Financial Statements 2016

Investor presentation

13 February 2016

Arion Bank

Arion Bank – universal bank

Arion Bank provides comprehensive financial services

Asset Management

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

Corporate Banking

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

Retail Banking

- ~ 29% market share
- Main provider of mortgages after HFF
- Wide range of financial services for individuals and SMEs
- Focus on digital services – app and ATMs

Investment Banking

- Comprehensive investment banking services
- Leader in capital markets and corporate finance
- Managed all IPOs in Iceland in 2015 and 2016

Subsidiaries perform vital role

Well balanced bank with moderate risk profile

VALITOR

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

okkar

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

STEFNIR

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

vörður

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

Highlights of 2016

Investing in exciting projects for the future

Solid year

- Strong growth in interest income owing to increase in interest-bearing assets
- Corporate lending up 5.3% and strong demand for loans
- Valitor sold its stake in Visa Europe Ltd. to Visa Inc. which had highly positive impact on Bank's financial results
- Substantial investment: Opening of branch at Keflavík International Airport, digital future and Valitor's international operation
- Weak performance of securities market had impact on operating results
- Valuation change in mortgages had positive impact
- Commission income down, partly due to fewer IPOs and market volatility
- Higher salary expenses owing to collective wage agreements and increase in number of employees

Sales & acquisitions – Arion Bank acquires Vördur

- Arion Bank acquired the insurance company Vördur, which has highest level of customer satisfaction according to surveys. The acquisition increases the Group's range of services
- Kolufell sold to Apartnor ehf.
- Subsidiary BG12 slhf. sells its 46% stake in Bakkavor Group Ltd.

Highlights of 2016

Arion Bank's credit terms continue to improve on international credit markets

Credit rating upgraded

- Bond issue in US dollars (approx. ISK 97 billion) to Kaupthing was one of measures to facilitate lifting of capital controls – 2/3 paid off during year
- Two €300 million bond issues, 3-year and 5-year instruments and terms offered to Bank continue to improve
- ISK 24.8 billion in covered bonds issued during the year
- Standard & Poor's upgraded Arion Bank's credit rating from BBB- to BBB with a positive outlook

STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

Single IPO in 2016

- Arion Bank managed listing of Skeljungur hf. on Nasdaq Iceland, only IPO during year
- Arion Bank has managed more than 60% of stock market listings in recent years

Syndicated loan to Landsvirkjun

- Arion Bank participated in USD 200 million syndicated multi currency loan to Landsvirkjun on the international market

Skeljungur

Highlights of 2016

Leader in digital solutions and new branch opened at Keflavík International Airport

Digital solutions improve service and reduce expense

- New and convenient way to become a customer online
- Online credit appraisal for buying a home confirmed in just a few minutes
- Payment plan for credit cards in online bank account and app in just seconds

New features for payment cards

- Customers received new contactless debit cards – Visa Debit
- New currency card for tourists introduced – prepaid international VISA card

New branch at Keflavík International Airport

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

Awards

- Euromoney named Arion Bank as best investment bank in Iceland in 2016
- Frjálsi Pension Fund nominated as best fund in Europe and got highest rating in Gallup's annual survey among fund members

EUROMONEY AWARDS FOR EXCELLENCE 2016

Highlights of 2016

Supporting entrepreneurs from primary schools to the workplace

Startup Reykjavík best business accelerator

- Arion Bank organizes Startup Reykjavík for fifth year in row and Startup Energy Reykjavík held for third successive year
- Arion Bank has invested in 71 start-ups through business accelerators
- Companies passing through business accelerators have raised ISK 2.6 billion in grants and equity
- Startup Reykjavík chosen as best business accelerator in Iceland in 2016 by Nordic Startup Awards

Supporting young entrepreneurs

- Partnership agreement with Junior Achievement which promotes innovation in Icelandic secondary schools
- Special finance day was held at Arion Bank in connection with NKG innovation competition for school children

Fin Tech Hackathon

- Arion Bank was the first Icelandic bank to host a FinTech hackathon. 11 teams took part and spent 30 hours nonstop programming FinTech solutions

Agreement with European Investment Fund

- Arion Bank and European Investment Fund signed an agreement aimed at providing loans to SMEs who intend to bring innovation into their businesses

Startup Reykjavík Arion banki Klak Innovit

Startup Energy Reykjavik

2016 Highlights

1 Strong banking operation in a robust economic environment

2 Success in digital solutions

3 Good progress in diversification of funding

4 Strong capital position and asset quality

Arion Bank

Headline figures for 2016

Net earnings ISK 21,739 million 2015: ISK 49,679 million	CET1 ratio 26.5% 2015: 22.3%	Cost-to-income ratio 57.2% 2015: 32.3%	Problem loans 1.6% 2015: 2.5%
Return on equity 10.5% 2015: 28.1%	Leverage ratio 18.0% 2015: 16.7%	Number of Employees 1,239 2015: 1,147	Mortgages/ Total loans 39.2% 2015: 39.4%

Arion Bank

Income Statement

Income Statement

All amounts in ISK million

Good performance in key sources

- Net interest income increased by 11% mainly due to more interest-bearing assets
- Net commission income decreases between years but favourable development in fourth quarter
- Net financial income is mostly due to profit from the sale of Valitor's stake in Visa Europe
- Increase in salaries due to new wage agreements and lay-off expense
- Positive net impairment mainly due to release of discount following revaluation of acquired mortgages and revised provision on FX loans

	2016	2015	Diff	Q4 2016	Q3 2016	Diff
Net interest income	29,900	26,992	11%	7,842	7,432	6%
Net commission income	13,978	14,484	(3%)	3,765	3,466	9%
Net financial income	5,162	12,844	(60%)	823	844	(2%)
Net insurance income	1,395	760	84%	731	272	169%
Share of profit of associates	908	29,466	(97%)	198	16	-
Other income	2,096	1,624	29%	431	435	(1%)
Operating income	**53,439**	**86,170**	**(38%)**	**13,790**	**12,465**	**11%**
Salaries and related expense	(16,659)	(14,892)	12%	(4,407)	(3,826)	15%
Other operating expenses	(13,881)	(12,919)	7%	(3,803)	(3,349)	14%
Bank levy	(2,872)	(2,818)	2%	(682)	(705)	(3%)
Net impairment	7,236	(3,087)	-	409	5,882	(93%)
Net earnings before taxes	**27,263**	**52,454**	**(48%)**	**5,307**	**10,467**	**(49%)**
Income tax expense	(6,410)	(3,135)	104%	(1,149)	(3,170)	(64%)
Net gain from disc. operations	886	360	146%	317	206	54%
Net earnings	**21,739**	**49,679**	**(56%)**	**4,475**	**7,503**	**(40%)**

Arion Bank

Adjusted Income Statement

All amounts in ISK million

Considerable one-off income

	2016	Adjustment	Adjusted	
Net interest income	29,900	530	30,430	1)
Net commission income	13,978	81	14,059	
Net financial income	5,162	(4,240)	922	2)
Net insurance income	1,395	0	1,395	
Share of profit of associates	908	(912)	(4)	3)
Other operating income	2,096	(110)	1,986	4)
Operating income	**53,439**	**(4,651)**	**48,788**	
Salaries and related expense	(16,659)	320	(16,339)	5)
Other operating expenses	(13,881)	1,474	(12,407)	5)
Bank levy	(2,872)	0	(2,872)	
Net impairment	7,236	(11,275)	(4,039)	6)
Earnings before tax	**27,263**	**(14,132)**	**13,131**	
Income tax	(6,410)	2,130	(4,280)	7)
Net gain from disc. operations	886	0	886	
Net earnings	**21,739**	**(12,002)**	**9,737**	

