Arion Bank

Consolidated **Financial Statements** 2019

Contents

Arion Bank in brief

2019

0.6%

Return on equity

56.0%

Cost-to-income

24.0%

Capital adequacy ratio

Rating from S&P

Long term: BBB+

Short term: A-2

Outlook: Negative

FINANCE
UNEP INITIATIVE

Equal Pay Certification

THE ALLBRIGHT.

In 25th place out of 333 listed in Sweden in gender equality

Arion Bank

- Arion Bank is a leading universal relationship bank in Iceland which provides a full range of financial services.
- After a long period of strong economic growth the economy is slowing down. Despite the landing being softer than most expected outlook for this year has deteriorated due to slower growth in the export sectors.
- The balance sheet remains strong with an equal split between retail and corporate loans, high capital ratios and strong asset quality.
- Arion Bank is the leading bank in digital solutions on the Icelandic market. In 2019 the Bank launched seven customer facing digital solutions.
- Increased focus on profitability through capital optimization, improved credit quality, digital solutions and automation and organizational efficiencies.

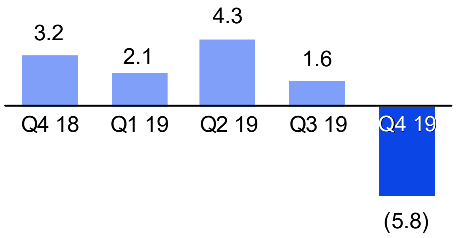
Key figures

(ISK million)

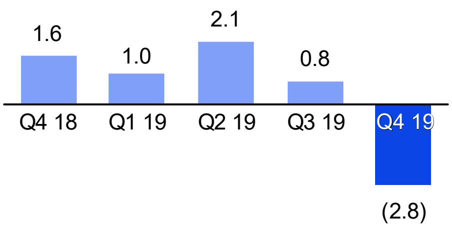
	12M 2019	12M 2018
Net earnings	1,100	7,777
ROE	0.6%	3.7%
ROE continuing operations	7.2%	4.3%
Net interest margin	2.8%	2.8%
Cost to income ratio	56.0%	56.9%

	31.12.2019	31.12.2018
Total assets	1,081,855	1,164,327
Loans to customers	773,955	833,826
Deposits	492,916	466,067
Borrow ings	304,745	417,782
Stage 3 gross	2.8%	2.6%
Leverage ratio	14.1%	14.2%
Number of employees	801	904
EUR/ISK	135.83	133.20

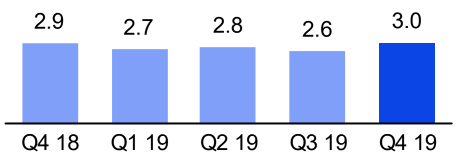
Return on equity (%)



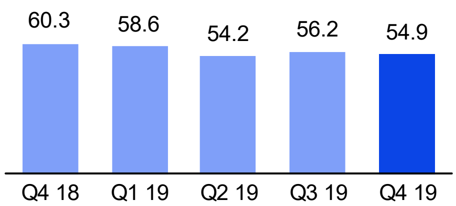
Net earnings (ISK billion)



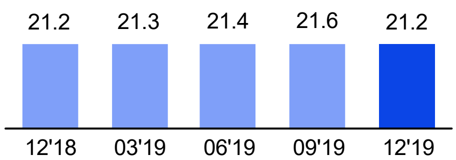
Net interest margin (%)



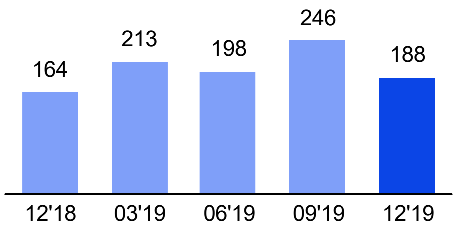
Cost-to-income ratio (%)



CET 1 ratio (%)



LCR ratio (%)



Endorsement and statement
by the Board of Directors and the CEO

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2019 include the Consolidated Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

About Arion Bank

Arion Bank is a universal bank which focuses on developing long-term relationships with its customers and is a market leader as a provider of cutting-edge and modern banking services. The Bank is listed on the main lists of Nasdaq Iceland and Nasdaq Stockholm.

As a universal bank Arion Bank provides services to households, corporates and investors and strives to meet the needs of customers requiring a diverse range of financial services. The Bank has three business segments: Retail Banking, Corporate & Investment Banking, and Markets. The service offering is further augmented by the subsidiaries Stefnir and Vördur. Stefnir is the largest fund management company in Iceland, and Vörður is the fourth largest insurance company in Iceland, providing non-life and life insurance. The diverse service offering at Arion Bank means that the revenue base is broad and the loan portfolio is well diversified between retail and corporate customers on the one hand and on the other hand different business sectors.

Arion Bank occupies a strong position on its markets owing to its efficiency and diverse range of products and services. The Bank's core strategy is to develop long-term relationships with customers by offering them outstanding services and tailor-made solutions. In order to simplify life for its customers the Bank has set itself the objective of being a leader in digital solutions and innovation, and numerous new digital solutions have been launched in the past few years. Digital solutions make the Bank's operations more efficient which in the long term reduces operating expenses across the Bank. The Bank's structure has been simplified and the branch network has been streamlined.

Arion Bank is a financially robust bank which places great importance on operating responsibly in harmony with society and the environment with the aim of creating future value for the benefit of its customers, shareholders, partners and society as a whole. The Bank also emphasizes the importance of paying competitive dividends to shareholders.

Arion Bank is an Icelandic bank which operates in Iceland and also provides services to companies in or linked to the seafood sector in Europe and North America.

Operations during the year

Arion Bank reported net earnings from continuing operations of ISK 14,055 million in 2019 and return on equity from continued operations measured 7.2%. Net earnings were significantly lower due to the effects of discontinued operations and assets held for sale and amounted to ISK 1,100 million. Return on equity was 0.6% in 2019. Total equity amounted to ISK 189,825 million at the end of the year. In March 2019 Arion Bank sold its entire shareholding in the associate Farice ehf. for a profit of ISK 732 million. In June 2019 Arion Bank sold its entire shareholding in Stodir hf. Arion Bank's shareholding represented 19% of outstanding share capital in Stodir. Stodir is the fifth largest shareholder of Arion Bank with a shareholding of 4.96% at year-end.

The Group's capital ratio, as calculated under the Financial Undertakings Act No. 161/2002, was 24.0% at year-end and the CET1 ratio was 21.2%, taking into account the share buy-back and proposed dividend payment following the AGM. This comfortably meets the requirements set by law and the Financial Supervisory Authority of the Central Bank of Iceland (FSA). The Bank's liquidity position was also strong at year-end and well above the regulatory minimum.

The main change on the asset side of the Bank's balance sheet in 2019 was a decrease in loans to customers of 7.2%, or by approximately ISK 60 billion. This decrease can primarily be attributed to the ISK 48 billion sale of mortgages to the Housing Financing Fund in October and a greater emphasis on the profitability of corporate lending, which in some cases has resulted in prepayments. Liquidity has been reduced substantially as the strong liquidity position was used to prepay expensive borrowings. This was the main change on the liabilities side; the Bank prepaid structured covered bond, CB 2, and bought back international bonds maturing in June 2020. Borrowings decreased by more than ISK 113 billion between years. Deposits, however, increased significantly, up almost 6%, and new subordinated borrowings amounted to approximately ISK 13 billion during the year. Equity decreased by approximately ISK 11 billion, which is due to dividends during the first half of the year and share buy-backs under a buy-back program in October. In July 2019 Standard & Poor's affirmed Arion Bank's long-term credit rating BBB+ but revised the outlook from stable to negative. The Bank's short-term credit rating remains A-2.

Disposal groups and assets held for sale

The operating results of the subsidiaries Valitor Holding hf., Stakksberg ehf. and Sólbjarg ehf. are presented as discontinued operations as they are all classified as held for sale.

Valitor Holding hf. (Valitor) is a market leader in Iceland in acquiring services and payment solutions and also operates in the Nordic region and in the United Kingdom. The operating results of Valitor have a negative effect on the consolidated financial results of Arion Bank in 2019. The company has had focused on growth over profitability and has reported considerable losses. The company has not fully realized its growth ambitions with the result that, following an impairment test of Valitor's intangible assets, it was necessary to make an impairment of Valitor's intangible assets of ISK 4 billion. Reykjavík District Court issued a decision on the case Datacell ehf. and Sunshine Press Productions ehf. vs. Valitor hf. where Valitor was ordered to pay the plaintiffs a total of ISK 1.2 billion in damages. The cost of the company's sale process was also considerable in 2019. The total negative effect of Valitor’s operating results was ISK 8.6 billion in 2019. The sale process of Valitor continues but is taking longer than originally expected. At the end of the year the net book value of Valitor was ISK 6.5 billion.

On 20 June 2019 Arion Bank acquired all shares in TravelCo hf. and its subsidiaries, following the enforcement of pledges. Sólbjarg ehf, a subsidiary of Arion Bank, administers the shareholding in TravelCo. TravelCo was established following the collapse of Primera Air ehf. and Primera Travel Group in 2018 and operates travel agencies in Scandinavia and Iceland. This change in ownership does not affect the daily operations or services of these companies. The financial results of TravelCo were negative by ISK 1.0 billion in 2019, of which ISK 0.6 billion was after the company was taken over by the Bank and classified as held for sale. At the end of the year the net book value of TravelCo was ISK 2.1 billion.

Endorsement and statement
by the Board of Directors and the CEO

Following the bankruptcy of United Silicon in 2018, an agreement was reached between the liquidator of the estate and Arion Bank, under which the Bank acquired all the company's main assets. The assets of the silicon plant are currently managed by Stakksberg ehf, a subsidiary of Arion Bank. The main reason for the negative effect of Stakksberg is the valuation changes of the silicon plant owned by Stakksberg at Helguvík. After ownership of the plant was transferred to Stakksberg the company has been working to reduce uncertainty regarding the recommissioning of the plant. The sale of the plant has been delayed for a number of external reasons. The financial results of Stakksberg were negative by ISK 3.8 billion in 2019. At year-end the book value of Stakksberg was ISK 2.7 billion.

Operational outlook

The organizational and strategic changes introduced at the end of the third quarter are already beginning to yield positive results. Risk-weighted assets in loans have decreased and their profitability has increased. The net interest margin has also increased due to measures on both the lending and funding sides. The Bank will continue with this strategy. We seek to offer our customers the solutions they need, whether through lending or different types of market funding. The Bank is highly capitalized, has strong liquidity in both Icelandic krónur and foreign currencies and is well prepared to meet the diverse needs of its retail and corporate customers.

Increased efficiency is a goal shared by all European banks and Arion Bank is no exception. The Bank will continue to seek ways to rationalize its business by more efficient use of capital and through technology in operations and digital channels.

The Bank has been working towards reducing Common Equity Tier 1 by paying dividends and buying back own shares, having obtained the permission of the FSA. The CET1 ratio is 21.2% at year-end and the Bank's target is around 17%. A prerequisite for reaching this target is that the Bank issue additional Tier 1 notes on the international markets, which it intends to do this year. This requires additional distribution of the Bank's common equity and the Bank may hold a reverse offer of own shares if the conditions are right and/or pay additional dividend. Improved operations of the Bank and the acquisition of own shares, at a price lower than the book value of equity, results in increased value for the shareholders going forward.

The Bank has slightly increased its lending internationally in the seafood sector. The Bank expects to expand in this area as it brings risk diversification and better use of capital, as according to FSA regulations the Bank needs to use less of its own capital in foreign loans than in loans on the domestic market.

The Bank has criticized the high levies in the Icelandic banking system, both in the form of excessive taxation and the special Icelandic implementation of international regulations. Both factors undermine the ability of the Icelandic banks and the Icelandic economy as a whole to compete with international competitors and economic growth has already begun to slow down in Iceland. The Bank's opinions on this matter have received strong support in the industry and the Bank will continue to draw attention to the implementation of capital buffers and tax environment which are only applicable to Iceland and the effect this has on Iceland's competitive position.

Economic environment and outlook

According to preliminary figures, GDP growth measured 0.2% in the first nine months of 2019, slightly stronger than expected. Even though this figure does not indicate a recession the subcomponents of GDP show that the economy has slowed down markedly. However, the outlook is for a milder slowdown than was expected. Despite this softer landing, the outlook for 2020 has deteriorated and it is now expected that GDP growth in 2020 will be 0.6%. Tourist arrivals decreased by 14% YoY and it is expected that the tourism sector is set for a slow turnaround with most analysts expecting the number of tourist arrivals to hold steady between years. Households have been reacting by showing caution, resulting in slower private consumption growth. While rising unemployment is expected to continue to dampen private consumption, increased purchasing power and rate cuts, which have buoyed the housing market, might soften the effects. Inflation is currently low and below the Central Bank of Iceland's 2.5% inflation target and is expected to remain so in the medium term. Last year's collective wage agreements between unions and employers, with an emphasis on longer term purchasing power, working hours and housing initiatives, laid the basis for economic stability over the next few years.

