxes

The amendments clarify the accounting treatment of deferred tax assets of debt instruments measured at fair value for accounting, but measured at cost for tax purposes. The amendment is effective from 1 January 2017. The Group is currently evaluating the impact, but does not anticipate that adopting the amendments would have a material impact on its Financial Statements.

Amendments to IAS 7 Statement of Cash Flows

The amendments to the standard, issued in January 2016, are intended to improve disclosures of financing activities and help users to better understand the reporting entities' liquidity positions. Under the new requirements, entities will need to disclose changes in their financial liabilities as a result of financing activities such as changes from cash flows and non-cash items (e.g., gains and losses due to foreign currency movements). The amendment is effective from 1 January 2017. The Group is currently evaluating the impact.

5-year overview

STATEMENT OF COMPREHENSIVE INCOME

	2016	2015	2014	2013	2012
Net interest income	29,900	26,992	24,220	23,800	27,142
Net fee and commission income	13,978	14,484	13,309	11,223	10,748
Net financial income	5,162	12,844	7,290	1,675	2,017
Net insurance income	1,395	760	664	750	685
Share of profit of associates	908	29,466	3,498	1,986	2,405
Other operating income	2,096	1,624	4,668	4,591	6,272
Operating income	53,439	86,170	53,649	44,025	49,269
Salaries and related expense	(16,659)	(14,892)	(13,979)	(13,537)	(12,459)
Other operating expense	(13,881)	(12,919)	(12,722)	(11,535)	(11,976)
Bank levy	(2,872)	(2,818)	(2,643)	(2,872)	(1,062)
Net impairment	7,236	(3,087)	2,135	(680)	(4,690)
Earnings before tax	27,263	52,454	26,440	15,401	19,082
Income tax expense	(6,410)	(3,135)	(4,679)	(3,143)	(3,633)
Net earnings from continuing operations	20,853	49,319	21,761	12,258	15,449
Net gain from discontinued operations, net of tax	886	360	6,833	399	1,607
Net earnings	21,739	49,679	28,594	12,657	17,056
Net other comprehensive income	(2,721)	2,916	(5)	(2)	2
Total comprehensive income	19,018	52,595	28,589	12,655	17,058

STATEMENT OF FINANCIAL POSITION

	2016	2015	2014	2013	2012
Assets					
Cash and balances with Central Bank	87,634	48,102	21,063	37,999	29,746
Loans to credit institutions	80,116	87,491	108,792	102,307	101,011
Loans to customers	712,422	680,350	647,508	635,774	566,610
Financial instruments	117,456	133,191	101,828	86,541	137,800
Investment property	5,358	7,542	6,842	28,523	28,919
Investments in associates	839	27,299	21,966	17,929	7,050
Intangible assets	11,057	9,285	9,596	5,383	4,941
Tax assets	288	205	655	818	463
Other assets	20,854	17,578	15,486	23,576	24,135
Total Assets	1,036,024	1,011,043	933,736	938,850	900,675
Liabilities and Equity					
Due to credit institutions and Central Bank	7,987	11,387	22,876	28,000	32,990
Deposits	412,064	469,347	454,973	471,866	448,683
Financial liabilities at fair value	3,726	7,609	9,143	8,960	13,465
Tax liabilities	7,293	4,922	5,123	4,924	3,237
Other liabilities	54,094	49,461	47,190	43,667	42,117
Borrowings	339,476	256,058	200,580	204,568	195,085
Subordinated liabilities	-	10,365	31,639	31,918	34,220
Total liabilities	824,640	809,149	771,524	793,903	769,797
Shareholders' equity	211,212	192,786	160,711	140,089	127,072
Non-controlling interest	172	9,108	1,501	4,858	3,806
Total equity	211,384	201,894	162,212	144,947	130,878
Total Liabilities and Equity	1,036,024	1,011,043	933,736	938,850	900,675

Arion Bank Consolidated Financial Statements 2016 89 Amounts are in ISK millions

Appendix

Unaudited

Corporate Governance Statement

Corporate governance statement of Arion Bank for 2016

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

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

Excellence in corporate governance

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

Compliance with guidelines on good corporate governance

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

Article 1.1.6 states that the board of a company shall post certain information on the candidates to the board on the company's website. Given the current shareholder structure the information in question has been sent directly to shareholders before the AGM and posted on the company's website following the AGM. The company will seek to post the information in question on its website in the future.