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

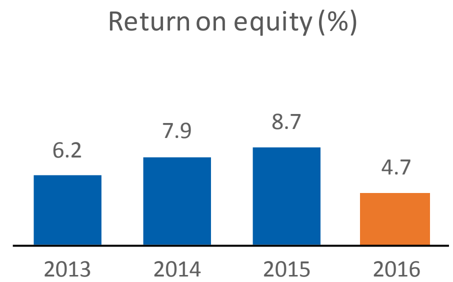
Arion Bank

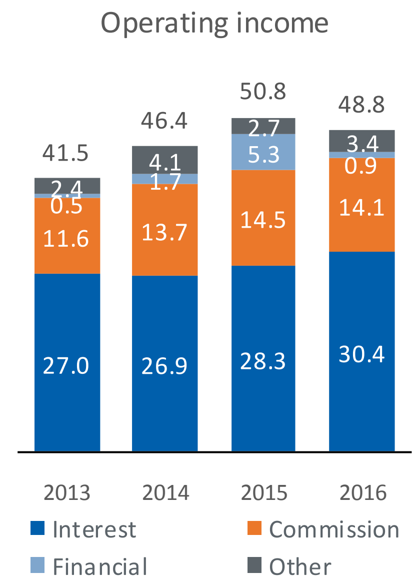
Adjusted earnings

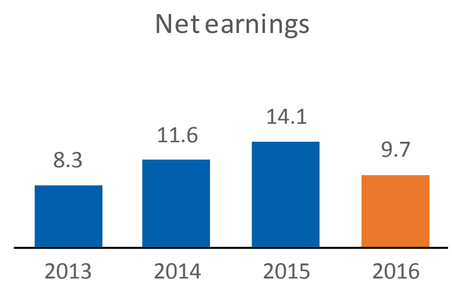
Amounts in ISK billion

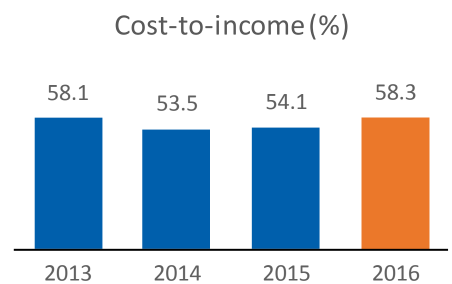
Increased equity affecting the return

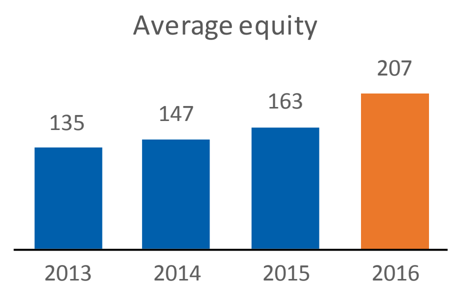
- Average equity used for calculation in adjusted earnings has increased by 53% from 2013
- Lower Net earnings in 2016 are primarily due to lower financial income from financial instruments and higher operating expenses relating to growth in Group operations and general cost increases
- Net interest margin is very stable and the positive development in Net interest income and Net fee and commission income reflects the strong platform at the Bank
- One-off expense is primarily related to lay-offs in September and professional services
- Special taxes on financial institutions are expected to remain in place, as the government has not announced that these taxes will be reduced in the near future









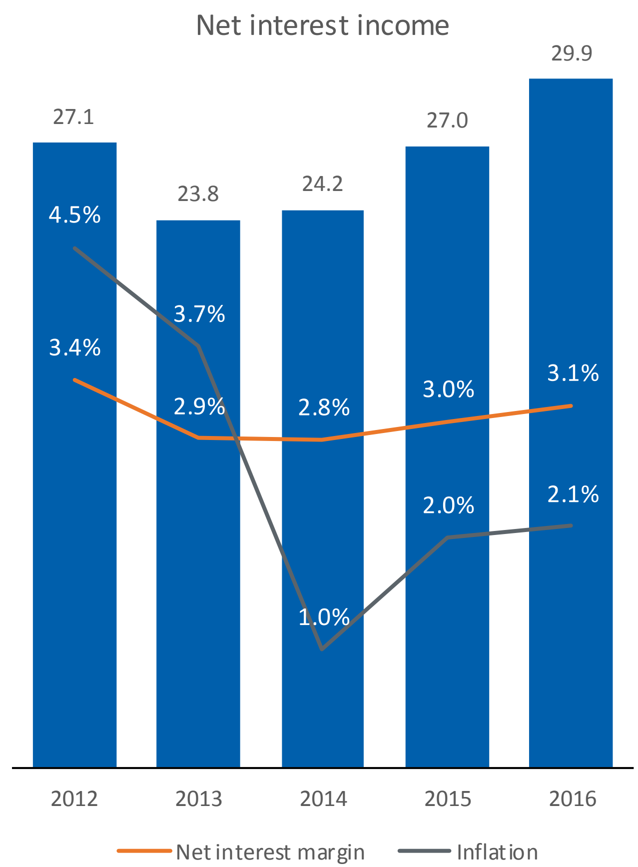


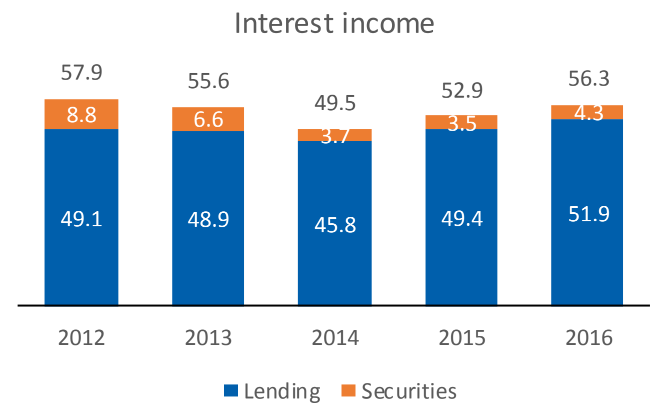
Net interest income

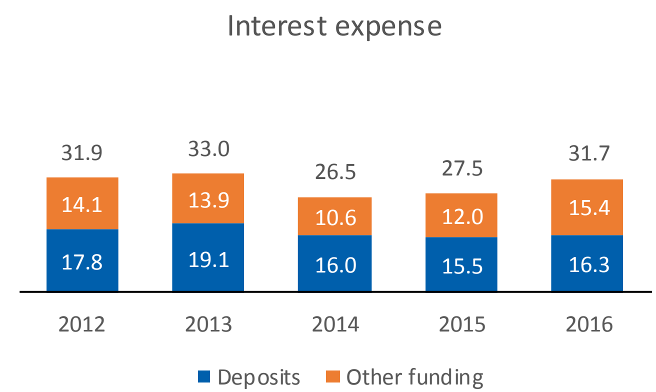
All amounts in ISK billion

Increased net interest margin despite higher funding expense

- Responsible lending activities and active liquidity management have resulted in stable net interest income, despite higher funding expense, but the quality of funding has improved significantly
- Growth in net interest income mostly due to increase in interest-bearing assets
- Average interest-bearing assets of ISK 950 billion, 6% increase from previous year
- Higher interest expense from other funding due to new bonds issued both domestically and inter-nationally replacing deposits







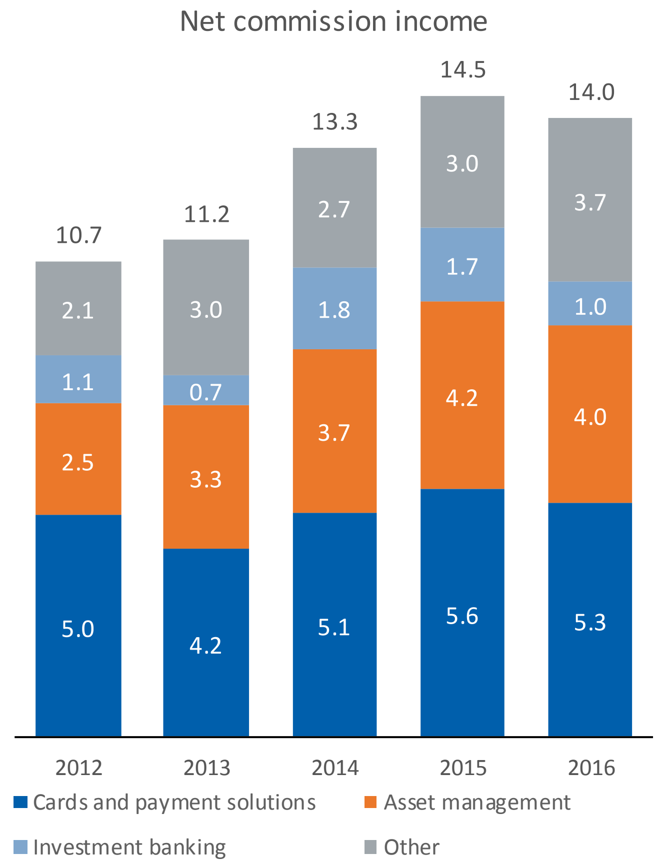
Arion Bank

Net commission income

All amounts in ISK billion

Good base in competitive environment

- Retail Bank performing well and the effects of the new Keflavik International Airport branch are starting to show in other fee income
- Turnover in Valitor's international operation continues to grow
    - 17-fold increase in turnover of acquiring services in ISK since 2013.
    - Substantial proportion of Valitor's income is in foreign currency and the appreciation of the króna has a negative impact on the company's results.
    - Margin has also decreased at Valitor which also affects the results of its card operation
- Investment Banking managed one IPO in 2016, compared with three in 2015. The division was also engaged in extensive activities for Arion Bank but income from these activities is not recognized in the consolidated financial statements.
    - Arranged covered bond issues
    - Arranged sale of assets
    - Managed asset portfolios