Employees

The Group had 801 full-time equivalent positions at the end of the year compared with 904 at the end of 2018; 687 of these positions were at Arion Bank, compared with 794 at the end of 2018. At the end of September 2019 organizational changes were introduced resulting in a 12% reduction in the number of employees, or approximately 100 people. Salary and salary related expenses of ISK 1,079 million were expensed in respect of the redundancies.

Funding and liquidity

The Group's liquidity position is strong, with a liquidity coverage ratio of 188%, see Note 44, well above the regulatory minimum of 100%.

Deposits, which are the core of the Bank's funding, increased by ISK 27 billion or approximately 6% from 2018 to 2019. The composition of deposits has changed in such a way that retail and SME deposits have proportionally increased but deposits from institutional investors have decreased. Long-standing economic growth, increased purchasing power of customers and the Bank's increased focus on deposits are the main reasons for this positive development.

In 2019 Arion Bank issued ISK 14 billion under its EMTN program. In November 2019 the Bank repurchased EUR 258 million (ISK 35 billion) of EUR 300 million bonds maturing in June 2020. All received offers were accepted.

Endorsement and statement
by the Board of Directors and the CEO

In 2019 Arion Bank concluded three subordinated issues in foreign currencies, EUR 5 million in March, NOK 300 million in July and SEK 225 million in December. The Bank also issued two new subordinated bonds series in Icelandic króna, totalling ISK 5.7 billion. The total issuance of Tier 2 capital was ISK 13.6 billion in 2019. The bonds are eligible as Tier 2 capital under the Icelandic Financial Undertakings Act No. 161/2002. The Tier 2 bond issue strengthens the Bank's own funds and is a milestone towards reaching a more optimal capital structure.

Arion Bank continued to issue covered bonds which are secured under the Covered Bond Act No. 11/2008. In 2019 the Bank issued covered bonds amounting to ISK 32,200 million.

In recent years Arion Bank has issued commercial paper on the domestic market. Given its strong liquidity position the Bank decided in the autumn to stop issuing commercial paper and no further issues are planned for the time being. Commercial paper amounting to ISK 14.5 billion was issued in 2019. Outstanding commercial paper at the end of 2019 amounted to ISK 1,680 million.

In 2019 Arion Bank fully prepaid the bond series Arion CB 2, a total of ISK 81 billion.

Group ownership

The main venue at which the Board and the Bank report information to the shareholders and propose decisions is at legally convened shareholders' meetings. The Bank provides an effective and accessible arrangement for communications between shareholders and the Board of Directors between those meetings. Any information sensitive to the market will be released through a MAR press release. Arion Bank also arranges quarterly meetings where the CEO, CFO and Investor Relations present the interim financial results.

At the end of December 2019 Taconic Capital was the largest shareholder of Arion Bank, with a holding of 23.53%, and Sculptor Capital Management was the second largest with a holding of 9.53%. Following the launch of a share buy-back program at the end of October, Arion Bank held 2.27% of own shares at the end of year. For further information on the shareholders of Arion Bank, see Note 36.

Capital, Dividend and RWAs

In September 2019, the FSA's annual Supervisory Review and Evaluation Process (SREP) for Arion Bank was concluded. The additional capital requirement under Pillar 2 is determined on the basis of the Group's internal capital adequacy assessment (ICAAP). The additional requirement is 3.1% of risk-weighted assets (RWA) based on the Group's Financial Statements as at 31 December 2018, excluding insurance subsidiaries. The previous requirement was 2.9% of RWA and the increase is primarily attributed to distressed assets that are classified as held for sale. As a result, the Bank's total regulatory requirement, including the combined capital buffer requirement, is 20.1% on 31 December 2019. In February 2020, the countercyclical capital buffer is set to increase by 0.25%, which results in a total capital requirement of 20.3% for the Bank. The ratio of risk-weighted assets was 66.5% at year-end 2019 and 68.4% at year-end 2018. Taking into account the Group's internal management buffer, currently 100-200bps, the Group's capital benchmark is 21.3% to 22.3%. The Group's target Common Equity Tier 1 ratio (CET1) is around 17%. The Group's capital adequacy ratio at 31 December 2019 was 24.0% and CET 1 ratio 21.2%. The ratios account for a foreseeable equity reduction of ISK 14.2 billion in the form of dividend distribution and purchase of own shares according to the Bank's share buy-back program. The Bank has recently taken active steps to normalize the Bank's capital structure in accordance with its capital policy. In April 2019, Arion Bank's share capital was reduced by 186 million shares, through the cancellation of the Bank's own shares. Arion Bank's share capital amounts to ISK 1,814 million after the reduction. In 2019, the Group's Tier 2 capital increased by ISK 13.5 billion through new issuance of subordinated bonds. Dividend payments and purchase of own shares amounted to ISK 12.4 billion in 2019. With the Bank now operating on a capital level close to the requirements, the Bank will increase its focus on capital management with the aim to improve profitability.

In September 2019 the Board of Directors of Arion Bank authorized the management of the Bank to initiate share buy-back programs in Iceland and Sweden to purchase own shares. This is in accordance with an authorization granted by Arion Bank's Annual General Meeting on 20 March 2019. In September 2019 the FSA approved the Bank's request to initiate the share buy-back program for up to 59 million own shares (corresponding to 3.25% of issued share capital) for up to ISK 4.5 billion market value. At year end 2019 Arion Bank had bought approximately 41 million shares in share buy-back programs in Sweden and Iceland, with approximately 18 million shares remaining from the program. In January 2020 the FME approved further buy-back of own shares for up to ISK 3.5 billion. The buy-back program will continue until the AGM in March 2020.

The Board of Directors proposes that the Bank pay dividends of ISK 10.0 billion equaling ISK 5.5 per share. The Board of Directors has the authority to propose that the Bank pay dividends or other disbursement of equity and may convene a special shareholders' meeting later in the year to propose any such distribution.

Risk management

The Group faces various risks arising from its day-to-day operations as a financial institution. 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 is the ability 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 Group's risk management, its structure and main risk factors are described in the notes and in the Bank’s unaudited Pillar 3 Risk Disclosures.

Endorsement and statement
by the Board of Directors and the CEO

Governance

At the last Annual General Meeting on 20 March 2019, six members were elected to serve on the Board of Directors until the next AGM, three women and three men. The new members were Liv Fiksdahl and Renier Lemmens, while Benedikt Gíslason, Brynjólfur Bjarnason, Herdís Dröfn Fjeldsted and Steinunn Kristín Þórðardóttir were re-elected. Furthermore, three Alternate Directors (two men and one woman) were elected, and they attend meetings of the Board of Directors in the event that a Director resigns or is unable to attend.

A shareholders' meeting of Arion Bank was held on 9 August 2019. Paul Richard Horner and Gunnar Sturluson were elected as new members of the Board of Directors and will serve until the Bank's next AGM. One of them replaces Benedikt Gíslason, who became CEO of the Bank on 1 July and resigned as a member of the Board of Directors before taking up the new position.

The Board of Directors of Arion Bank is committed to good corporate governance and endeavors to promote responsible behavior and corporate culture within Arion 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 relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. Arion Bank was initially in December 2015 and again in April 2019 recognized as a company which had achieved excellence in corporate governance. The recognition applies 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 attends 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. The Board of Directors appoints a Chief Executive Officer who is responsible for the day-to-day operations in accordance with the 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. One of the committee members on the Board Audit Committee is not a Board member and is independent of the Bank and its shareholders.

The main roles of the Board, as further specified in the rules of procedure of the Board, include approving the Bank's strategy, supervising financial affairs and accounting and ensuring that appropriate internal controls are in place. The Board ensures that the Bank has active Internal Audit, Compliance and Risk Management departments. The Internal Auditor is appointed by the Board of Directors and works independently of other departments of the Bank in accordance with a charter from the Board. The Internal Auditor provides independent and objective assurance and advice designed to add value and improve the Bank's operations. The Compliance Officer, who reports directly to the CEO, works independently within the Bank in accordance with a charter from the Board. The main role of Compliance is to ensure that the Bank has in place proactive measures to reduce the risk of rules being breached in the course of its activities. Compliance is also responsible for coordinating the Bank’s measures against money laundering and terrorist financing. The duties of Compliance are carried out under a risk-based compliance plan approved by the Board of Directors, including a training and monitoring schedule.

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 legislation, regulations and recognized guidelines in force when the Bank's annual financial statements 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 one exception, which is explained in more detail in the Corporate Governance Statement.

Sustainability and non-financial reporting

Arion Bank is a strongly capitalized bank which provides universal banking services to companies and individuals with the aim of creating future value for the benefit of our customers, shareholders, partners and society as a whole. Arion Bank's sustainability policy bears the title Together we make good things happen and indicates that the Bank intends to act as a role model by promoting responsible and profitable business practices, which take into account the environment, the economy and the society in which the Bank operates.

We refer to Arion Bank's values as cornerstones and they are designed to provide guidance when making decisions and in everything the employees say and do. They refer to the Bank's role, attitude and conduct. The values are we make a difference, we get things done, and we say what we mean. The Bank's code of conduct is designed to support responsible decision-making and has been approved by the Board of Directors.

In September 2019 the Bank became a signatory to the United Nations Principles for Responsible Banking (UN PRB). These principles, presented during the autumn at the start of the UN General Assembly, align banking with international goals and commitments such as the UN Sustainable Development Goals and the Paris Climate Agreement. In December the Board of Directors adopted a new environment and climate policy which is aligned with the principles.

Arion Bank's activities are governed by the provisions of the Annual Accounts Act on non-financial reporting, which, among other things, apply to the status and influence of the company in respect of environmental, social and human resources issues. The Bank's Annual Report, which will be published on 19 February 2020, contains this information and descriptions of the company's business model, non-financial performance indicators, the company's sustainability policy and information on the due diligence process. It also discusses human rights and how the company is tackling financial crime. A description of the main risks faced by the Bank can be found in the Pillar 3 Risk Disclosures which is published simultaneously with the Annual Report.

Non-financial reporting is based on the Global Reporting Initiative, GRI Core. When sharing information on non-financial factors of the business, the ESG reporting guide for the Nasdaq Nordic and Baltic exchanges and the 10 Principles of the UN Global Compact are also used a reference. The Bank also looks to the UN Sustainable Development Goals.

The Annual Report will be available online here: https://arsskyrsla2019.arionbanki.is.

Endorsement and statement
by the Board of Directors and the CEO

Endorsement of the Board of Directors and the Chief Executive Officer

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2019 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 Consolidated Financial Statements give a true and fair view of the financial performance and cash flow of the Group for the year ended 31 December 2019 and its financial position as at 31 December 2019.

Furthermore, in our opinion the Consolidated 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 Consolidated Financial Statements of Arion Bank for the year ended 31 December 2019 and confirm them by means of their signatures.

Reykjavík, 12 February 2020

Board of Directors

Brynjólfur Bjarnason
Chairman

Gunnar Sturluson

Herdís Dröfn Fjeldsted
Vice Chairman

Liv Fiksdahl

Paul Richard Horner

Renier Lemmens

Steinunn Kristín Thórdardóttir

Chief Executive Officer

Benedikt Gíslason

Independent Auditor's report

To the Board of Directors and shareholders of Arion Bank.