Article 1.5. states that a shareholders' meeting shall appoint a nomination committee or decide how it should be appointed. The Bank's majority shareholder appoints seven out of eight Board members and the minority shareholder appoints the eighth member. The Bank has not considered it necessary to appoint a nomination committee given the current shareholder structure.

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

Legal framework for the Bank's operation

Arion Bank is a financial institution which operates in accordance with the Financial Undertakings Act No. 161/2002. Acts of law which apply to the Bank's operations include the Financial Undertakings Act No. 161/2002, the Securities Transactions Act No. 10/2007 and Public Limited Companies Act No. 2/1995. The Bank is a universal bank which provides a comprehensive range of financial services relating to savings, loans, asset management, corporate finance and capital markets. The Bank has issued financial instruments which have been admitted for trading on regulated securities markets in Iceland, Norway and Luxembourg, and is therefore subject to the disclosure requirements of issuers pursuant to the Securities Transactions Act No. 108/2007 and the rules of the relevant stock exchanges.

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

Internal controls, auditing and accounting

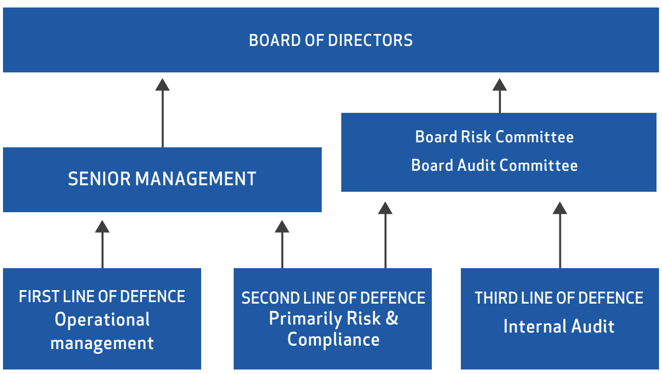
Internal control

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

The set-up distinguishes between the following roles:

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

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



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

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

Compliance

The Compliance unit is an independent control function which reports directly to the CEO, in accordance with the Compliance Charter issued by the Board of Directors. The role of Compliance is to ensure that Arion bank operates in accordance with law, rules and good business conduct, using efficient pre-emptive measures and endorsing a good corporate culture in that regard.

- Compliance provides oversight of regulatory requirements and responsibility, and assists employees in understanding applicable requirements at any given time, by providing access to appropriate training, advice and information
- Compliance contributes to ensuring efficient internal controls, and to ensuring that appropriate actions are taken to address any deficiencies
- Compliance safeguards the Bank from the possible abuse of its services, and ensures that the Bank knows its counterparties, the nature of each business relationship, and its obligations thereto
- Compliance promotes transparency, and the providing of adequate information to customers, investors and authorities
- Compliance promotes responsible handling of confidential information

Compliance had seven full time employees at the end of 2016.

Risk Management

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

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

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

Internal Audit

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

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

Internal Audit had eight employees at the end of 2016.

Auditing and accounting

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

Customers' Ombudsman

The Customers' Ombudsman is appointed by the Chief Executive Officer. The role of the Ombudsman is to ensure fairness and objectivity, prevent discrimination against the customer and make certain that the process for handling cases is transparent and documented. The Customers' Ombudsman examined 160 cases in 2016, compared with 185 cases in 2015 and 202 cases in 2014.

Cornerstones, code of ethics and corporate social responsibility

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

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

Arion Bank demonstrates sustainable banking by making a difference to its customers and performing its role as a financial institution conscientiously and responsibly. Arion Bank takes an active role in its society and development. Financial institutions are one of the pillars of society and their role is to help our customers, both individuals and companies, reach their goals. Arion Bank places great importance on doing things fairly with the interests of its customers, employees, shareholders and the community at heart. In December the Board of Directors of Arion Bank adopted a new policy on sustainability which, like the Bank's cornerstones, is based on the culture which has evolved at the Bank over the last few years. The policy is entitled *Together we make good things happen*. At the end of 2016 the Bank also became a participant in the UN Global Compact initiative.