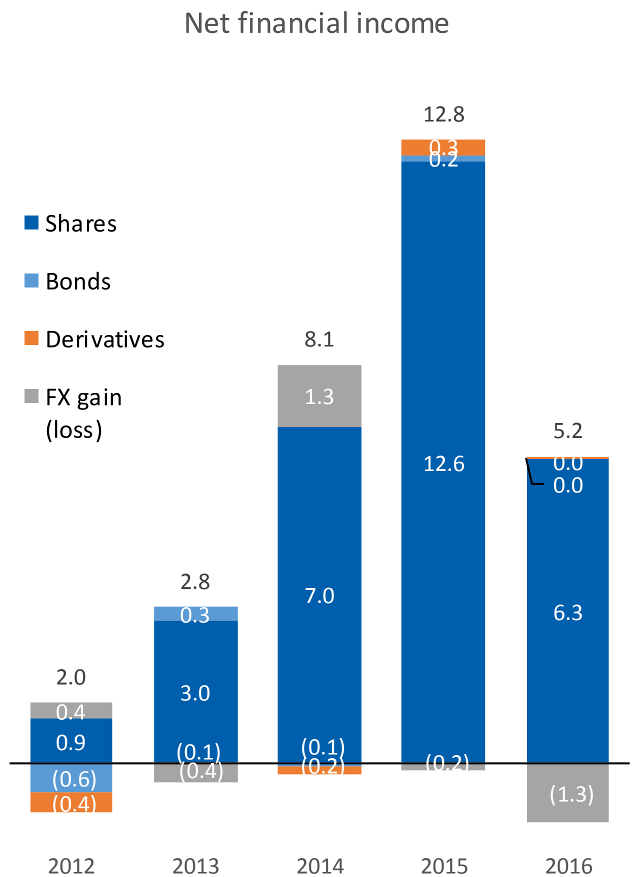
Arion Bank

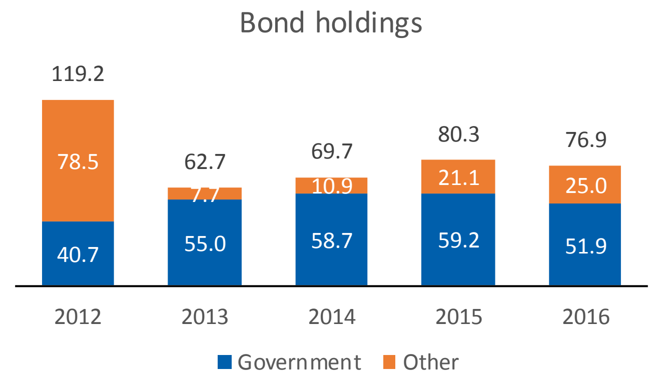
Net financial income

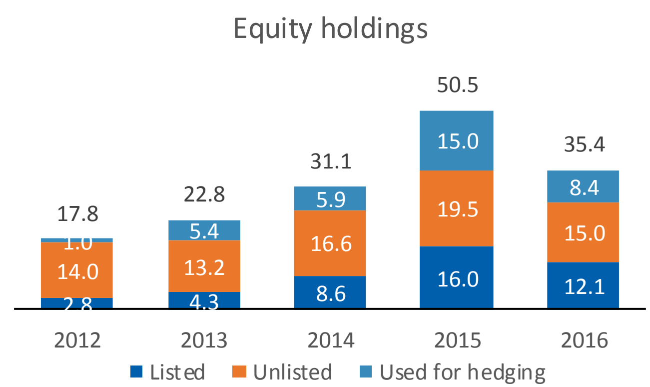
All amounts in ISK billion

One-off income from equity holdings affecting the outcome

- Equity holdings decreased during the year, mainly due to sale of equity holding in Visa Europe and sale of listed and unlisted holdings
- Financial instruments increased with the acquisition of Vördur at the end of Q3, ISK 4.5 billion in bond holdings and ISK 4.2 billion in equity holdings
- The Icelandic stock market underperformed during 2016 with OMXI8 dropping 9.0% during the year
- The ISK continued to strengthen during the year resulting in a FX loss at subsidiary level







Arion Bank

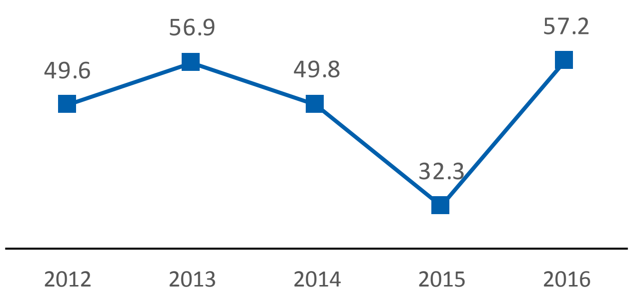
Total operating expense

All amounts in ISK billion

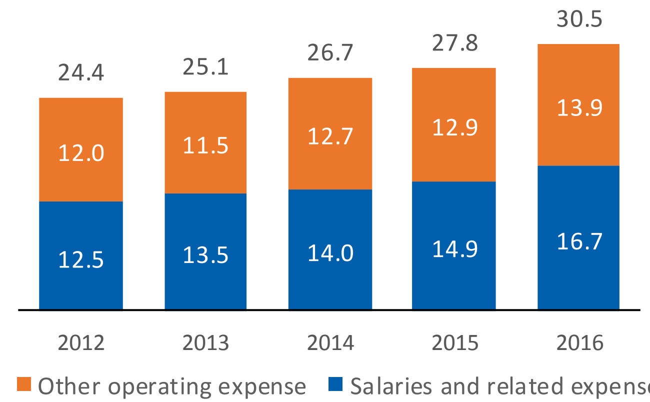
Challenge to maintain acceptable Cost-to-income ratio

- Increase in salaries and related expenses due to expansion of Bank's operations, by opening a major new branch at Keflavík International Airport, increased activities at Valitor and the incorporation of the insurance company into the Group in Q4. New collective wage agreements and the cost associated with lay-offs at the end of September also had a major impact.
- Increase in professional services, marketing expenses and IT expenditures compared with prior years
- Cost-to-income ratio volatile mainly due to large one-off income items