Opinion

We have audited the Consolidated Financial Statements of Arion Bank hf. for the year ended December 31, 2019 which comprise the Consolidated Income Statement, Consolidated Statement of Comprehensive Income, Consolidated Statement of Financial Position, 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, 2019, 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 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***
Impairment charges for loans and provisions for guarantees	
Loans to customers for the Group amounted to ISK 783,126 million at 31 December 2019, and the total allowance account for the Group amounted to ISK 9,720 million (including off-balance positions) at 31 December 2019. The Group evaluates its impairment on loans on the basis of IFRS 9, resulting in impairment charges being recognized when losses are expected based on forecasting models. Management has provided further information about the accounting policies for expected credit losses in note 56 and about loan impairment charges and provisions for guarantees in notes 15 and 42. Measurement of loan impairment charges for loans and provisions for guarantees is deemed a key audit matter as the determination of assumptions for expected credit losses is subjective due to the level of judgement applied by Management. The most significant judgements are: • Assumptions used in the expected credit loss models to assess the credit risk related to the exposure and the expected future cash flows of the customer. • Timely identification of exposures with significant increase in credit risk and credit impaired exposures. • Valuation of collateral and assumptions used for manually assessed credit-impaired exposures.	Based on our risk assessment and industry knowledge, we have examined the impairment charges for loans and provisions for guarantees and evaluated the methodology applied as well as the assumptions made according to the description of the key audit matter. As part of our audit, we have examined the Group's implementation of IFRS 9. As part of our review of the implementation we performed substantive procedures on the Group's impairment models and reviewed the methodology implemented for expected credit loss calculations. We used risk modelling specialists as well as IFRS specialists as part of our audit. Our examination included the following elements: • Testing of key controls over key assumptions used in the expected credit loss models to assess the credit risk related to the exposure and the expected future cash flows of the customer. • Substantively testing evidence to support the assumptions used in the expected credit loss models applied in stage allocation, assumptions applied to derive lifetime possibility of default and methods applied to derive loss given default. • Testing of key controls and substantive testing of timely identification of exposures with significant increase in credit risk and timely identification of credit impaired exposures. • Testing of key controls over models and manual processes for valuation of collateral used in the expected credit loss calculations. • Substantively testing evidence to support appropriate determination of assumptions for loan impairment charges and provisions for guarantees including valuation of collateral and assumptions of future cash flows on manually assessed credit impaired exposures.

Independent Auditor's report

Key Audit Matters	*How the matter was addressed in the audit*
Revenue recognition	
Interest income is a key element to the core business of the Bank. This is the single largest item in the consolidated income statement. Interest income is subject to contractual terms and is highly reliant on IT controls and other controls within the Bank's control environment. Therefore, we consider interest income as a key audit matter. The basis for revenue recognition and accounting policies are presented in Note 51 to the consolidated financial statements.	We reviewed the policies, processes and controls surrounding revenue recognition. We have tested relevant controls related to accounting for interest income. We have tested the appropriateness of the interest calculation in accordance with IFRS. We tested interest income by a select sample of loans and compared the underlying data to the loans system. In addition, we performed analytical procedures on interest income. The Bank's applications controls for the IT systems were tested for interest calculation. Furthermore, we selected a sample of loans to ensure that interest is being accrued correctly.
Disposal groups held for sale valuation	
Disposal groups held for sale amounts to ISK 42,044 million among assets in the Consolidated Balance sheet at year-end and the comparable amount among debts is ISK 28,631 million. The Group evaluates this category of assets in accordance with IFRS 5 and according to note 29 there are three disposal companies for consideration where the Bank holds all the share capital. Valuation for Disposal groups held for sale involves management judgements and the assumptions involve a high level of uncertainties, which can be challenging to verify. The valuation is based on many assumptions like future growth, yield, value of cash generating units etc. that can have a significant impact on the valuation and therefore the Bank's net income and balance sheet. The application of IFRS 5 'Non-Current Asset Held for Sale and Discontinued operations' is significant to our audit also because the assessment of the classification can be complex. We need to make sure that the management is committed to a plan to sell and the asset is available for immediate sale.	Based on our risk assessment and industry knowledge, we have examined the valuation of assets and disposal groups held for sale and evaluated the methodology applied as well as the assumptions made according to the description of the key audit matter. We reviewed the policies, processes and controls surrounding the valuation for groups held for sale. We have tested relevant controls related to accounting for groups available for sale. We have tested the appropriateness of the classification of groups available for sale is in accordance with IFRS 5. We have used valuation specialists to challenge the management judgement and key assumption for the valuation.

Other information

The Board of Directors and CEO are responsible for the other information. The other information comprises the unaudited appendix to the Consolidated Financial Statements, 5-year overview, key figures, unaudited quarterly statements in note number 6 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 the statement by the Board of Directors and the CEO as stated below.

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 statements 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.

Independent Auditor's report

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 aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Consolidated Financial Statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional skepticism 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 Bank 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 Committee, 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, 12 February 2020

Deloitte ehf.

Páll Grétar Steingrímsson
State Authorized Public Accountant

Haukur Ingi Hjaltalín
State Authorized Public Accountant

Consolidated Income Statement

	Notes	2019	2018
Interest income		58,307	59,316
Interest expense		(27,990)	(29,997)
Net interest income	7	**30,317**	**29,319**
Fee and commission income		11,499	11,658
Fee and commission expense		(1,549)	(1,308)
Net fee and commission income	8	**9,950**	**10,350**
Net insurance income	9	2,886	2,589
Net financial income	10	3,212	2,302
Share of profit of associates	26	756	27
Other operating income	11	877	1,584
Other net operating income		**7,731**	**6,502**
Operating income		**47,998**	**46,171**
Salaries and related expenses	12	(14,641)	(14,278)
Other operating expenses	13	(12,222)	(12,000)
Operating expenses		**(26,863)**	**(26,278)**
Bank levy	14	(2,984)	(3,386)
Net impairment	15	(382)	(3,525)
Earnings before income tax		**17,769**	**12,982**
Income tax expense	16	(3,714)	(4,046)
Net earnings from continuing operations		**14,055**	**8,936**
Discontinued operations held for sale, net of income tax	17	(12,955)	(1,159)
Net earnings		**1,100**	**7,777**

Attributable to

Shareholders of Arion Bank hf.		1,096	7,116
Non-controlling interest		4	661
Net earnings		**1,100**	**7,777**

Earnings per share

Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	18	0.61	3.86

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Comprehensive Income

	Notes	2019	2018
Net earnings		**1,100**	**7,777**
Net gain on financial assets carried at fair value through OCI, net of tax		482	89
Realized net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement	10	(433)	(112)
Changes to reserve for financial instruments at fair value through OCI		**49**	**(23)**
Exchange difference on translating foreign subsidiaries		135	123
Other comprehensive income that is or may be reclassified subsequently to the Income Statement		**184**	**100**
Total comprehensive income		**1,284**	**7,877**

Attributable to

	2019	2018
Shareholders of Arion Bank	1,280	7,216
Non-controlling interest	4	661
Total comprehensive income	**1,284**	**7,877**

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Financial Position

Assets	Notes	2019	2018
Cash and balances with Central Bank	19	95,717	83,139
Loans to credit institutions	20	17,947	56,322
Loans to customers	21	773,955	833,826
Financial instruments	22-24	117,406	114,557
Investment property	24	7,119	7,092
Investments in associates	26	852	818
Intangible assets	27	8,367	6,397
Tax assets	28	2	90
Assets and disposal groups held for sale	29	43,626	48,584
Other assets	30	16,864	13,502
Total Assets		**1,081,855**	**1,164,327**

Liabilities	Notes	2019	2018
Due to credit institutions and Central Bank	23	5,984	9,204
Deposits	23	492,916	466,067
Financial liabilities at fair value	23	2,570	2,320
Tax liabilities	28	4,404	5,119
Liabilities associated with disposal groups held for sale	29	28,631	26,337
Other liabilities	31	32,697	30,107
Borrowings	23,32	304,745	417,782
Subordinated liabilities	23,33	20,083	6,532
Total Liabilities		**892,030**	**963,468**

Equity	Notes	2019	2018
Share capital and share premium	35	55,715	59,010
Other reserves		9,493	14,822
Retained earnings		124,436	126,897
Total Shareholders' Equity		**189,644**	**200,729**
Non-controlling interest		181	130
Total Equity		**189,825**	**200,859**
Total Liabilities and Equity		**1,081,855**	**1,164,327**

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Changes in Equity

			Restricted reserves									
	Share capital	Share premium	Gain in subs. & assoc., unrealized	Gain in securities, unrealized	Capitalized develop- ment cost	Financial assets at fair value thr. OCI, unrealized	Statutory reserve	Foreign currency trans- lation reserve	Retained earnings	**Total share- holders' equity**	Non- cont- rolling interest	**Total equity**
Equity 1 January 2019	1,814	57,196	12,373	417	-	87	1,637	308	126,897	**200,729**	130	**200,859**
Net earnings									1,096	**1,096**	4	**1,100**
Net fair value gain						481				**481**		**481**
Realized net gain transferred to the Income Statement						(433)				**(433)**		**(433)**
Translation difference								135		**135**		**135**
Total comprehensive income	-	-	-	-	-	48	-	135	1,096	**1,279**	4	**1,284**
Dividend paid									(9,069)	**(9,069)**		**(9,069)**
Purchase of treasury stock *	(41)	(3,242)								**(3,283)**		**(3,283)**
Changes in treasury stock **	(0)	(13)								**(13)**		**(13)**
Changes in reserves			(6,246)	275	459				5,512	**-**		**-**
Acquisition of a subsidiary										**-**	47	**47**
Equity 31 December 2019	1,773	53,942	6,127	692	459	135	1,637	443	124,436	**189,644**	181	**189,825**

* Refers to the purchase of own shares following an approval of the Board of Directors to authorize the Bank to initiate share buy-back programs in Iceland and Sweden (the Programs) to purchase own shares, which is in line with an authorization granted by the AGM on 20 March 2019. The purpose of the Programs is to reduce the Bank's share capital (in line with the Bank's dividend policy). The Bank may purchase up to 59,000,000 share in total under the Programs corresponding to 3.25% of the current issued share capital, or for up to ISK 4.5 billion market value.

** In 2018 close to 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees stock grant programme, an employee who resigns within the vesting period of two years, returns the shares to the Bank.

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Changes in Equity

			Restricted reserves									
	Share capital	Share premium	Gain in subs. & assoc., unrealized	Gain in securities, unrealized	Capitalized develop-ment cost	Financial assets at fair value thr. OCI unrealized	Statutory reserve	Foreign currency trans-lation reserve	Retained earnings	**Total share-holders' equity**	Non-cont-rolling interest	**Total equity**
Equity 31 December 2017	2,000	73,861	14,050	903	-	-	1,637	185	132,971	**225,606**	128	**225,734**
Impact of adopting IFRS 9, 1 January 2018				(108)		110			939	**941**		**941**
Restated opening balance	2,000	73,861	14,050	795	-	110	1,637	185	133,910	**226,548**	128	**226,676**
Net earnings									7,116	**7,116**	661	**7,777**
Net fair value gain						89				**89**		**89**
Realized net gain transferred to the Income Statement						(112)				**(112)**		**(112)**
Translation difference								123		**123**		**123**
Total comprehensive income	-	-	-	-	-	(23)	-	123	7,116	**7,216**	661	**7,877**
Dividend paid									(16,184)	**(16,184)**		**(16,184)**
Purchase of treasury stock **	(190)	(16,949)								**(17,139)**		**(17,139)**
Own shares allocated to employees *	4	291								**295**		**295**
Changes in treasury stock *	(0)	(7)								**(7)**		**(7)**
Changes in reserves			(1,677)	(378)					2,055	**-**		**-**
Sale of a subsidiary										**-**	(659)	**(659)**
Equity 31 December 2018	1,814	57,196	12,373	417	-	87	1,637	308	126,897	**200,729**	130	**200,859**

* In 2018 close to 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees stock grant programme, an employee who resigns within the vesting period of two years, returns the shares to the Bank.

** Refers to the changes in the holding of own shares related to the decision to accept an offer from Kaupskil ehf., a subsidiary of Kaupthing ehf., to buy back 9.5% of issued share capital in Arion Bank, or 190 million shares. The decision to accept the offer from Kaupskil ehf. is in line with the decision taken at a shareholders' meeting on 12 February 2018 to amend the Bank's articles of association with a temporary authorization for the Board of Directors to buy back shares issued by the Bank. Arion Bank paid ISK 90.087 a share, a total of ISK 17,139 million.