Further information on this can be found in the Bank 's annual report.

Board of Directors and committees

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

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

The Board of Directors is generally elected for a term of one year at the company's annual general meeting. At Arion Bank's annual general meeting on 17 March 2016, seven Directors and three Alternates were elected to the Board of Directors. At the Bank's shareholders' meeting on 15 September 2016 it was decided to add an extra member to the Board and the Board currently consists of eight members. The Bank's majority shareholder, Kaupskil, appoints seven out of eight Board members and the Icelandic state, as a minority shareholder appoints the eighth member. When electing the Board care is taken to ensure at least 40% representation of each gender among directors and alternates. Currently the Board consists of four men and four women and the Chairman is a woman. The elected Board Directors have diverse backgrounds and extensive skills, experience and expertise.

Information on the independence of Directors was sent to shareholders before the shareholders' meeting and the information was published on the Bank's website after the general meeting. The minutes of the AGM and shareholders' meetings are sent to the shareholders following the meeting but have not been published on the Bank's website because of the current shareholder structure.

The Board of Directors meets at least ten times a year. In 2016 the Board met on 13 occasions. The Chairman directs and is responsible for the work of the Board. The Chairman chairs Board meetings and ensures that there is enough time allocated to the discussion of important issues and that strategy issues are discussed thoroughly. The Chairman is not permitted to undertake any other work for the Bank unless part of the normal duties of the Chairman.

According to the Board's Rules of Procedure the Board is permitted to establish committees to discuss particular areas of the Bank's operations. At the first scheduled meeting of the new Board following the AGM the Board appoints members to each of its sub-committees and assesses whether it is necessary to appoint external members to certain committees in order to bring in a greater level of expertise. One of the committee members in the Board Audit Committee and Risk Committee, Lúdvík Karl Tómasson, is not a Board Director and is independent of the Bank and its shareholders. The Board sub-committees are as follows:

- Board Audit Committee: Its main task is, inter alia, to try and guarantee the quality of the financial statement and other financial information from the Bank and the independence of its auditors.

- Board Risk Committee: The Committee's main role is, inter alia, to evaluate the Bank's risk policy and risk appetite and to have a thorough knowledge of the risk assessments and methods used to manage risk employed by the Bank.

- Board Credit Committee: Its main task is to attend to credit issues which exceed the credit limits of its sub-committees.

- Board Remuneration Committee: The Committee's main task is to advise the Board on the terms of remuneration to the Chief Executive Officer and other employees hired directly by the Board. Regular tasks at committee meetings are to review the remuneration policy, the human resources policy, salary distribution and the incentive system if one is in place. The Bank's remuneration policy shall be examined and approved by a shareholders' meeting annually.

Sub-committees regularly inform the Board of their activities. Furthermore, the Board has access to all material used by the sub-committees. The Board Audit and Risk Committee met four times during the year before the committee was divided into two committees in March 2016; the Board Audit Committee, which met four times during the year, and the Board Risk Committee, which met seven times during the year. The Board Credit Committee met 10 times during the year, and the Board Remuneration Committee met seven times. Below is an overview of the attendance of individual Directors.