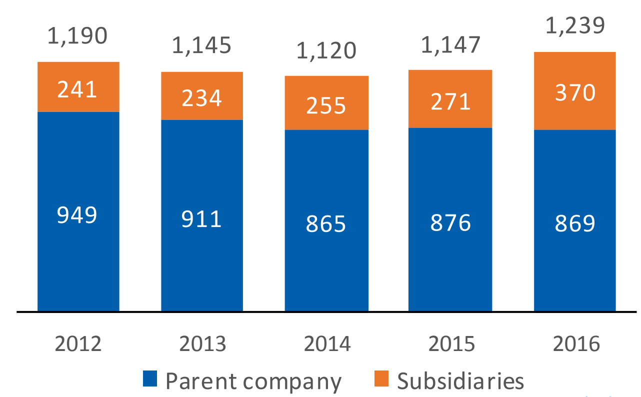
Cost-to-income ratio (%)*



Total operating expense



Number of employees



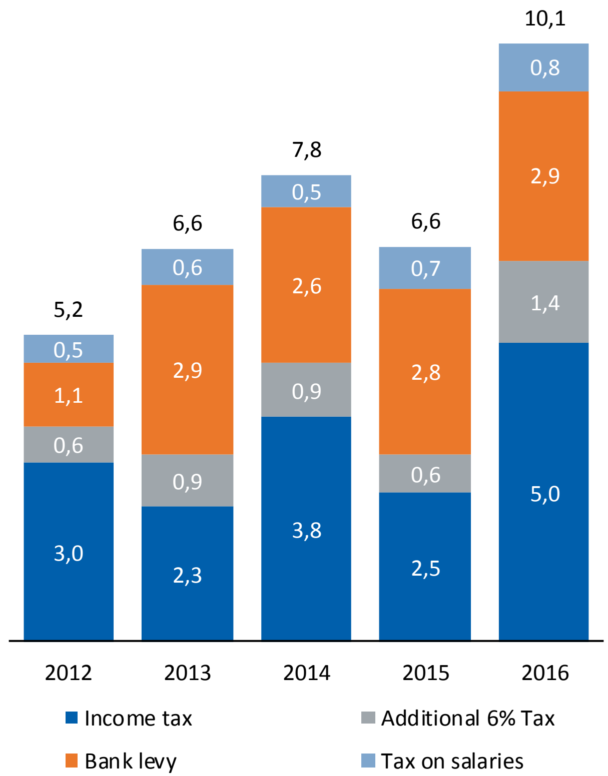
* Cost-to-income ratio (salaries and related expenses + other operating expenses/operating income)

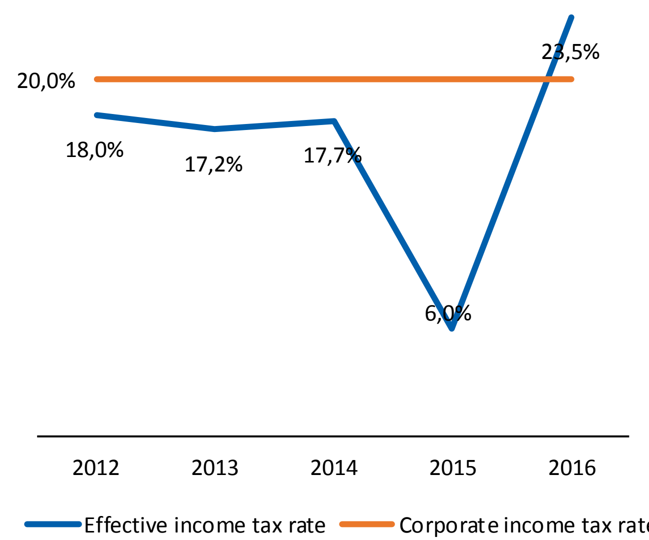
Taxes

All amounts in ISK billion

Special taxes on financial institutions have major impact

- Icelandic corporate income tax rate is 20%
- Financial institutions pay additional taxes:
    - 6% additional income tax on taxable income above ISK 1 Bn
    - Bank levy of 0.376% on total debt above ISK 50 Billion
    - 5.5% tax on employee salaries (6.75% in 2013)





Balance Sheet

Balance Sheet

All amounts in ISK billion

Strong and simple balance sheet

- Focus on lending and long-term funding in 2016
- Appreciation of ISK in 2016 reduced foreign loans in ISK and growth of loans between years
- Deposit base stabilizing following the funding agreement with Kaupthing in January
- The Bank has been active in the funding market, internationally and domestic
- Subordinated loans fully prepaid during the year
- Strong liquidity and equity position

Assets	**2016**	**2015**	**2014**	**2013**	**2012**
Cash & balances with CB	88	48	21	38	30
Loans to credit institutions	80	87	109	102	101
Loans to customers	712	680	648	636	567
Financial assets	117	133	102	87	138
Investment property	5	8	7	29	29
Investments in associates	1	27	22	18	7
Other assets	32	27	26	30	30
Total Assets	**1,036**	**1,011**	**934**	**939**	**901**

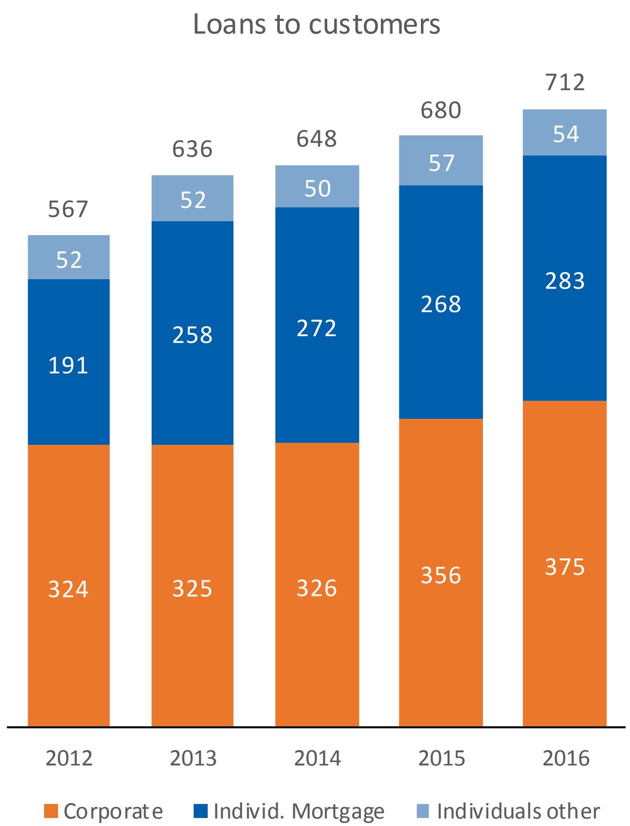
Liabilities and Equity					
Due to credit institutions & CB	8	11	23	28	33
Deposits from customers	412	469	455	472	449
Other liabilities	65	62	61	58	59
Borrowings	339	256	201	205	195
Subordinated loans	-	10	32	32	34
Shareholders Equity	211	193	161	140	127
Non-controlling interest	0	9	2	5	4
Total Liabilities and Equity	**1,036**	**1,011**	**934**	**939**	**901**

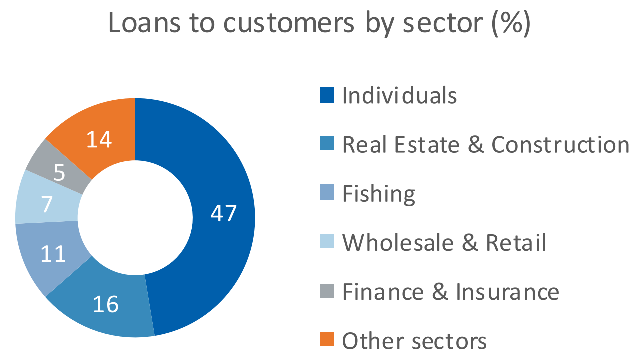
Loans to customers

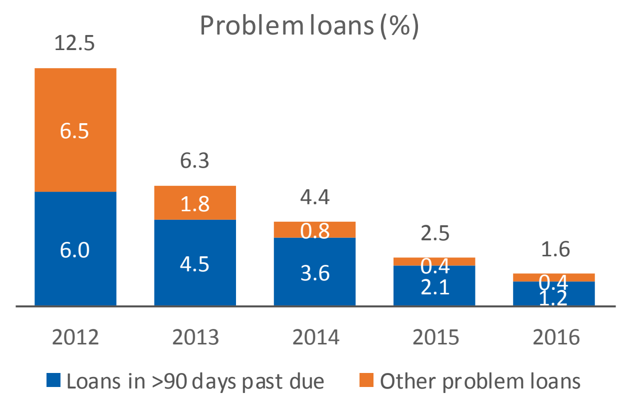
All amounts in ISK billion

Healthy growth of loans and more robust loan book

- Continued good balance in loans to corporates and individuals
- Increase in loans to customers during the year, both corporate and individuals
- Increase in loans to corporates dampened by FX development
- Strong pipeline for corporate loans. Fierce competition on the mortgage market, particularly with pension funds
- Good diversification in the corporate loan book