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Cash flows

	2019	2018
Operating activities		
Net earnings	1,100	7,777
Non-cash items included in net earnings	(10,284)	(14,194)
Changes in operating assets and liabilities:		
Loans to credit institutions, excluding bank accounts	16,152	14,863
Loans to customers	62,318	(50,267)
Financial instruments and financial liabilities at fair value	(2,047)	(9,846)
Deposits	24,457	(2,802)
Borrowings	(119,010)	14,867
Other changes in operating assets and liabilities	(7,098)	(4,731)
Interest received	56,705	47,119
Interest paid *	(27,641)	(24,712)
Dividend received	132	3,082
Income tax paid	(4,341)	(5,667)
Net cash used in operating activities	**(9,557)**	**(24,511)**
Investing activities		
Proceeds from sale of associates	740	-
Acquisition of associates	(19)	(60)
Proceeds from sale of subsidiaries	-	265
Acquisition of subsidiaries	(80)	-
Acquisition of intangible assets	(2,750)	(1,372)
Proceeds from sale of property and equipment	643	12
Acquisition of property and equipment	(498)	(374)
Net cash used in investing activities	**(1,964)**	**(1,529)**
Financing activities		
Issued subordinated liabilities	13,625	6,780
Purchase of treasury stock	(3,283)	(17,139)
Dividend paid to shareholders of Arion Bank	(9,069)	(16,184)
Net cash from (used) in financing activities	**1,273**	**(26,543)**
Net decrease in cash and cash equivalents	(10,248)	(52,583)
Cash and cash equivalents at beginning of the year	110,589	181,898
Cash and cash equivalents transferred to Assets and disposal groups held for sale	-	(22,198)
Effect of exchange rate changes on cash and cash equivalents	1,845	3,472
Cash and cash equivalents	**102,186**	**110,589**
Cash and cash equivalents		
Cash and balances with Central Bank	95,717	83,139
Bank accounts	16,437	38,038
Mandatory reserve deposit with Central Bank	(9,968)	(10,588)
Cash and cash equivalents	**102,186**	**110,589**
Non-cash changes due to acquisition of TravelCo		
Assets and disposal groups held for sale	1,632	-
Loans to customers	(1,632)	-

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

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

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Notes to the Consolidated Financial Statements

General information

Arion Bank hf., the Parent Company, was established on 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion Bank hf. is located at Borgartún 19, Reykjavík. The Consolidated Financial Statements for the year ended 31 December 2019 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

The Consolidated Financial Statements were approved and authorized for publication by the Board of Directors of Arion Bank on 12 February 2020.

In preparing the Consolidated Financial Statements, the Bank has applied the concept of materiality to the presentation and level of disclosure. Only essential and mandatory information is disclosed which is relevant to an understanding by the reader of the Consolidated Financial Statements.

Statement of compliance

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS), 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.

The same accounting policies, presentation and methods of computation are followed in these Consolidated Financial Statements as were applied in the Consolidated Financial Statements for the year ended 31 December 2018, except for IFRS 16 Leases, effective 1 January 2019, see Note 2.

Basis of measurement

The Consolidated Financial Statements have been prepared on a historical cost basis except for the following:

- assets and liabilities measured under IFRS 9. For details on the accounting policy, see Note 52;
- investment properties are measured at fair value and
- non-current assets and disposal groups held for sale are state at the lower of their carrying amounts and fair value, less cost to sell.

Functional and presentation currency

The Consolidated 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 USD was 121.04 and 135.83 for EUR (31.12.2018: USD 116.34 and EUR 133.20).

2. Changes in accounting policies

Arion Bank adopted IFRS 16 Leases from 1 January 2019. The Group has not early adopted any standards, interpretations or amendments that have been issued but are not effective.

IFRS 16

The Group applied IFRS 16 Leases for the first time in 2019. IFRS 16 introduces new or amended requirements with respect to lease accounting in order to remove the distinction between operating and finance lease requirements and requiring the recognition of a right-of-use asset and a lease liability at commencement for all leases, except for short-term leases and leases of low value assets. The Group has applied IFRS 16 using the modified retrospective approach, with no restatement of comparative information. With the application of IFRS 16, the nature of expenses related to operating leases changes as the Group recognizes a depreciation charge for right-of-use assets and interest expense on lease liabilities. Previously, the Group recognized operating lease expense on a straight-line basis over the term of the lease. At initial application on 1 January 2019 the Group recognized lease liabilities of ISK 1 billion and a right-of-use asset in the same amount.

3. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Consolidated Financial Statements requires management to make judgements, estimates and assumptions that affect the reported amount of revenues, expenses, assets and liabilities, and the accompanying disclosures, as well as the disclosure of contingent liabilities. Uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of assets or liabilities affected in future periods.

Estimates and assumptions

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are described below. The Group based its assumptions and estimates on parameters available when the Consolidated Financial Statements were prepared. Existing circumstances and assumptions about future developments, however, may change due to market changes or circumstances arising that are beyond the control of the Group. Such changes are reflected in the assumptions when they occur.

Notes to the Consolidated Financial Statements

3. Significant accounting estimates and judgements in applying accounting policies, continued

– *Impairment of financial assets*

The book value of financial assets which fall under the impairment requirements of IFRS 9 are presented net of expected credit losses in the statement of financial position. On a monthly basis expected credit losses are recalculated for each asset, the calculations being derived from PD, LGD and EAD models. In addition to the model outcomes, the assessment of expected credit losses is based on three key factors; management's assumptions regarding the development of macroeconomic factors over the next five years, how those factors affect each model and how to estimate a significant increase in credit risk. The assumptions for macroeconomic development is incorporated into each model for three scenarios; a base case, an optimistic case and a pessimistic case. Management estimates the probability weight for each scenario used for calculations of the probability weighted expected credit losses. The amount of expected credit losses to be recognized is dependent on the Bank's definition of significant increase in credit risk, which controls the impairment stage each asset is allocated to. Management has estimated factors to measure significant increase in credit risk from origination, by comparison of changes in PD values, annualized lifetime PD values, days past due and watch list. For further information see Note 55.

– *Assets and disposal groups held for sale*

Legal entities acquired exclusively with view to resale and discontinued operations held for sale are measured at the lower of carrying amount and fair value, less cost to sell. For most part, fair value at the date of classification of these legal entities and discontinued operations was calculated using valuation models based on discontinued future cash flows that incorporated significant non-market observable inputs and assumptions. The use of reasonably possible alternative inputs and assumptions to these models, in particular changes to the discount rate employed (representing the required rate of return on equity), could have impact on the value of these

Real estates acquired exclusively with view to resale are measured at the lower of carrying amount and fair value, less costs to sell. Fair value at the date of classification is based on independent property values or management valuation. As the fair value measurement of real estates is based on valuation techniques there is uncertainty about the actual fair value of assets.

– *Impairment of intangible assets*

The carrying amounts of goodwill, infrastructure and customer relationship and related agreements are reviewed annually to determine whether there is indication of impairment. If any such indication exists the asset's recoverable amount is estimated. 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 assets 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.

– *Revaluation of investment properties*

The Group carries its investment properties at fair value, with changes in fair value being recognized in the statement of profit or loss. For investment properties, either a valuation methodology based on present value calculations, as there is a lack of comparable market data because of the nature of the properties, or the investment properties were valued by reference to transactions involving properties of a similar nature, location and condition.

4. The Group

Shares in the main subsidiaries in which Arion Bank holds a direct interest			Equity interest	
	Operating activity	Currency	2019	2018
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland .	Retail banking	ISK	-	100.0%
BG12 slhf., Katrínartún 2, Reykjavík, Iceland	Holding company	ISK	62.0%	62.0%
Eignarhaldsfélagid Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland	Real estate	ISK	100.0%	100.0%
Eignabjarg ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Leiguskjól ehf., Lágmúli 6, Reykjavík, Iceland	Retail banking	ISK	51.0%	-
Stefnir hf., Borgartún 19, Reykjavík, Iceland	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjördur, Iceland	Payment solutions	ISK	100.0%	100.0%
VISA Ísland ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland	Insurance	ISK	100.0%	100.0%

The subsidiaries Eignabjarg ehf. (holding company of Stakksberg ehf. and Sólbjarg ehf.) and Valitor Holding hf. are classified as held for sale in accordance with IFRS 5.

In November 2019 Arion Bank acquired a 51% shareholding in Leiguskjól ehf., an entity offering guarantees for residential property renting.

In October 2019 Arion Bank liquidated Arion Bank Mortgages Institutional Investor Fund when ISK 48 billion of mortgage loans were sold to the Icelandic Housing Fund and ISK 8 billion were transferred to the Bank.

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 and is based on the Group's management and internal reporting structure. Segment performance is evaluated based on earnings before tax.

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.

5. Operating segments

Arion Bank introduced new organizational structure for the Bank which came in effect at the end of September 2019. The number of divisions were reduced and the responsibility for various other tasks was redistributed within the Bank with the aim of simplifying the

Markets comprises Asset Management and Capital Markets. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. Asset Management also administers pension funds. The operation of Stefnir hf. is presented under the segment. Stefnir hf. is an independently operating financial company owned by Arion Bank and manages a broad range of mutual funds, investment funds and institutional investor funds. Capital markets is a securities and foreign exchange brokerage and provides clients with a diverse range of fixed income services and risk management products. Asset management comprises Institutional Asset Management, Private Banking and Pension Fund Administration.

Corporate & Investment Banking services large and medium-sized corporate clients and investors, both in Iceland and abroad. The division is divided into Corporate Banking and Corporate Finance.

Corporate Banking's experienced account managers specialize in key economic sectors such as retail and services, seafood, energy and real estate. The division provides a full range of lending products such as guarantees, deposit accounts, payment solutions and a variety of value-added digital solutions to meet the needs of the Bank's larger corporate clients. The Corporate Banking portfolio includes several larger international transactions, partly in syndicates with other Icelandic banks and international banks.

Arion Bank's Corporate Finance works closely with Corporate Banking, providing customers with various financial advisory and capital raising services, including M&A and LBO services. Furthermore, Corporate Finance offers financial structuring advice, as well as various services on public offerings of securities.

Retail Banking provides a comprehensive range of products and services, including mortgage loans, savings and current accounts, vehicle and equipment financing, factoring, payment cards, pension services, insurance and funds, to both individuals and SMEs. Retail Banking has a strong focus on digital banking solutions, using the online bank and the Arion Bank app as key channels. Retail Banking operates out of 19 branches across Iceland with over 100,000 customers.

Treasury is responsible for the Bank's liquidity, currency and interest rate management. Treasury is a market maker in Iceland in domestic securities and FX. Treasury is responsible for funds' transfer pricing and hedging and pricing of financial products. FX sales is part of the Treasury unit. Treasury also handles all debt issuance both in the domestic and foreign markets and maintaining the Banks credit ratings.

Vördur is the fourth largest insurance company in Iceland, providing non-life and life insurance.

Subsidiaries include the subsidiaries Eignarhaldsfélagid Landey ehf., which holds the main part of investment property of the Group and the holding companies VISA Ísland ehf., BG12 slhf. and other smaller entities of the Group. The subsidiary Valitor Holding is classified as Disposal group held for sale. The subsidiary EAB 1 ehf. was sold in October 2018.

Supporting units include the Bank's headquarters which carry out support functions such as the CEO office, Risk Management, Finance (excluding Treasury) and IT. The information presented relating to the supporting units does not represent an operating segment. A significant proportion of expenses from support functions is allocated to operating segments in a separate line in the operating segment overview.

At the beginning of 2019 the proportion of the loan book divided between Corporate & Investment Banking and Retail Banking changed. SME loans amounting to approx. ISK 49 billion were transferred from Retail Banking to Corporate & Investment Banking. At the same time 20 employees were transferred between the operating segments. As a result of these changes the figures are not fully comparable with those from 2018.

At the beginning of 2019 the allocation of cost changed so that total expense is now allocated to the following operating segments: Asset Management, Corporate & Investment Banking, Retail Banking and Treasury. Prior to the change cost relating to the Board of Directors, the CEO's Office and Compliance was not allocated to the operating segments. Comparative figures for 2018 have not been restated.