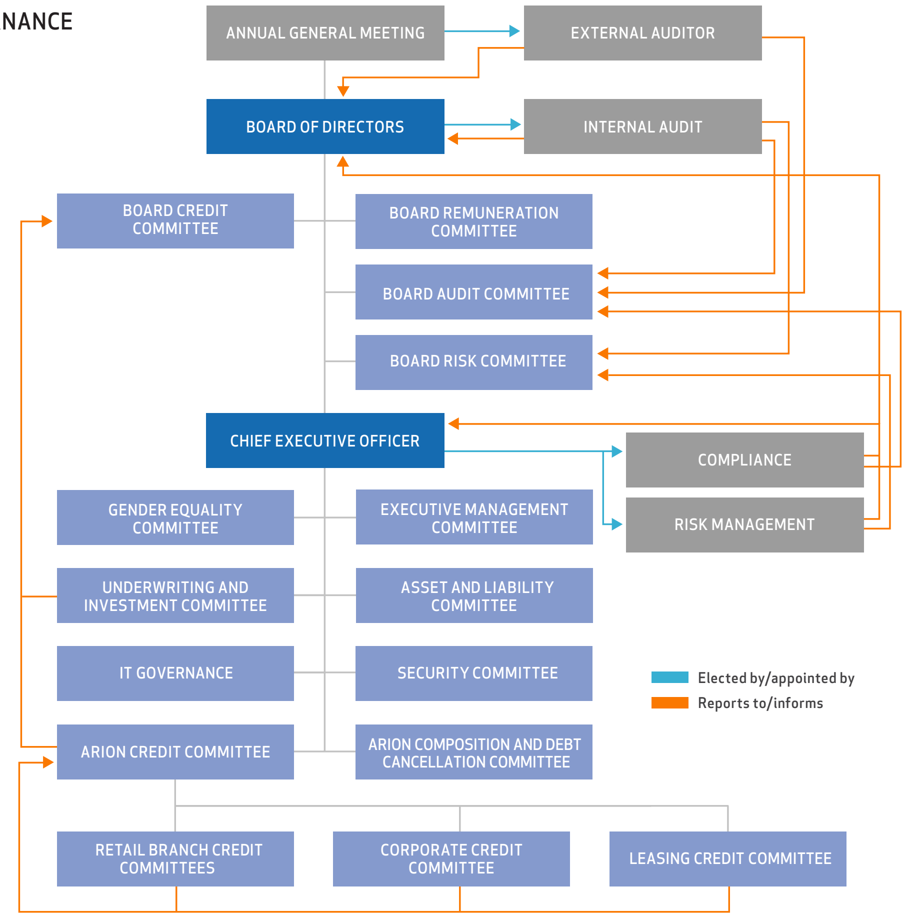
The Board and its sub-committees carry out an annual performance assessment, at which it assesses its work, the necessary number of Board Directors, the Board structure, achievements and work of the sub-committees with respect to the aforementioned. This assessment was last performed by the Board and its sub-committees at their meetings and between meetings during the period 16 November 2016 to 26 January 2017.

Director	Period	Board (13)	BARC (4)	BAC (4)	BRIC (7)	BCC (10)	BRC (7)
Monica Caneman	1 Jan. - 31 Dec.	13	-	-	-	9	-
Guðrún Johnsen	1 Jan. - 31 Dec.	13	4	-	7	-	7
Brynjólfur Bjarnason	1 Jan. - 31 Dec.	13	-	4	-	9	-
Benedikt Olgeirsson	1 Jan. - 31 Dec.	13	-	-	6	10	-
Þóra Hallgrímsdóttir	1 Jan. - 31 Dec.	12	4	4	-	-	7
Kirstín Flygenring	1 Jan - 31 Dec.	13	-	4	-	-	7
Måns Höglund	1 Jan - 31 Dec.	12	3	-	7	9	-
John P. Madden (1)	15 Sept. – 31 Dec.	4	-	-	-	-	-
Ólafur Örn Svansson	1 Jan. - 31 Dec.	0	-	-	-	-	-
Björg Arnardóttir	1 Jan. - 31 Dec.	0	-	-	-	-	-
Sigurbjörg Ásta Jónsdóttir	1 Jan. - 31 Dec.	0	-	-	-	-	-
Lúðvík Tómasson	1 Jan. - 31 Dec.	-	4	3	6	-	-

(1) John P. Madden was appointed as a Board Director at a shareholders' meeting on 15 September 2016

The board of directors of Arion bank

ARION BANK GOVERNANCE OVERVIEW



Monica Caneman, Chairman

Monica was born in 1954. She is Swedish and lives in Sweden. She was first elected as a Director at a shareholders' meeting on 18 March 2010. She is not a shareholder of Arion Bank and is an independent Director. Monica is Chairman of the Board Credit Committee. She graduated with a BSc in business and economics from the Stockholm School of Economics in 1976. Monica currently serves on the boards of numerous companies and non-profit organizations and is the chairman of several of them.

Monica previously worked at Skandinaviska Enskilda Banken (now SEB) where she held various positions in marketing and commercial banking, i.e. a member of the Group Executive Committee, Group Management and deputy CEO and became an alternate member of the board of directors at the same time. Since 2001 Monica has built a career around board assignments.