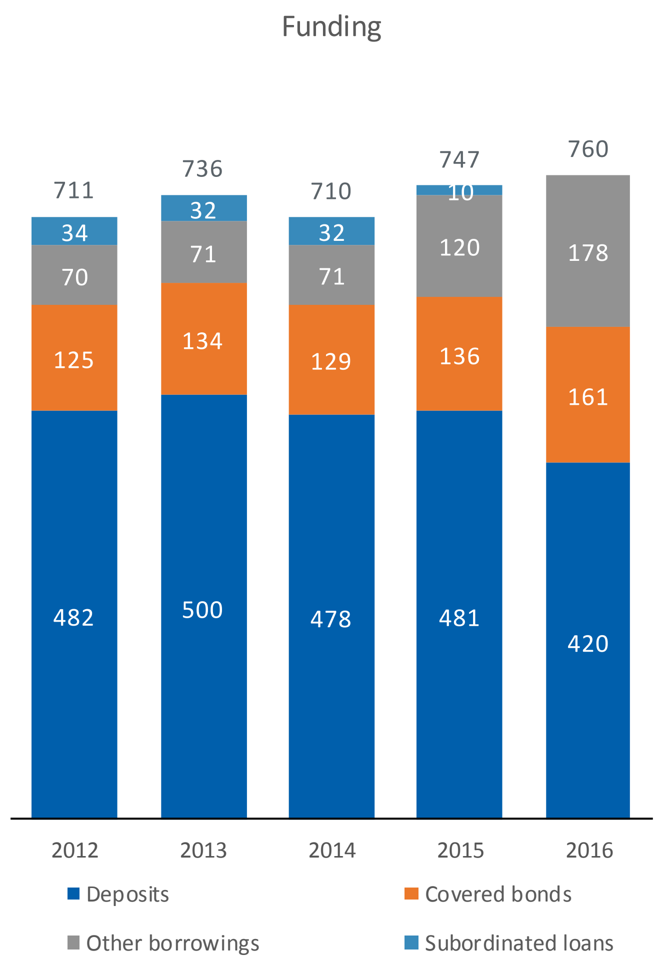
Arion Bank

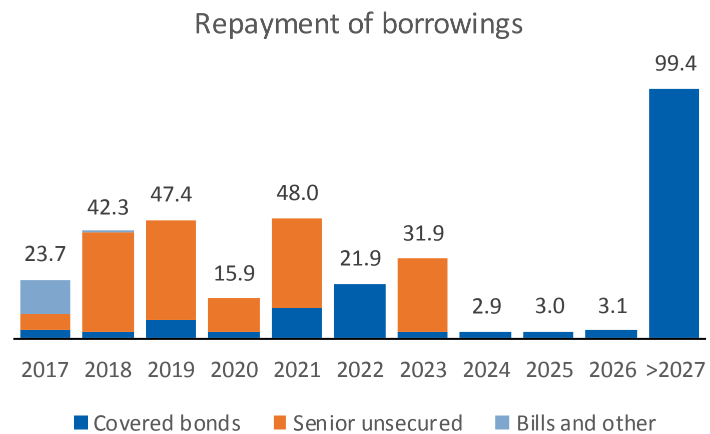
Liabilities and equity

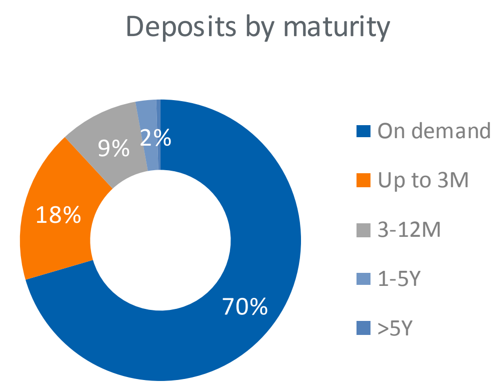
All amounts in ISK billion

Diversified funding source and manageable repayments

- In January a funding agreement was reached with Kaupthing with deposits in foreign currency at Arion Bank and secured loan at Central Bank changed to EMTN 7-year $747 million bonds. $489 million was prepaid during the year
- The Bank issued a new 3-year €300 million bond in April and 5-year €300 million bond in November, which are trading favourably on the secondary market, as are other bonds issued by Arion Bank
- The Bank continues to issue covered bonds on the Icelandic market, a total of ISK 24.8 billion during 2016







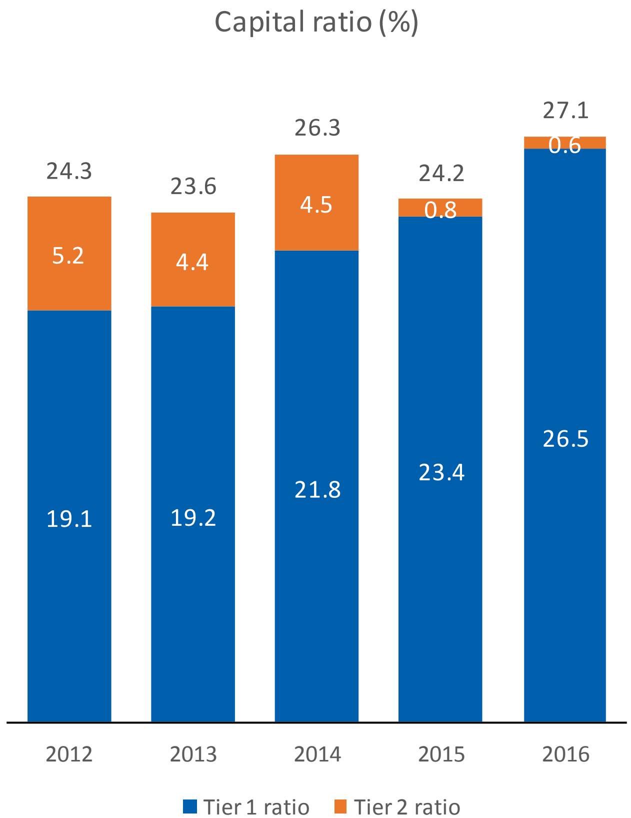
Arion Bank

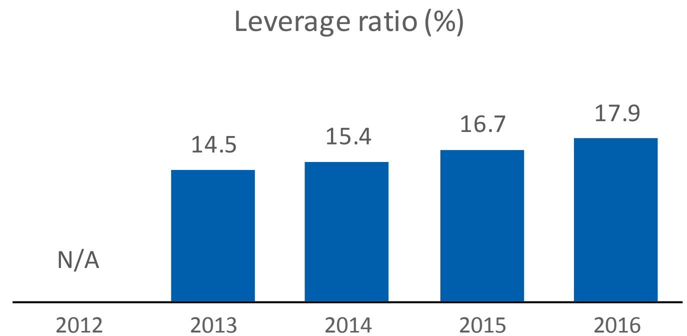
Capital base

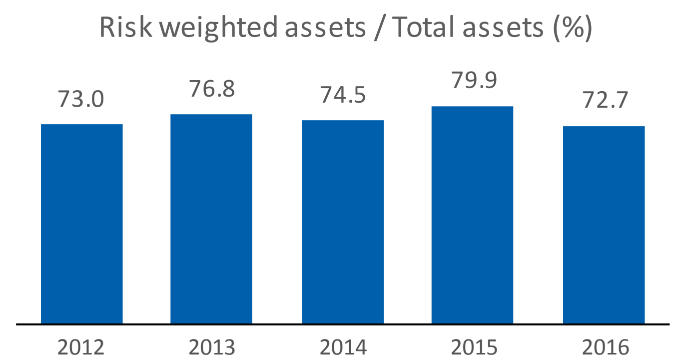
All amounts in ISK billion

Strong capital offer many possibilities

- No dividend payment in 2016 at request of majority shareholder
- Solid level of capitalization due to strong profit generation
- The Bank is using standardized approach calculating RWA
- Reduction in risk-weighted assets due to decrease in loan commitments and lower FX imbalance
- Tier 2 capital consisted only of subordinated liabilities from 2013 to 30 June 2016. Tier 2 capital at year-end consisted of equity general credit risk adjustments