Notes to the Consolidated Financial Statements

5. Operating segments, continued

2019	Markets and Stefnir	Corporate & Investment Banking	Retail Banking	Treasury	Vördur	Other sub-sidiaries	Supporting units and elimi-nations	Total
Net interest income	1,017	9,129	17,303	3,438	228	(628)	(170)	30,317
Net fee and commission income	4,318	1,936	4,803	(196)	(80)	(940)	109	9,950
Net insurance income	-	-	-	-	2,929	-	(43)	2,886
Net financial income	219	(222)	(26)	940	1,321	638	342	3,212
Share of profit of associates and net impairment	-	-	-	-	-	-	756	756
Other operating income (loss)	25	(17)	432	11	20	552	(146)	877
Operating income	5,579	10,826	22,512	4,193	4,418	(378)	848	47,998
Operating expense	(1,920)	(1,471)	(6,802)	(385)	(2,240)	(63)	(13,982)	(26,863)
Allocated expense	(1,470)	(3,401)	(6,207)	(1,040)	(16)	(6)	12,140	-
Bank levy	(142)	(726)	(1,064)	(1,052)	-	-	-	(2,984)
Net impairment	-	(8,879)	2,287	3	-	6,208	(1)	(382)
Earnings before income tax	2,047	(3,651)	10,726	1,719	2,162	5,761	(995)	17,769
Net seg. rev. from ext. customers	2,832	20,244	34,637	(15,950)	4,157	1,199	879	47,998
Net seg. rev. from other segments	2,747	(9,418)	(12,125)	20,143	261	(1,577)	(31)	-
Operating income	5,579	10,826	22,512	4,193	4,418	(378)	848	47,998
Depreciation and amortization	2	4	164	-	224	1	1,151	1,546
Total assets	69,692	320,545	475,199	457,579	27,028	58,515	(326,703)	1,081,855
Total liabilities	62,540	251,581	416,197	436,229	16,869	37,530	(328,916)	892,030
Allocated equity	7,152	68,964	59,002	21,350	10,159	20,985	2,213	189,825

2018	Asset Manage-ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Subsidi-aries and Other divisions	Head-quarters and Elimination	Total
Net interest income	702	5,932	297	17,665	4,553	323	(153)	29,319
Net fee and commission income	3,393	1,191	1,866	4,976	(324)	(882)	130	10,350
Net insurance income	-	-	-	-	-	2,632	(43)	2,589
Net financial income	50	(823)	5	4	480	2,098	488	2,302
Share of profit of associates and net impairment	-	5	-	-	-	4	18	27
Other operating income	19	1	-	696	-	564	304	1,584
Operating income	4,164	6,306	2,168	23,341	4,709	4,739	744	46,171
Operating expense	(1,522)	(526)	(876)	(6,830)	(216)	(2,092)	(14,216)	(26,278)
Allocated expense	(835)	(2,899)	(672)	(6,382)	(1,032)	(7)	11,827	-
Bank levy	(165)	(693)	(46)	(1,192)	(1,290)	-	-	(3,386)
Net impairment	-	(3,753)	16	220	(22)	16	(2)	(3,525)
Earnings (loss) before income tax	1,642	(1,565)	590	9,157	2,149	2,656	(1,647)	12,982
Net seg. rev. from ext. customers	1,341	16,416	1,727	37,984	(17,551)	5,298	956	46,171
Net seg. rev. from other segments	2,823	(10,110)	441	(14,643)	22,260	(559)	(212)	-
Operating income	4,164	6,306	2,168	23,341	4,709	4,739	744	46,171
Depreciation and amortization	1	5	1	392	-	140	782	1,321
Total assets	71,244	289,076	16,302	594,154	486,982	91,852	(385,283)	1,164,327
Total liabilities	66,028	223,176	15,685	512,992	475,811	58,976	(389,200)	963,468
Allocated equity	5,216	65,900	617	81,162	11,171	32,876	3,917	200,859

Comparative amounts have not been restated based on the organizational structure changes in 2019.

Income taxes and discontinued operations held for sale are excluded from the profit and loss segment information.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

Quarterly statements

6. Operations by quarters, unaudited

2019	Q1	Q2	Q3	Q4	Total
Net interest income	7,434	7,808	7,382	7,693	30,317
Net fee and commission income	2,218	2,478	2,639	2,615	9,950
Net insurance income	253	823	1,087	723	2,886
Net financial income	766	1,023	934	489	3,212
Share of profit (loss) of associates and net impairment	727	(8)	30	7	756
Other operating income	310	94	272	201	877
Operating income	11,708	12,218	12,344	11,728	47,998
Salaries and related expense	(3,630)	(3,805)	(4,130)	(3,076)	(14,641)
Other operating expense	(3,232)	(2,814)	(2,810)	(3,366)	(12,222)
Operating expenses	(6,862)	(6,619)	(6,940)	(6,442)	(26,863)
Bank levy	(906)	(912)	(809)	(357)	(2,984)
Net impairment	(1,081)	(988)	484	1,203	(382)
Earnings before income tax	2,859	3,699	5,079	6,132	17,769
Income tax expense	(622)	(891)	(1,278)	(923)	(3,714)
Net earnings from continuing operations	2,237	2,808	3,801	5,209	14,055
Discontinued operations, net of tax	(1,219)	(715)	(3,040)	(7,981)	(12,955)
Net earnings	1,018	2,093	761	(2,772)	1,100

2018	Q1	Q2	Q3	Q4	Total
Net interest income	6,827	7,314	7,209	7,969	29,319
Net fee and commission income	2,205	2,712	2,687	2,746	10,350
Net insurance income	143	758	984	704	2,589
Net financial income	1,387	1,119	570	(774)	2,302
Share of profit (loss) of associates and net impairment	(20)	2	34	11	27
Other operating income	268	600	422	294	1,584
Operating income	10,810	12,505	11,906	10,950	46,171
Salaries and related expense	(3,616)	(3,949)	(3,129)	(3,584)	(14,278)
Other operating expense	(3,143)	(2,978)	(2,864)	(3,015)	(12,000)
Operating expenses	(6,759)	(6,927)	(5,993)	(6,599)	(26,278)
Bank levy	(804)	(879)	(938)	(765)	(3,386)
Net impairment	(135)	(166)	(2,651)	(573)	(3,525)
Earnings before income tax	3,112	4,533	2,324	3,013	12,982
Income tax expense	(890)	(1,302)	(973)	(881)	(4,046)
Net earnings from continuing operations	2,222	3,231	1,351	2,132	8,936
Discontinued operations, net of tax	(273)	(169)	(201)	(516)	(1,159)
Net earnings	1,949	3,062	1,150	1,616	7,777

The half-year results were reviewed by the Bank's auditors. Other quarterly statements and the split between quarters were not audited or reviewed by the Bank's auditors.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

Notes to the Consolidated Income Statement

7. Net interest income

2019	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total
Interest income				
Cash and balances with Central Bank	4,008	-	-	4,008
Loans	52,757	46	-	52,803
Securities	-	608	727	1,335
Other	161	-	-	161
Interest income	56,926	654	727	58,307
Interest expense				
Deposits	(11,949)	-	-	(11,949)
Borrowings	(15,473)	-	-	(15,473)
Subordinated liabilities	(449)	-	-	(449)
Other	(119)	-	-	(119)
Interest expense	(27,990)	-	-	(27,990)
Net interest income	28,936	654	727	30,317

2018				
Interest income				
Cash and balances with Central Bank	4,625	-	-	4,625
Loans	53,457	354	-	53,811
Securities	-	249	358	607
Other	273	-	-	273
Interest income	58,355	603	358	59,316
Interest expense				
Deposits	(13,323)	-	-	(13,323)
Borrowings	(16,524)	-	-	(16,524)
Subordinated liabilities	(19)			(19)
Other	(131)	-	-	(131)
Interest expense	(29,997)	-	-	(29,997)
Net interest income	28,358	603	358	29,319

Interest spread	2019	2018
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	2.8%	2.8%

Amounts are in ISK millions

8. Net fee and commission income

	2019			2018		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	3,931	(504)	3,427	3,950	(433)	3,516
Capital markets and corporate finance	1,652	(36)	1,616	1,987	(34)	1,953
Lending and financial guarantees	2,112	-	2,112	2,050	-	2,050
Collection and payment services	1,542	(100)	1,442	1,597	(89)	1,508
Cards and payment solution	1,557	(256)	1,301	1,374	(139)	1,235
Other	705	(653)	52	700	(613)	87
Net fee and commission income	11,499	(1,549)	9,950	11,658	(1,308)	10,350

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

Fee and commission income from capital markets and corporate finance includes miscellaneous corporate finance services plus commission from capital markets relating to sales of shares, bonds, FX and derivatives.

Fee and commission income from lending and financial guarantees is mainly related to lending activities, extension fees, advisory services and documentation, notification and payment fees plus fees from the issuing of guarantees on behalf of customers.

Fee and commission income on collection and payment services is generated billing services, such as issuing invoices and payment collection notices, wire transfer services and other payment services.

Commission from cards and payment solutions is mainly from the Bank's issuance of credit and debit cards and other card related commission, e.g. yearly fee on cards and transaction fee.

Other fee and commission income is mainly fees relating to FX transactions at branches and in ATMs, custody and market making on the Icelandic stock exchange.

9. Net insurance income

	2019	2018
Earned premiums, net of reinsurers' share		
Premiums written	11,796	10,974
Premiums written, reinsurers' shares	(399)	(347)
Change in provision for unearned premiums	(291)	(400)
Earned premiums, net of reinsurers' share	11,106	10,227
Claims incurred, net of reinsurers' share		
Claims paid	(7,272)	(7,018)
Claims paid, reinsurers' share	157	108
Change in provision for claims	(1,104)	(813)
Changes in provision for claims, reinsurers' share	(1)	85
Claims incurred, net of reinsurers' share	(8,220)	(7,638)
Net insurance income	2,886	2,589

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

10. Net financial income

	2019	2018
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	3,056	1,073
Loss on prepayments of borrowings	(405)	-
Net (loss) gain on fair value hedge of interest rate swap	(145)	673
Realized gain on financial assets carried at fair value through OCI	585	151
Net foreign exchange gain	121	405
Net financial income	3,212	2,302

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

	2019	2018
Equity instruments	2,330	1,146
Debt instruments	803	216
Derivatives	(31)	72
Loans	(46)	(361)
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	3,056	1,073

Net (loss) gain on fair value hedge of interest rate swap

	2019	2018
Fair value change of interest rate swaps designated as hedging instruments	759	1,182
Fair value change on bonds issued by the Group attributable to interest rate risk	(904)	(509)
Net (loss) gain on fair value hedge of interest rate swap	(145)	673

11. Other operating income

	2019	2018
Fair value changes on investment property	-	471
Net gain on assets held for sale	382	680
Other income	495	433
Other operating income	877	1,584

Net gain on assets held for sale

	2019	2018
Income from real estates and other assets	484	838
Expense related to real estates and other assets	(102)	(158)
Net gain on assets held for sale	382	680

Real estates and other assets classified as assets held for sale are generally the result of foreclosures on companies and individuals.

12. Personnel and salaries

Number of employees

	2019	2018
Average number of full-time equivalent positions during the year	866	928
Full-time equivalent positions at the end of the year	801	904

Number of employees at the parent company

	2019	2018
Average number of full-time equivalent positions during the year	755	820
Full-time equivalent positions at the end of the year	687	794

Salaries and related expense

	2019	2018
Salaries	11,715	11,038
Defined contribution pension plans	1,685	1,577
Salary-related expense	1,700	1,663
Capitalization of salaries due to implementation of core systems	(459)	-
Salaries and related expense	14,641	14,278

Salaries and related expense for the parent company

	2019	2018
Salaries	10,211	9,634
Defined contribution pension plans	1,469	1,377
Salary-related expense	1,477	1,463
Capitalization of salaries due to implementation of core systems	(459)	-
Salaries and related expense for the parent company	12,698	12,474

Amounts are in ISK millions

12. Personnel and salaries, continued

At the end of September 2019 a new organizational structure was introduced, resulting in a reduction in the number of employees of 12%, or approximately 100 people. Salary and salary related expenses of ISK 1,079 million were expensed in 2019 in respect of these redundancies.

Salary and salary related expenses of ISK 150 million were expensed in 2019 in respect of the resignation of Höskuldur H. Ólafsson, the Bank's former CEO, and ISK 102 million in respect of the resignation of two Managing Directors of the Bank; the Managing Director of the Legal division and the Managing director of IT.

In June 2018 Arion Bank adopted a share-based remuneration programme, when a limited stock grant was offered to all employees of the parent company, excluding internal control units, in connection with the IPO and listing of the Bank. Remuneration was paid in the form of deferred shares with a vesting period of two years. The Bank recognizes expenses related to the programme as salaries and related expenses, a total of ISK 651 million, over the vesting period, or approximately ISK 27 million per month from June 2018.

In 2019 the Group made a provision of ISK 37 million (2018: ISK 67 million) for performance plan payments, including salary-related expense, for which the Bank made no provision (2018: nil). Forty percent of the payment is deferred for three years in accordance with FSA rules on remuneration policies for financial undertakings. At the end of the year the Group's accrual for performance plan payments amounted to ISK 371 million (2018: ISK 608 million), of which the Bank's accrual amounts to ISK 239 million (2018: ISK 452 million).