Gudrún Johnsen, Vice Chairman

Gudrún was born in 1973. She was first elected as a Director at a shareholders' meeting on 18 March 2010. She is not a shareholder of Arion Bank and is an independent Director. Gudrún is Chairman of the Board Remuneration Committee and a member of the Board Risk Committee. Gudrún completed an MA in applied economics at the University of Michigan, Ann Arbor in the United States in 2002 and gained an MA in statistics from the same university the following year. She graduated with a BA in economics from the University of Iceland in 1999. Gudrún is currently a lecturer in finance at the faculty of business administration at the University of Iceland.

Gudrún has previously worked as a securities broker, specialist in the Financial Systems Department of the International Monetary Fund (IMF) in Washington DC, senior researcher for the Parliamentary Special Investigation Commission looking into the causes and events leading up to the fall of the Icelandic banking system in 2008 and as an assistant professor at Reykjavík University. She has served on the board of a fund management company of MP Bank hf. and is the current chairman of the research and development company THOR ehf.

Benedikt Olgeirsson

Benedikt was born in 1961. He was first elected as a Director at a shareholders' meeting on 18 December 2013. He is not a shareholder of Arion Bank and is an independent Director. Benedikt is a member of the Board Risk Committee and the Board Credit Committee. He gained an MSc in construction engineering and project management at the University of Washington in Seattle in 1987. Benedikt completed a degree in civil engineering from the University of Iceland in 1986. Benedikt is currently the managing director of corporate development at Landspítali University Hospital.

Benedikt has previously worked as managing director of Atorka hf., managing director of Parlogis ehf. and served as Deputy CEO of Landspítali University Hospital. He was also a manager at Eimskip hf. and has worked as a project manager in civil engineering. Benedikt has served as board director at several companies such as Promens hf., Icepharma hf. which he chaired, Parlogis ehf. and InterBulk Group, which is listed on the London Stock Exchange.

Brynjólfur Bjarnason

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

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

John P. Madden

John P. Madden was born in 1973. John is a dual US and British citizen and he lives in the United Kingdom. He was first elected as a Director at a shareholders' meeting on 15 September 2016. He is not a shareholder of Arion Bank and is a dependent Director. He gained a BA in political economy from Williams College in Massachusetts in 1996. John is a managing director at Kaupthing ehf., which is the majority shareholder of Arion Bank through its subsidiary Kaupskil ehf. He has also worked at BC Partners, Arle, ICG since 2014.

Previously John worked at Arcapita, first in the United States, then in the United Kingdom. Prior to that he was at Lehman Brothers, New York. John is currently on the board of directors at Fairhold Securitisation Limited and Noreco.

Kirstín Þ. Flygenring

Kirstín was born in 1955. She was first elected to the Board as an Alternate at a shareholders' meeting on 22 March 2012. She was elected to the Board as a Director at the Bank's annual general meeting on 20 March 2014. She is not a shareholder of Arion Bank and is an independent Director. Kirstín is a member of the Board Audit Committee and the Board Remuneration Committee. Kirstín completed an MA in economics from Northwestern University in Illinois in 1983. In 1980 she graduated with a cand. oecon. degree from the University of Iceland. She completed a course in practical media studies at the University of Iceland and gained a diploma in European competition law from Kings College London. Kirstín currently works as an independent consultant.

Kirstín has previously served as a member of the Icelandic parliament's investigative committee on the Housing Financing Fund and has worked as a part-time lecturer and adjunct at the University of Iceland, specialist at the Institute for Research in Finance and Economics at Reykjavík University and as an economist at the National Economic Institute, the Department of Economics at the Central Bank of Iceland, and for the OECD. Kirstín has also held several positions on boards and committees and was, for example, the chairman of the Competition Committee, a board member of Midengi ehf. and has served on the Post and Telecommunications Arbitration Committee since 2008.

Måns Höglund

Måns was born in 1951. He is Swedish and lives in Portugal. He was first elected as a Director at Arion Bank's Annual General Meeting on 24 March 2011. He is not a shareholder of Arion Bank and is an independent Director. Måns is Chairman of the Board Risk Committee and a member of the Board Credit Committee. He graduated with a BSc in business and economics from the Stockholm School of Economics in 1975.