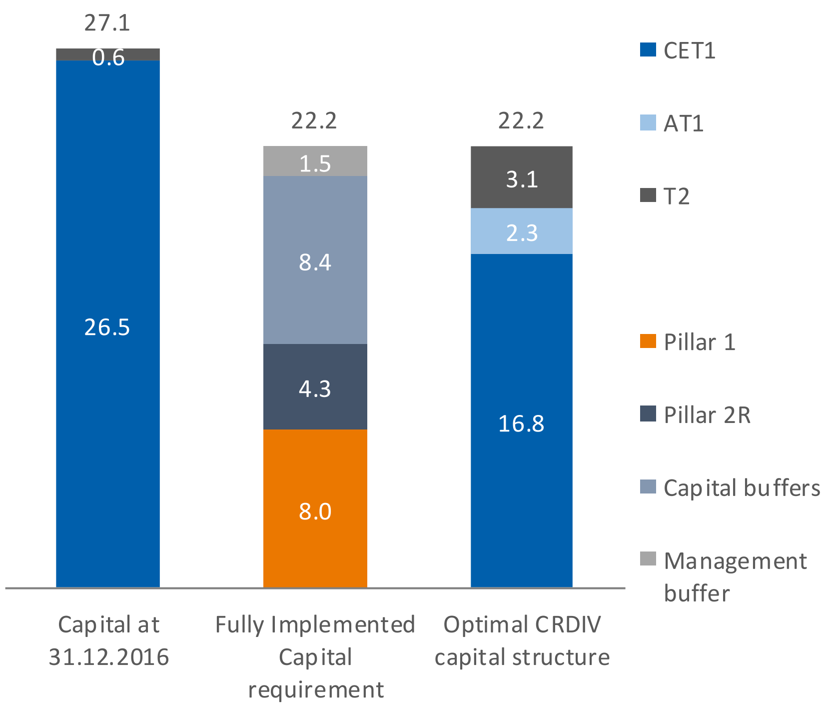


Arion Bank

Capital base

Capital structure and requirements

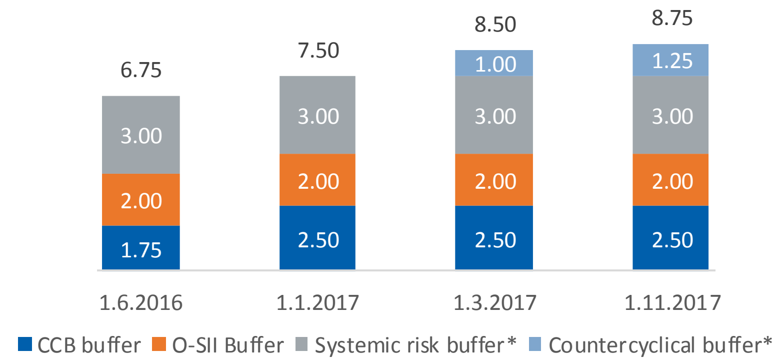
Capital structure and capital need



- The Bank's capital calculations are based on CRDIV/CRR. The adoption of Basel III results in higher risk-weighted assets, ceteris paribus, the effect of which is countered by the inclusion of the Bank's general provisions as Tier 2 capital

- At Q4 of 2017, the combined capital buffer requirement reaches 8.4% given the Group's current risk profile. The official requirement is expected to moderately increase following FME's recognition of capital buffers in foreign countries
- The FME's SREP results indicates a total regulatory capital requirement of 20.7%, including fully-implemented buffers
- Including a management buffer of 1.5%, the Group had a surplus capital of ISK 37 billion at 31 December 2016

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

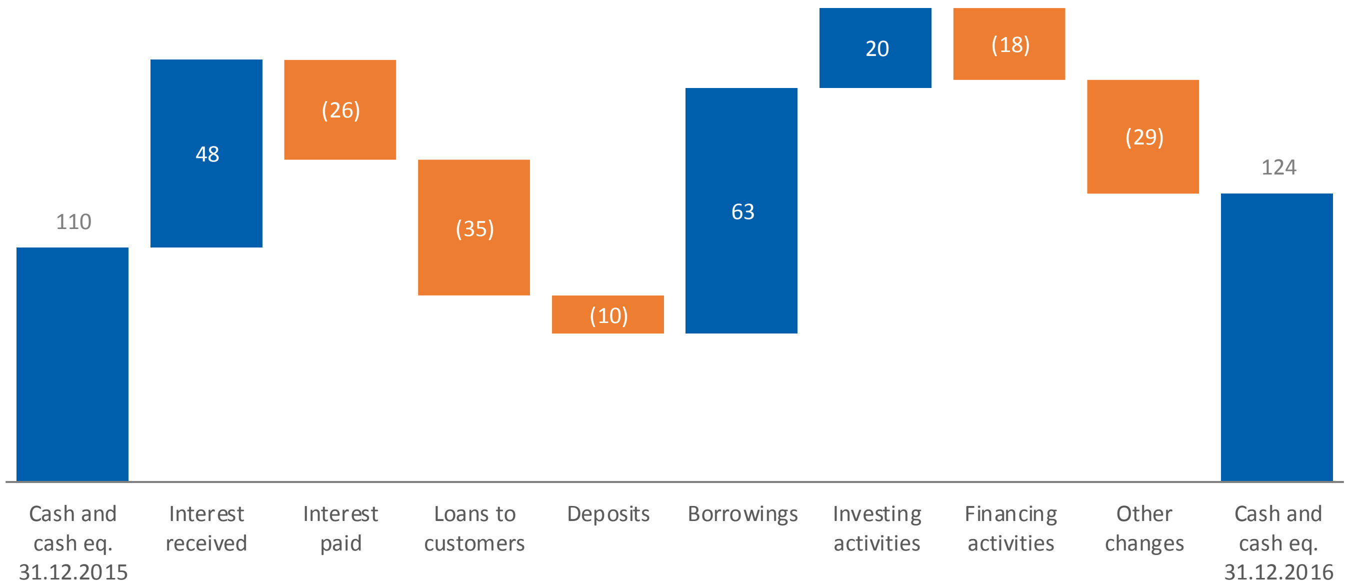


*Only applies to domestic RWA

Cash flow

All amounts in ISK billion

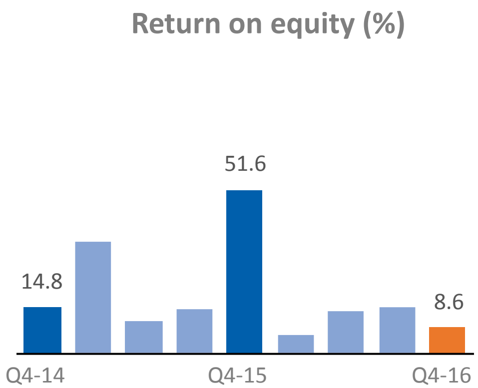
Focus on funding contributed in cash flow

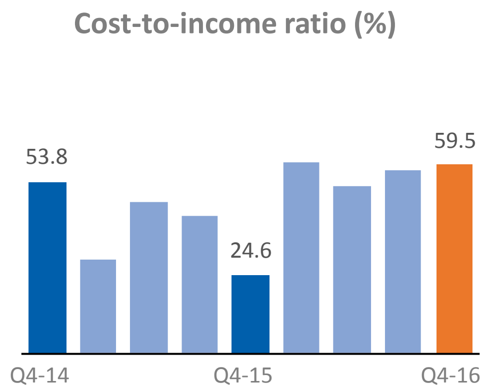


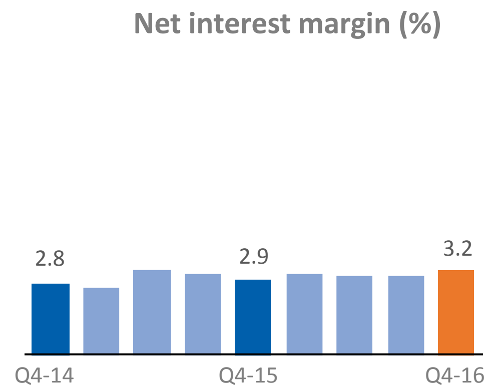
- The Bank has been very active in the funding market during 2016 with ISK 63 million in new Borrowings
- Investing activities include disposal of Bakkavor Group for ISK 27 billion and acquisition of Vördur for ISK 5.3 billion
- Financing activities consist of ISK 9 billion settlement of subordinated loan and ISK 9 billion paid out to minority shareholders in BG 12
- Large non-cash changes due to funding agreement with Kaupthing in deposits and borrowings