Remuneration to the Board of Directors	2019			2018		
	Fixed remuner-ation*	Additional remuner-ation**	Total	Fixed remuner-ation*	Additional remuner-ation**	Total
Brynjólfur Bjarnason, Chairman of the Board	10.7	5.6	16.3	8.1	4.9	13.0
Herdís Dröfn Fjeldsted, Vice Chairman, Director from 15.3.2018	8.1	5.7	13.8	4.3	3.7	8.0
Gunnar Sturluson, Director from 9.8.2019	2.2	0.8	3.0	-	-	-
Liv Fiksdahl, Director from 20.3.2019	8.9	1.5	10.4	-	-	-
Paul Richard Horner, Director from 9.8.2019	4.5	0.8	5.3	-	-	-
Renier Lemmens, Director from 20.3.2019	8.9	2.9	11.8	-	-	-
Steinunn Kristín Thórdardóttir, Director ***	17.1	5.0	22.1	5.4	3.4	8.8
Eva Cederbalk, Chairman of the Board until 20.3.2019	4.8	0.6	5.4	21.5	3.1	24.6
Benedikt Gíslason, Director from 5.9.2018 to 26.6.2019	2.8	2.6	5.4	1.7	1.2	3.0
Måns Höglund, Director until 20.3.2019	2.4	1.1	3.5	10.7	4.9	15.7
Jakob Már Ásmundsson, Director until 30.5.2018	-	-	-	2.2	1.9	4.1
John P. Madden, Director until 5.9.2018	-	-	-	2.4	0.9	3.3
Kirstín Th. Flygenring, Director until 15.3.2018	-	-	-	1.1	0.9	1.9
Thóra Hallgrímsdóttir, Director until 15.3.2018	-	-	-	1.1	1.0	2.0
Alternate directors of the Board	4.5	1.5	6.0	3.7	0.9	4.6
Total remuneration	74.9	28.0	103.0	62.1	27.0	89.1

* 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.

*** The Annual General Meeting approved that members of the Board of Directors who reside outside of Iceland receive double the monthly salary of Board members who reside in Iceland. In 2019 Steinunn Kristín Thórdardóttir, who resides abroad, received a retroactive correction in this respect.

Remuneration to key management personnel	2019		2018	
	Salaries	Performance-based payments	Salaries	Performance-based payments
Benedikt Gíslason, CEO from 1.7.2019	28.1	-	-	-
Ásgeir H. Reykfjörd Gylfason, deputy CEO from 5.9.2019 and MD of Corporate & Investment banking from 26.9.2019	22.5	-	-	-
Ida Brá Benediktsdóttir, MD of Retail banking	40.0	1.9	36.9	4.3
Margrét Sveinsdóttir, MD of Markets	34.8	2.7	34.1	5.8
Stefán Pétursson, CFO	47.2	3.0	43.6	6.0
Höskuldur H. Ólafsson, CEO until 30.4.2019	22.6	4.8	67.5	7.2
Lýdur Thorgeirsson, MD of Investment banking until 26.9.2019	25.6	-	36.4	0.2
Rúnar Magni Jónsson, MD of Corporate banking until 26.9.2019	24.5	1.4	6.8	-
Freyr Thórdarson, MD of Corporate banking until 31.5.2018	-	-	24.7	2.4
Two managing directors (three until 26.9.2019) of the Bank's divisions who are members of the Bank's Executive Committee (2018: three)	87.2	5.1	104.0	7.2
Total remuneration	332.5	18.9	354.0	33.1

Head of Investor relation, Sture Stölen was a contractor of the Bank in 2018 and until 23 September 2019.

Performance based payments in 2019 are deferred payments based on the Group's performance in 2015.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

12. Personnel and salaries, continued

Board Members receive remuneration for their involvement in board committees. In addition to 14 Board meetings (2018: 21) during the year 16 Board Credit Committee meetings (2018: 20), 6 Board Audit Committee meetings (2018: 5), 9 Board Risk Committee meetings (2018: 9) and 5 Board Remuneration Committee meetings (2018: 7) were held. Four committee meetings with alternate directors of the Board were held in 2019 (2018: 4).

The 2019 Annual General Meeting of the Bank held on 20 March 2019 approved the monthly salaries for 2019 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 952,800, ISK 714,800 and ISK 476,600 (2018: ISK 907,423; 680,793; 453,900) respectively. It was also approved that the salary of Alternate Board Members would be ISK 241,400 (2018: ISK 229,912) per meeting, up to a maximum of ISK 476,600 (2018: ISK 453,900) per month. For Board Members resident abroad, the aforementioned amounts are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 190,600 (2018: ISK 181,560) per month for each committee they serve on and the Chairman of the board committees ISK 247,600 (2018: ISK 235,777).

13. Other operating expense

	2019	2018
IT expense	4,527	4,074
Professional services	1,198	1,351
Housing expense	1,082	1,220
Other administration expense	3,134	3,162
Depositors' and Investors' Guarantee Fund	735	872
Depreciation of property and equipment	638	556
Depreciation of right of use asset	128	-
Amortization of intangible assets	780	765
Other operating expense	12,222	12,000

Auditor's fee

	2019	2018
Audit and review of the Consolidated Financial Statements for the relevant fiscal year	133	182
Other audit related services for the relevant fiscal year	10	56
Auditor's fee	143	238
Of which fee to others than the auditor of the Parent company	-	1

14. Bank levy

The Bank levy is 0.376% on total debts excluding tax liabilities, in excess of ISK 50 billion. The tax is assessed on Financial Undertakings but non-financial subsidiaries are exempt from this tax.

15. Net impairment

	2019	2018
Net change in impairment of cash and balances with Central Bank	2	5
Net change in impairment of loans to credit institutions	19	(32)
Net change in impairment of loans to corporates	(1,216)	(2,771)
Net change in impairment of loans to individuals	930	1,119
Write offs on loans and receivables to corporates	(1,796)	(1,706)
Write offs on loans and receivables to individuals	(1,321)	(1,045)
Payments on loans and receivables previously written off from corporates	20	42
Payments on loans and receivables previously written off from individuals	154	123
Net change in impairment of financial instruments at FVOCI	(1)	(5)
Net change in impairment of loan commitments, guarantees and unused credit facilities	207	(215)
Net impairment on financial instruments	(3,002)	(4,485)
Increase in book value of loans to corporates	91	54
Increase in book value of loans to individuals	2,529	906
Other value changes of loans	2,620	960
Net impairment	(382)	(3,525)

Increase in book value of loans to individuals and corporates is mainly due to release of discount from loans acquired with discount during the years 2008 to 2013, both due to impairments and other discount rate than reflected in the interest rates of the loans. The discount release was primarily related to loans that were paid up or sold during the year.

Amounts are in ISK millions

16. Income tax expense

	2019	2018
Current tax expense	3,174	3,716
Deferred tax expense	540	330
Income tax expense	**3,714**	**4,046**

Reconciliation of effective tax rate

	2019		2018	
Earnings before tax		17,769		12,982
Income tax using the Icelandic corporate tax rate	20.0%	3,554	20.0%	2,596
Additional 6% tax on Financial Undertakings	2.3%	402	5.5%	709
Non-deductible expenses	1.0%	181	0.0%	4
Tax exempt revenue	(6.4%)	(1,132)	(2.9%)	(376)
Non-deductible taxes	3.4%	597	5.2%	677
Tax incentives not recognized in the Income Statement	0.1%	21	1.7%	222
Other changes	0.5%	91	1.6%	214
Effective tax rate	20.9%	3,714	31.2%	4,046

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

Tax exempt revenues consist mainly of profit from equity positions.

Bank levy of 0.376% on liabilities exceeding ISK 50 billion is non-deductible.

17. Discontinued operations held for sale, net of income tax

	2019	2018
Net loss from discontinued operations held for sale	(13,681)	(1,269)
Income tax expense	726	110
Discontinued operations held for sale, net of income tax	**(12,955)**	**(1,159)**

Discontinued operations held for sale, net of income tax

	2019	2018
Valitor Holding hf.	(8,555)	(1,271)
Stakksberg ehf.	(3,799)	112
Sólbjarg ehf.	(601)	-
Discontinued operations held for sale, net of income tax	**(12,955)**	**(1,159)**

Income Statement of Valitor Holding hf.

			Valitor contribution	
	Valitor	Elimination	2019	2018
Net interest income	512	88	600	820
Net fee and commission income	5,768	1,378	7,146	6,211
Net financial income	168	-	168	(202)
Other operating income	59	-	59	24
Operating income	6,507	1,466	7,973	6,853
Salaries and related expense	(5,593)	-	(5,593)	(4,366)
Other operating expense	(6,966)	-	(6,966)	(3,868)
Operating expenses	(12,559)	-	(12,559)	(8,234)
Net impairment	(4,112)	-	(4,112)	(40)
Operating loss before income tax	(10,164)	1,466	(8,698)	(1,421)
Income tax expense	250	(107)	143	150
Operating loss	(9,914)	1,359	(8,555)	(1,271)

Operating loss of Stakksberg and Sólbjarg of ISK 4,400 million are due to impairment of the entities underlying assets.

For further information about Valitor Holding hf., Stakksberg ehf. and Sólbjarg ehf. see Note 29.

18. Earnings per share

	Continued operations		Discontinued operations		Net Earnings	
	2019	2018	2019	2018	2019	2018
Net earnings attributable to the shareholders of Arion Bank	14,051	8,275	(12,955)	(1,159)	1,096	7,116
Weighted average number of outstanding shares	1,809	1,841	1,809	1,841	1,809	1,841
Basic earnings per share	7.77	4.49	(7.16)	(0.63)	0.61	3.86

There were no instruments at the end of the year that could potentially dilute basic earnings per share (2018: none).

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

Notes to the Consolidated Statement of Financial Position

19. Cash and balances with Central Bank

	2019	2018
Cash on hand	4,206	5,059
Cash with Central Bank	81,543	67,492
Mandatory reserve deposit with Central Bank	9,968	10,588
Cash and balances with Central Bank	95,717	83,139

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

20. Loans to credit institutions

	2019	2018
Bank accounts	16,437	38,038
Money market loans	-	17,101
Other loans	1,510	1,183
Loans to credit institutions	17,947	56,322

21. Loans to customers

	Individuals		Corporates		Total	
2019	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	14,421	13,720	18,709	17,780	33,130	31,500
Credit cards	13,028	12,786	1,373	1,281	14,401	14,067
Mortgage loans	310,562	310,195	23,475	23,211	334,037	333,406
Other loans	33,105	31,868	368,453	363,114	401,558	394,982
Loans to customers	371,116	368,569	412,010	405,386	783,126	773,955
2018						
Overdrafts	14,536	13,616	19,200	18,267	33,736	31,883
Credit cards	12,958	12,706	1,348	1,305	14,306	14,011
Loans to customers at fair value	-	-	4,812	4,812	4,812	4,812
Mortgage loans	343,119	342,469	23,417	23,351	366,536	365,820
Other loans	33,560	31,692	390,767	385,608	424,327	417,300
Loans to customers	404,173	400,483	439,544	433,343	843,717	833,826

The total book value of pledged loans that were pledged against amounts borrowed was ISK 182 billion at the end of the year (31.12.2018: ISK 203 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk management disclosures.

22. Financial instruments

	2019	2018
Bonds and debt instruments	65,874	71,451
Shares and equity instruments with variable income	21,600	20,265
Derivatives	6,617	6,241
Securities used for economic hedging	23,315	16,600
Financial instruments	117,406	114,557

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

23. Financial assets and financial liabilities

2019	Amortized cost	Fair value through OCI	Mandatorily at fair value thr. P/L	Total
Financial assets				
Loans				
Cash and balances with Central Bank	95,717	-	-	95,717
Loans to credit institutions	17,947	-	-	17,947
Loans to customers	773,955	-	-	773,955
Loans	887,619	-	-	887,619
Bonds and debt instruments				
Listed	-	47,698	16,479	64,177
Unlisted	-	1,196	501	1,697
Bonds and debt instruments	-	48,894	16,980	65,874
Shares and equity instruments with variable income				
Listed	-	-	9,632	9,632
Unlisted	-	-	7,417	7,417
Bond funds with variable income, unlisted	-	-	4,551	4,551
Shares and equity instruments with variable income	-	-	21,600	21,600
Derivatives				
OTC derivatives	-	-	5,001	5,001
Derivatives used for hedge accounting	-	-	1,616	1,616
Derivatives	-	-	6,617	6,617
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	10,852	10,852
Shares and equity instruments with variable income, listed	-	-	12,459	12,459
Shares and equity instruments with variable income, unlisted	-	-	4	4
Securities used for economic hedging	-	-	23,315	23,315
Other financial assets				
Accounts receivable	3,617	-	-	3,617
Other financial assets	5,058	-	-	5,058
Other financial assets	8,675	-	-	8,675
Financial assets	896,294	48,894	68,512	1,013,700
Financial liabilities				
Due to credit institutions and Central Bank	5,984	-	-	5,984
Deposits	492,916	-	-	492,916
Borrowings	304,745	-	-	304,745
Subordinated liabilities	20,083	-	-	20,083
Short position in bonds	-	-	385	385
Short position in bonds, used for economic hedging	-	-	107	107
Short position in equity	-	-	24	24
Derivatives	-	-	2,054	2,054
Other financial liabilities	6,408	-	-	6,408
Financial liabilities	830,136	-	2,570	832,706