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

Thóra Hallgrímsdóttir

Thóra was born in 1974. She was first elected as an Alternate Director at a shareholders' meeting on 24 March 2011. She was elected as a Director at a shareholders' meeting on 21 March 2013. She is not a shareholder of Arion Bank and is an independent Director. Thóra is a member of the Board Audit Committee and the Board Remuneration Committee. Thóra completed an MA in law at the University of Iceland in 2000 and qualified as an attorney to the district court in 2002. Since 2011 she has worked as a specialist in the faculty of law at Reykjavík University in insurance law, contract law and law of tort.

Before that Thóra worked as a lawyer for two Icelandic insurance companies: Tryggingamidstödin hf. and Sjóvá-Almennar tryggingar hf. Thóra is currently a board member of the rehabilitation fund Virk-Starfsendurhæfingarsjódur ses. and the Association of Icelandic Lawyers and is the CEO for the Icelandic Law Journal (Tímarit Lögfraedinga). Thóra serves as chairman of the insurance complaints committee and chairman of the seamen and fishermen's arbitration committee.

Alternate directors:

Björg Arnardóttir, business studies graduate, Sigurbjörg Ásta Jónsdóttir, lawyer and Ólafur Örn Svansson, Supreme Court attorney.

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

Communications between the Shareholders and the Board of Directors

On behalf of its creditors Kaupthing, through its subsidiary Kaupskil, took ownership of Arion Bank on 8 January 2010. Icelandic State Financial Investments (ISFI), which represent the government of Iceland's holdings in financial institutions, owns 13% of shares. The Chairman of the Board of Directors communicates with shareholders on behalf of the Board of Directors and the Bank between legally convened shareholders' meetings, which are the main venue at which the Board and the Bank report information to the shareholders. Shareholders have, at the Board's request, also arranged quarterly meetings at which the Chief Executive Officer presents the interim financial results.

Chief Executive Officer

Höskuldur H. Ólafsson

Höskuldur was born in 1959. He was appointed CEO of Arion Bank in June 2010. Höskuldur is not a shareholder of Arion Bank and no stock option agreements have been entered into with him. Höskuldur joined the Bank from Valitor hf. where he had been CEO since 2006. Prior to that he worked at the Icelandic transportation company Eimskip hf. for 17 years and held a range of management positions, including that of deputy CEO. He has also served on the boards of directors of numerous companies and organizations in Iceland and abroad. Höskuldur graduated with a cand. oecon. degree in business administration from the University of Iceland in 1987.

The CEO and the executive committee carry out the Bank's daily operations in accordance with a strategy set out by the Board. The CEO shall provide the Board with reports on the Bank's operations and financial position and all important issues which may affect the Bank's operations and finances. With respect to other duties responsibilities and duties of the CEO please refer to Chapter VII of the Financial Undertakings Act and Chapter IX of the Public Limited Companies Act. The duties of the CEO and his responsibilities take into account the legal environment in which the Bank operates at any given time and the rules which the Board of Directors may establish.

Executive Committee

The Bank's Executive Committee consists of ten people, including the CEO, Höskuldur H. Ólafsson; Freyr Thórdarson, Managing Director of Corporate Banking, Gísli S. Óttarsson, Chief Risk Officer, Helgi Bjarnason, Managing Director of Retail Banking, Ida Brá Benediktsdóttir, Managing Director of Investment Banking, Jónína S. Lárusdóttir, Managing Director of Legal Division, Margrét Sveinsdóttir, Managing Director of Asset Management, Rakel Óttarsdóttir, Managing Director of IT, Sigurjón Pálsson, Chief Operating Officer and Stefán Pétursson, Chief Financial Officer.

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

Information on violations of laws and regulations

Arion Bank has not been denied registration, authorization, membership or permission to conduct certain business, activity or operations. The Bank has not been subject to withdrawal, revocation or dismissal of registration, authorization, membership or permission.

Information on legal cases relating to Arion Bank can be found in the notes to the annual financial statement.

This Corporate Governance Statement was examined and approved at a meeting of the Board of Directors on 13 February 2017.

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