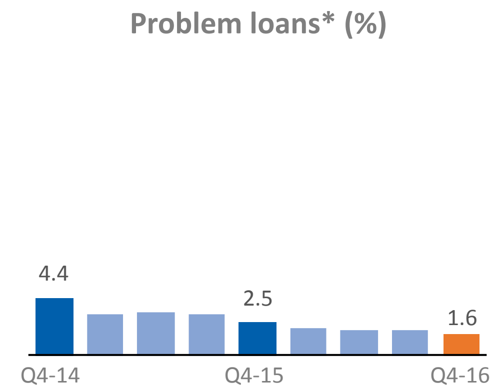
Key financial indicators

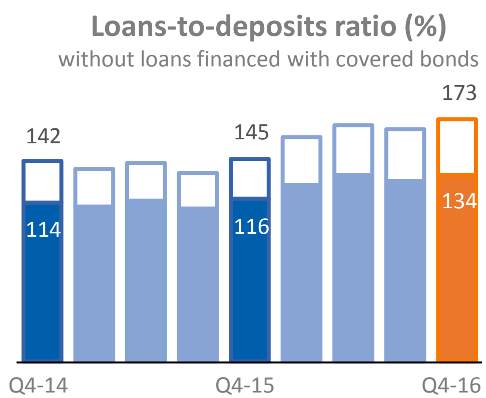
Key financial indicators by quarters

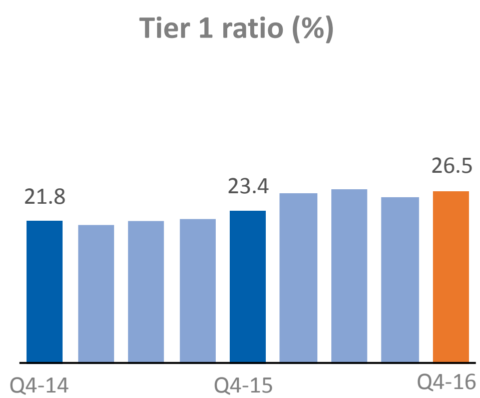


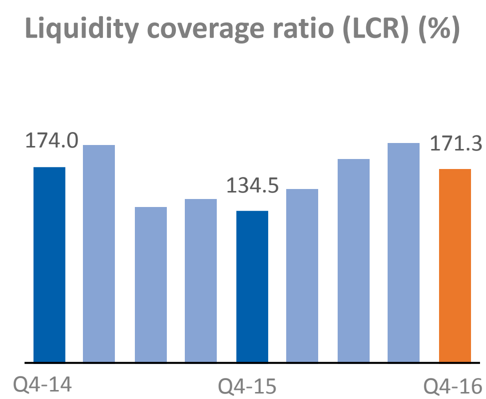


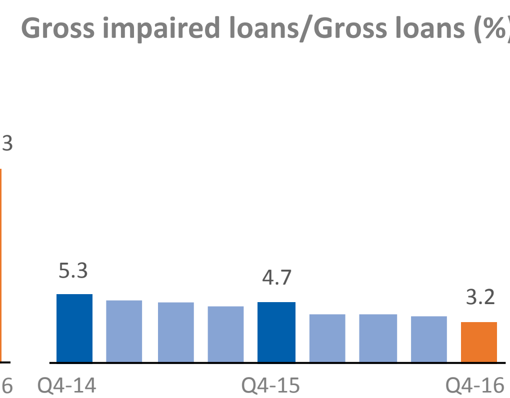






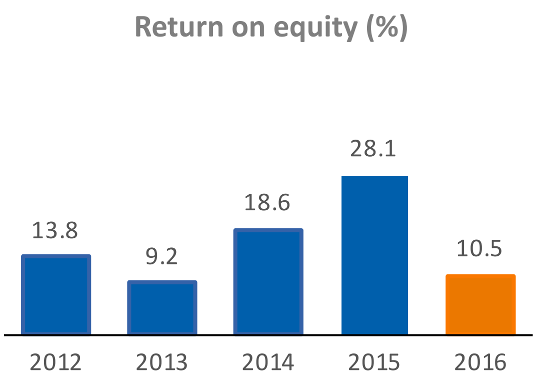


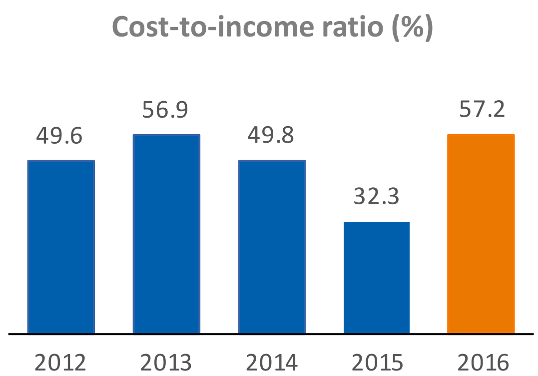


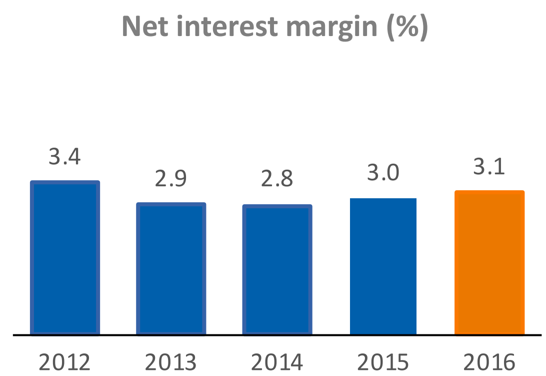


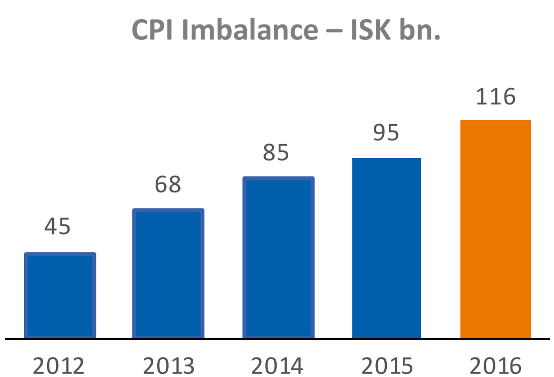
* Problem loans (past due but not impaired loans over 90 days + individually impaired loans) as % of loans to customers