Amounts are in ISK millions

23. Financial assets and financial liabilities, continued

2018			Manda-	
Financial assets	Amortized cost	Fair value through OCI	torily at fair value thr. P/L	Total
Loans				
Cash and balances with Central Bank	83,139	-	-	83,139
Loans to credit institutions	56,322	-	-	56,322
Loans to customers	829,014	-	4,812	833,826
Loans	968,475	-	4,812	973,287
Bonds and debt instruments				
Listed	-	51,329	17,274	68,603
Unlisted	-	2,459	389	2,848
Bonds and debt instruments	-	53,788	17,663	71,451
Shares and equity instruments with variable income				
Listed	-	-	7,270	7,270
Unlisted	-	-	9,867	9,867
Bond funds with variable income, unlisted	-	-	3,128	3,128
Shares and equity instruments with variable income	-	-	20,265	20,265
Derivatives				
OTC derivatives	-	-	5,020	5,020
Derivatives used for hedge accounting	-	-	1,221	1,221
Derivatives	-	-	6,241	6,241
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	10,010	10,010
Shares and equity instruments with variable income, listed	-	-	6,587	6,587
Shares and equity instruments with variable income, unlisted	-	-	3	3
Securities used for economic hedging	-	-	16,600	16,600
Other financial assets				
Accounts receivable	3,751	-	-	3,751
Other financial assets	2,056	-	-	2,056
Other financial assets	5,807	-	-	5,807
Financial assets	974,282	53,788	65,581	1,093,651
Financial liabilities				
Due to credit institutions and Central Bank	9,204	-	-	9,204
Deposits	466,067	-	-	466,067
Borrowings	417,782	-	-	417,782
Subordinated liabilities	6,532	-	-	6,532
Short position in bonds	-	-	488	488
Short position in equity, used for economic hedging	-	-	37	37
Derivatives	-	-	1,795	1,795
Other financial liabilities	6,130	-	-	6,130
Financial liabilities	905,715	-	2,320	908,035

Amounts are in ISK millions

23. Financial assets and financial liabilities, continued

Bonds and debt instruments measured at fair value, specified by issuer

2019	FVOCI	Mandatorily FVPL	Total
Financial and insurance activities	417	5,613	6,030
Public sector	41,417	7,259	48,676
Corporates	7,060	4,108	11,168
Bonds and debt instruments at fair value	48,894	16,980	65,874
2018			
Financial and insurance activities	2,962	7,364	10,326
Public sector	44,084	8,724	52,808
Corporates	6,742	1,575	8,317
Bonds and debt instruments designated at fair value	53,788	17,663	71,451

The total amount of pledged bonds was ISK 6.0 billion at the end of the year (31.12.2018: ISK 5.9 billion). Pledged bonds comprised Icelandic Government Bonds and corporate 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.

24. 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

2019

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	57,196	8,650	28	65,874
Shares and equity instruments with variable income	5,169	14,876	1,555	21,600
Derivatives	-	5,001	-	5,001
Derivatives used for hedge accounting	-	1,616	-	1,616
Securities used for economic hedging	22,819	496	-	23,315
Investment property	-	-	7,119	7,119
Assets at fair value	85,184	30,639	8,702	124,525
Liabilities at fair value				
Short position in bonds	385	-	-	385
Short position in equity	24	-	-	24
Short position in bonds, used for economic hedging	107	-	-	107
Derivatives	-	2,054	-	2,054
Liabilities at fair value	516	2,054	-	2,570

Amounts are in ISK millions

24. Fair value hierarchy, continued

2018

Assets at fair value	Level 1	Level 2	Level 3	Total
Loans to customers	-	4,812	-	4,812
Bonds and debt instruments	61,909	9,500	42	71,451
Shares and equity instruments with variable income	3,980	14,956	1,329	20,265
Derivatives	-	5,020	-	5,020
Derivatives used for hedge accounting	-	1,221	-	1,221
Securities used for economic hedging	16,597	3	-	16,600
Investment property	-	-	7,092	7,092
Assets at fair value	82,486	35,512	8,463	126,461

Liabilities at fair value				
Short position in bonds	488	-	-	488
Short position in equity, used for economic hedging	37	-	-	37
Derivatives	-	1,795	-	1,795
Liabilities at fair value	525	1,795	-	2,320

Transfers from Level 1 to Level 2 amounted to ISK 20 million in 2019 (2018: Transfers from Level 2 to Level 1 amounted to ISK 496 million).

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

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 23 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.

Level 1: Fair value established from quoted market prices

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from quoted 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 valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent market transactions between knowledgeable and willing parties, if available, reference to 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.

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.

Level 2 instruments include unlisted shares, unlisted funds with underlying bonds and equity holdings (share certificates), unlisted and less liquid listed bonds and all OTC derivatives.

Amounts are in ISK millions

24. Fair value hierarchy, continued

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

In some 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	Financial assets		
2019	property	Bonds	Shares	Total
Balance at the beginning of the year	7,092	42	1,329	8,463
Net fair value changes	-	20	62	82
Additions	30	5	281	316
Disposals	(3)	(27)	(117)	(147)
Transfers out of Level 3	-	(12)	-	(12)
Balance at the end of the year	7,119	28	1,555	8,702
2018				
Balance at the beginning of the year	6,613	39	1,130	7,782
Net fair value changes	471	10	56	537
Additions	284	-	210	494
Disposal	(276)	(7)	(1)	(284)
Transfers out of Level 3	-	-	(66)	(66)
Balance at the end of the year	7,092	42	1,329	8,463

Line items where effects of Level 3 assets are recognized in the Consolidated Income Statement

	Investment	Financial assets		
2019	property	Bonds	Shares	Total
Net financial income	-	20	62	82
Effects recognized in the Income Statement	-	20	62	82
2018				
Net financial income	-	10	56	66
Other operating income	471	-	-	471
Effects recognized in the Income Statement	471	10	56	537

Amounts are in ISK millions

24. Fair value hierarchy, continued

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

2019	Carrying value	Fair value	Unrealized gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	95,717	95,717	-
Loans to credit institutions	17,947	17,947	-
Loans to customers	773,955	777,320	3,365
Other financial assets	8,675	8,675	-
Financial assets not carried at fair value	896,294	899,659	3,365
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	5,984	5,984	-
Deposits	492,916	492,916	-
Borrowings	304,745	316,589	(11,844)
Subordinated liabilities	20,083	20,177	(94)
Other financial liabilities	6,408	6,408	-
Financial liabilities not carried at fair value	830,136	842,074	(11,938)

2018			
Financial assets not carried at fair value			
Cash and balances with Central Bank	83,139	83,139	-
Loans to credit institutions	56,322	56,322	-
Loans to customers	829,014	837,153	3,327
Other financial assets	5,807	5,807	-
Financial assets not carried at fair value	974,282	982,421	3,327
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	9,204	9,204	-
Deposits	466,067	466,067	-
Borrowings	417,782	426,390	(8,608)
Subordinated liabilities	6,532	6,454	78
Other financial liabilities	6,130	6,130	-
Financial liabilities not carried at fair value	905,715	914,245	(8,530)

Loans to customers are largely with variable interest rate. Those loans, including corporate loans, are presented at book value as they have generally short duration and very limited interest rate risk. Loans with fixed interest rate, mainly long term retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account loan to value. 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.

Amounts are in ISK millions

24. Fair value hierarchy, continued

Derivatives	Notional	Fair value	
2019	value	Assets	Liabilities
Forward exchange rate agreements	90,121	1,196	407
Fair value hedge of interest rate swap	114,337	1,616	-
Interest rate and exchange rate agreements	65,823	2,312	1,168
Bond swap agreements	9,936	46	48
Share swap agreements	12,710	1,447	431
Derivatives	292,927	6,617	2,054
2018			
Forward exchange rate agreements	60,940	901	406
Fair value hedge of interest rate swap	146,520	1,221	-
Interest rate and exchange rate agreements	109,698	2,749	1,252
Bond swap agreements	7,526	18	45
Share swap agreements	7,455	1,340	84
Options - purchased agreements	834	12	8
Derivatives	332,973	6,241	1,795

Fair value hedge of interest rate swap

The Group applies fair value hedge accounting only with respect to interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest, with identical cash flows to the borrowings. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate euro bonds, see Note 32, arising from changes in interest rates. On 1 January 2018 the Group adopted IFRS 9, but has elected to continue to apply the hedge accounting principles under IAS 39. For further information about the Group's hedge accounting policy, see Note 57.

	Notional	Maturity	Fair value		Gain/loss on FV
2019		date	Assets	Liabilities	changes
Interest rates swaps - EUR	108,667	1-5 years	1,608	-	457
Interest rates swaps - EUR	5,670	3-6 months	8	-	302
2018					
Interest rates swaps - EUR	146,520	1-5 years	1,221	-	1,182

	Book	Accumulated fair value		Gain/loss on FV
2019	value	Assets	Liabilities	changes
EUR 500 million - issued 2016/18 - 5 years	67,713	157	-	(410)
EUR 300 million - issued 2017 - 3 years	5,635	33	-	(199)
EUR 300 million - issued 2018 - 3 years	41,601	-	756	(295)
Hedged borrowings	114,949	190	756	(904)
2018				
EUR 500 million - issued 2016/18 - 5 years	65,845	640	-	(161)
EUR 300 million - issued 2017 - 3 years	40,034	1	-	(19)
EUR 300 million - issued 2018 - 3 years	40,328	-	343	(329)
Hedged borrowings	146,207	641	343	(509)

The effectiveness of each hedge is measured regularly with linear regression. The relationship between fair value changes of an interest rate swap on the one hand and a borrowing on the other hand is examined. In all cases the effectiveness is within limits, or between 93-105%.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

25. 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				
2019	Gross assets before nettings	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, net
Reverse repurchase agreements	6,539	(44)	6,495	(5,921)	-	574	-	6,495
Derivatives	4,601	-	4,601	(713)	-	3,888	2,016	6,617
Total assets	11,140	(44)	11,096	(6,634)	-	4,462	2,016	13,112
2018								
Reverse repurchase agreements	12,026	(50)	11,976	(10,387)	-	1,589	-	11,976
Derivatives	4,082	-	4,082	(840)	-	3,242	2,159	6,241
Total assets	16,108	(50)	16,058	(11,227)	-	4,831	2,159	18,217

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the Balance Sheet				
2019	Gross liabilities before nettings	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	5,965	(44)	5,921	(5,921)	-	-	-	5,921
Derivatives	761	-	761	(713)	-	48	1,293	2,054
Total liabilities	6,726	(44)	6,682	(6,634)	-	48	1,293	7,975
2018								
Repurchase agreements	10,437	(50)	10,387	(10,387)	-	-	-	10,387
Derivatives	878	-	878	(840)	-	38	917	1,795
Total liabilities	11,315	(50)	11,265	(11,227)	-	38	917	12,182

Reverse repurchase agreements and repurchase agreements are recognized within the line items Financial instruments and Due to credit institutions and Central Bank respectively.

26. Investments in associates

The Group's interest in its principal associates	2019	2018
Audkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	25.4%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	-	35.8%
JCC ehf., Borgartún 19, Reykjavík, Iceland	33.3%	33.3%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	20.0%	20.0%
220 Fjördur ehf., Fjardargata 13-15, Hafnarfjördur, Iceland	37.4%	37.4%
SER eignarhaldsfélag ehf., Borgartún 19, Reykjavík	35.3%	35.3%

Investments in associates

Carrying amount at the beginning of the year	818	760
Acquisitions	18	85
Transfers to assets held for sale	-	(55)
Disposals	(740)	-
Share of profit of associates and profit from sale	756	27
Investment in associates	852	818

In March 2019 Arion Bank sold its entire shareholding in Farice ehf. The sale generated a profit of ISK 732 million and is recognized in the Consolidated Income Statement.

Amounts are in ISK millions

27. Intangible assets

Intangible assets comprise the following categories: Goodwill, which arises on business combinations; Infrastructure, Customer relationships and related agreements which are identified during the acquisition of subsidiaries and related to the activities of the businesses being acquired; and Software, which is acquired (i.e. software licenses) and expenses of implementation.

Infrastructure, which is capitalized as an intangible asset, is related to the asset management operation and branding of the insurance operation. The business activity is based on years of developing 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. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The lifetime of these agreements is based on the experience of the Group and the industry. As a result, these agreements are assessed as having an identified useful lifetime.