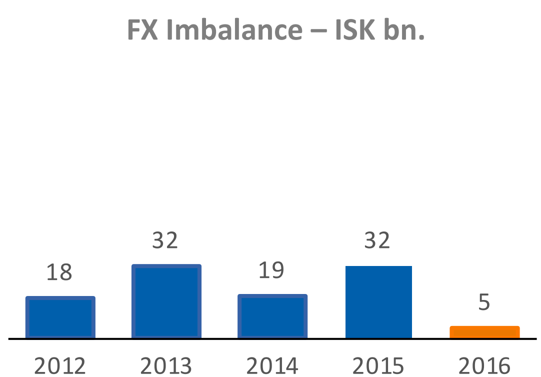
Key financial indicators

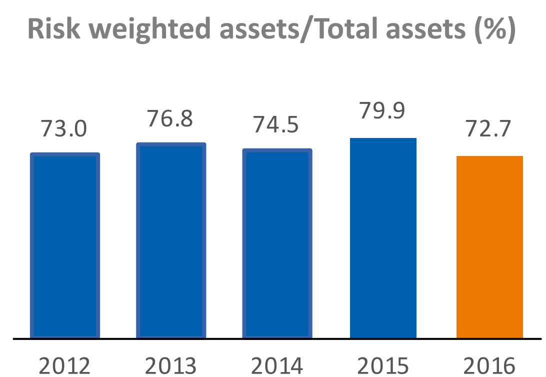








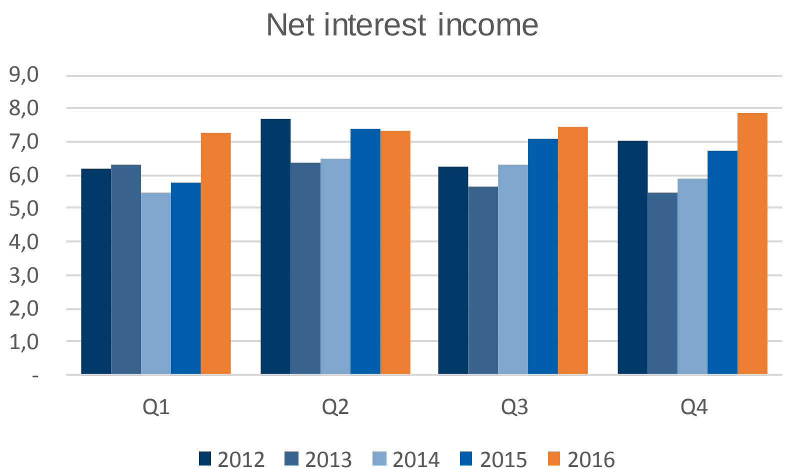


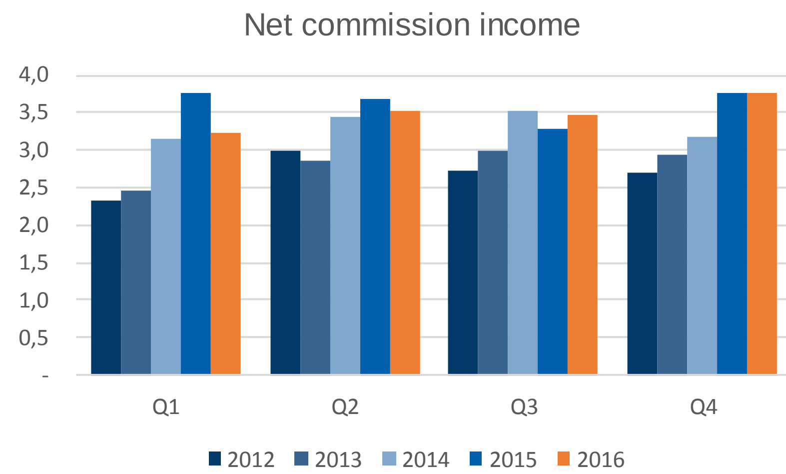


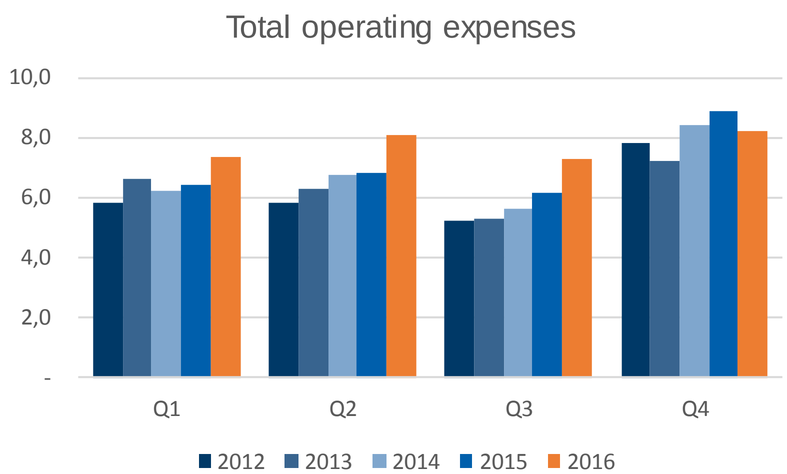
Arion Bank

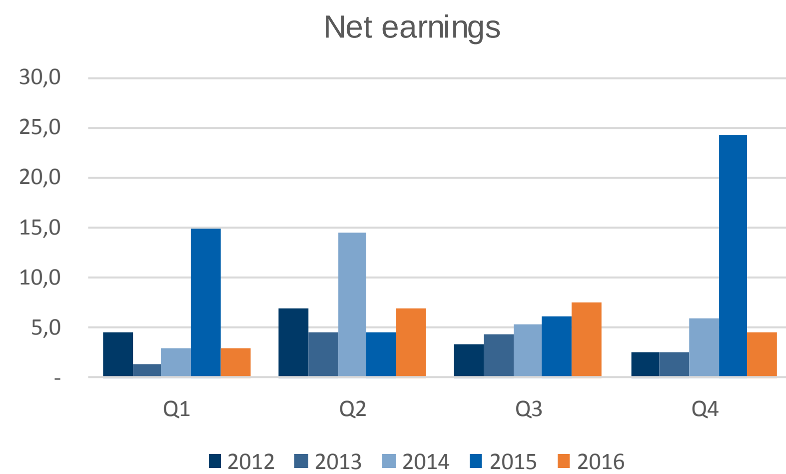
Development of key figures

All amounts in ISK billion









Key figures

All amounts in ISK million

	2016	2015	2014	2013	2012	Q4 2016	Q3 2016	Q2 2016	Q1 2016	Q4 2015
Operations										
Net interest income	29,899	26,992	24,220	23,800	27,142	7,842	7,431	7,353	7,273	6,705
Net commission income	13,977	14,485	13,309	11,223	10,748	3,764	3,467	3,527	3,219	3,758
Operating income	53,439	86,170	53,649	44,025	49,249	13,790	12,465	15,224	11,959	36,057
Operating expenses	30,540	27,812	26,699	25,072	24,412	8,209	7,175	7,958	7,198	8,739
Net earnings	21,739	49,677	28,595	12,657	17,056	4,477	7,503	6,876	2,883	24,283
Return on equity	10.5%	28.1%	18.6%	9.2%	13.8%	8.6%	14.4%	13.3%	5.7%	51.6%
Net interest margin	3.1%	3.0%	2.8%	2.9%	3.4%	3.2%	3.1%	3.1%	3.1%	2.9%
Return on assets	2.1%	5.0%	3.0%	1.4%	1.9%	1.7%	2.9%	2.7%	1.1%	10.0%
Cost-to-income ratio	57.2%	32.3%	49.8%	56.9%	49.6%	59.5%	57.6%	52.3%	60.2%	24.2%
Cost-to-total assets	3.0%	2.9%	2.9%	2.8%	2.8%	3.2%	2.8%	3.2%	2.9%	3.5%
Balance Sheet										
Total assets	1,036,024	1,011,043	933,735	938,849	900,675	1,036,024	1,038,479	1,035,003	1,028,606	1,011,043
Loans to customers	712,422	680,350	647,508	635,774	566,610	712,422	715,907	713,136	694,004	680,350
Mortgages	298,971	284,784	282,045	266,168	195,273	298,971	294,954	289,707	285,886	284,784
Problem loans	1.6%	2.5%	4.4%	6.3%	12.5%	1.6%	2.0%	1.9%	2.1%	2.5%
RWA/ Total assets	72.7%	79.9%	74.5%	76.8%	73.0%	72.7%	73.2%	71.8%	71.5%	79.9%
Tier 1 ratio	26.5%	23.4%	21.8%	19.2%	19.1%	26.5%	25.5%	26.8%	26.2%	23.4%
Leverage ratio	18.0%	16.7%	15.4%	14.5%	-	18.0%	17.4%	18.1%	17.3%	16.7%
Liquitdity coverage ratio	171.3%	134.5%	174.0%	123.0%	-	171.3%	194.1%	179.8%	153.4%	134.5%
Loans to deposits ratio	172.9%	145.0%	142.3%	134.7%	126.3%	172.9%	165.7%	168.6%	160.2%	145.0%

Going forward

Arion Bank operates in strong and growing economy

Growth in loan portfolio on the back of the underlying growth in the Icelandic economy

Focus on digitalization across both clientfacing offerings and automation to further increase efficiency

Arion Bank

Going forward

Continued focus on increasing commission income

Arion Bank will seek to optimize equity by paying dividends and acquiring own shares

Arion Bank

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Contact:

Haraldur Guðni Eiðsson
Head of Corporate Communications and Financial Institutions
haraldur.eidsson@arionbanki.is

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