Acquired software and internally developed software is capitalized on the basis of the cost of acquiring and bringing the software into service. Expenditure on internally developed software is recognized as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and when it can reliably measure the costs to complete the development. The capitalized costs of internally developed software include external expenses directly attributable to developing the software and salary and salary related expenses of implementation of core systems. Capitalized costs of software are amortized over its useful life. Computer software licenses and internally developed software recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

Policies applied to the Group's intangible assets	Goodwill and infrastructure	Customer relationship and related agreements	Software
Useful lives	Undefined	Finite 6-15 years and undefined	Finite 3-10 years
Amortization method	Impairment test	Straight-line basis over 6-15 years and impairment test	Straight-line basis over 3-10 years
Internally generated or acquired	Acquired	Acquired	Acquired and internally generated

2019	Goodwill	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	669	2,383	787	2,558	6,397
Additions	-	-	-	2,291	2,291
Additions, capitalized salaries	-	-	-	459	459
Amortization	-	-	(60)	(720)	(780)
Intangible assets	669	2,383	727	4,588	8,367

2018	Goodwill	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	4,315	3,705	1,492	4,336	13,848
Additions	-	-	-	1,372	1,372
Transfers to assets and disposal groups held for sale	(3,646)	(1,322)	(445)	(2,645)	(8,058)
Amortization	-	-	(260)	(505)	(765)
Intangible assets	669	2,383	787	2,558	6,397

Goodwill is recognized among assets in the operating segment Vördur, see Note 5.

Impairment testing

The methodology for impairment testing on the Infrastructure and Customer relationship, 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 no impairment was recognized in 2019 (2018: nil).

	2019		2018	
Discount and growth rates	Discount rates	Growth rates	Discount rates	Growth rates
Asset Management operation	10.8%	2.5%	13.0%	2.5%
Insurance operation	12.8%	2.5%	16.0%	2.5%

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

28. Tax assets and tax liabilities

	2019		2018	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	3,461	-	4,650
Deferred tax	2	943	90	469
Tax assets and tax liabilities	2	4,404	90	5,119

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

	2019 Assets	2019 Liabilities	2018 Assets	2018 Liabilities
Foreign currency denominated assets and liabilities	2	(272)	-	(305)
Investment property and property and equipment	-	(261)	-	(221)
Financial assets	248	-	567	-
Other assets and liabilities	149	(359)	157	(375)
Deferred tax related to foreign exchange gain	-	(449)	-	(302)
Tax loss carry forward	1	-	100	-
	400	(1,341)	824	(1,203)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(398)	398	(734)	734
Deferred tax assets and tax liabilities	2	(943)	90	(469)

Deferred tax assets are recognized for unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilized. Significant management judgement is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and the level of future taxable profits, together with future tax planning strategies.

The Group has ISK 1,899 million (31.12.2018: ISK 2,347 million) of tax losses carried forward. These losses relate to subsidiaries that have a history of losses, do not expire, and may not be used to offset taxable income elsewhere in the Group. The subsidiaries neither have any taxable temporary difference nor any tax planning opportunities available that could partly support the recognition of these losses as deferred tax assets. On this basis, the Group has determined that it cannot recognize deferred tax assets on the tax losses carried forward. If the Group was able to recognize all unrecognized deferred tax assets, profit and equity would have increased by ISK 380 million (2018: ISK 469 million).

Changes in deferred tax assets and tax liabilities

2019	At 1 Jan.	Changes due to Valitor	Recognized through equity	Recognized in profit or loss	At 31 Dec.
Foreign currency denominated assets and liabilities	(305)	-	-	35	(270)
Investment property and property and equipment	(221)	-	-	(40)	(261)
Financial assets	567	-	-	(319)	248
Other assets and liabilities	(218)	-	(22)	30	(210)
Deferred foreign exchange differences	(302)	-	-	(147)	(449)
Tax loss carry forward	100	-	-	(99)	1
Change in deferred tax assets and tax liabilities	(379)	-	(22)	(540)	(941)

2018	At 1 Jan.	Changes due to Valitor	Recognized through equity	Recognized in profit or loss	At 31 Dec.
Foreign currency denominated assets and liabilities	293	-	-	(598)	(305)
Investment property and property and equipment	(982)	465	-	296	(221)
Financial assets	468	-	-	99	567
Other assets and liabilities	(259)	60	(222)	203	(218)
Deferred foreign exchange differences	(9)	-	-	(293)	(302)
Tax loss carry forward	440	(303)	-	(37)	100
Change in deferred tax assets and tax liabilities	(49)	222	(222)	(330)	(379)

29. Assets and disposal groups held for sale and associated liabilities

Assets and disposal groups held for sale	2019	2018
Valitor Holding hf.	30,657	40,003
Stakksberg ehf.	2,711	6,516
Sólbjarg ehf.	8,676	-
Disposal groups held for sale	42,044	46,519
Real estate	1,553	2,021
Other assets	29	44
Assets and disposal groups held for sale	43,626	48,584

Amounts are in ISK millions

29. Assets and disposal groups held for sale and associated liabilities, continued

Liabilities associated with disposal groups held for sale	2019	2018
Valitor Holding hf.	22,052	26,337
Sólbjarg ehf.	6,579	-
Liabilities associated with disposal groups held for sale	28,631	26,337

Real estates and other assets classified as assets held for sale are generally the result of foreclosures on companies and individuals.

Valitor Holding hf.

Arion Bank's shareholding in the subsidiary Valitor Holding hf. (Valitor) was 100% at 31 December 2019. The Bank is in the process of potentially divesting the Bank's shareholding in Valitor and appointed Citi as a sales advisor. The Bank is aiming for having completed the sale of Valitor within the next 12 months. In accordance with IFRS 5 Non-current assets and disposal groups held for sale, Valitor is classified as asset held for sale in these Consolidated Financial Statements.

	2019	2018
Assets		
Cash and balances with Central Bank	9,363	7,441
Loans to credit institutions	12,312	19,300
Loans to customers	2,061	2,258
Financial instruments	28	174
Investments in associates	66	58
Intangible assets	4,720	8,267
Tax assets	293	101
Other assets	1,814	2,404
Total assets	30,657	40,003
Liabilities		
Due to credit institutions and Central Bank	2	-
Financial liabilities at fair value	26	8
Tax liabilities	321	136
Other liabilities	21,703	26,185
Borrowings	-	8
Total Liabilities	22,052	26,337
Elimination within Arion Bank Group	(2,086)	2,116
Book value of Valitor	6,519	15,782

Sólbjarg ehf., a subsidiary of Eignabjarg ehf.

On 20 June 2019 Arion Bank acquired all shares in TravelCo hf. and its subsidiaries (hereafter "TravelCo") following the enforcement of pledges. Sólbjarg ehf, of which the Bank is the beneficial owner, is the holding company of TravelCo. TravelCo was established following the collapse of Primera Air ehf. and Primera Travel Group hf. and owns and runs tour operators in Scandinavia and Iceland. This enforcement primarily represents a change in ownership and does not affect the daily operations or services of the tour operators. Arion Bank's rationale for acquiring TravelCo was to safeguard the continued operation of the tour operators as well as the Bank's interests. Arion Bank is in the process of divesting all of the Bank's shareholding in TravelCo and the company is therefore classified as held for sale in accordance with IFRS 5. At year-end 2019 Arion Bank signed a sales and purchase agreement for the sale of a subsidiary of Sólbjarg ehf., Terra Nova Sól ehf. The sale has not been finalized and is subject to a due diligence process and an approval from the Icelandic Competition Authority.

Stakksberg ehf., a subsidiary of Eignabjarg ehf.

On 22 January 2018 United Silicon was declared bankrupt following serious operational problems which resulted in its operating license being temporarily suspended, following a failed attempt at reaching a composition arrangement with its creditors. In February 2018 an agreement was reached between the administrator of the bankrupt estate of United Silicon and Arion Bank, whereby the Bank foreclosed against its collateral and acquired all the company's main assets. The assets of the silicon plant are currently managed by Stakksberg ehf., which is held by the Bank through the subsidiary Eignabjarg ehf. Stakksberg ehf. has, since the transfer of the assets from United Silicon, successfully worked to reduce uncertainties surrounding the recommissioning of the silicon plant, with measures including the securing of all necessary operating permits, power supply and undertaking further engineering design groundwork necessary for the carrying out of remedial work prior to the reopening of the plant. Stakksberg ehf. is currently engaged in the final stages of concluding a new environmental impact assessment for the plant. The proposed remedial actions fully fit within the scope of the current local plan for Stakksberg's plot in Helguvík. Nevertheless Reykjanesbær will be required to amend the current local plan to reflect building licenses which have already been issued by Reykjanesbær. The Bank's objective is to divest Stakksberg ehf. on the basis of this preparatory work. Stakksberg is therefore classified as held for sale in accordance with IFRS 5.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

30. Other assets

	2019	2018
Property and equipment	5,243	5,797
Right of use asset	902	-
Accounts receivable	3,617	3,751
Unsettled securities trading	3,178	92
Investment for life assurance policyholders where risk is held by policyholder	1,008	833
Sundry assets	2,916	3,029
Other assets	16,864	13,502

Property and equipment

	Real estate	Equip-ment	Total 2019	Total 2018
Gross carrying amount at the beginning of the year	6,058	6,407	12,465	14,071
Additions	-	498	498	374
Disposals	(274)	(364)	(638)	(231)
Transfer to Assets and disposal groups held for sale	-	-	-	(1,749)
Gross carrying amount at the end of the year	5,784	6,541	12,325	12,465
Accumulated depreciation at the beginning of the year	(1,975)	(4,693)	(6,668)	(7,510)
Depreciation	(138)	(500)	(638)	(556)
Disposals	-	224	224	198
Transfer to Assets and disposal groups held for sale	-	-	-	1,200
Accumulated depreciation at the end of the year	(2,113)	(4,969)	(7,082)	(6,668)
Property and equipment	3,671	1,572	5,243	5,797

The official real estate value (Registers Iceland) amounted to ISK 6,024 million at the end of the year (2018: ISK 6,241 million) and the insurance value amounts to ISK 11,038 million (2018: ISK 10,715 million).

Right-of-use asset

	2019	2018
Adoption of IFRS 16 Leases 1 January 2019	984	-
Addition	20	-
Indexation	26	-
Depreciation	(128)	-
Right-of-use asset	902	-

Right-of-use asset consists of real estates for own use.

31. Other liabilities

	2019	2018
Accounts payable	654	633
Unsettled securities trading	365	34
Depositors' and Investors' Guarantee Fund	167	226
Technical provision	14,709	13,324
Technical provision for life assurance policyholders were investment risk is held by policyholder	1,008	833
Withholding tax	1,492	1,590
Bank levy	2,984	3,386
Accrued expenses	3,441	3,018
Prepaid income	1,573	1,599
Impairment of off-balance items	481	717
Lease liability	914	-
Sundry liabilities	4,909	4,747
Other liabilities	32,697	30,107

Amounts are in ISK millions

31. Other liabilities, continued

Technical provision	Technical provision	Reinsurers' share	Total 2019	Technical provision	Reinsurers' share	Total 2018
Claims reported and loss adjustment expenses	7,742	(221)	7,521	6,871	(192)	6,679
Claims incurred but not reported	1,426	(82)	1,344	1,193	(113)	1,080
Claims outstanding	9,168	(303)	8,865	8,064	(305)	7,759
Provision for unearned premiums	5,541	(4)	5,537	5,260	(3)	5,257
Own technical provision	14,709	(307)	14,402	13,324	(308)	13,016

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 on future fiscal years.

Lease liability	2019	2018
Adoption of IFRS 16 Leases 1 January 2019	984	-
Addition	20	-
Indexation	21	-
Interest expense	45	-
Lease payments	(156)	-
Lease liability	914	-

Amounts are in ISK millions

32. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	2019	2018
ARION CBI 19, ISK 4,500 million	2013	2019	At maturity	Fixed, CPI linked, 2.50%	-	4,743
ARION CB 19, ISK 2,740 million	2016	2019	At maturity	Fixed, 5.50%	-	1,746
ARION CBI 21, ISK 10,220 million	2014	2021	At maturity	Fixed, CPI linked, 3.50%	10,176	9,950
ARION CB 22, ISK 28,720 million	2015	2022	At maturity	Fixed, 6.50%	28,264	28,503
ARION CB 24 ISK 19,240 million	2019	2024	At maturity	Fixed, 6.00%	16,060	-
ARION CBI 25, ISK 37,940 million	2017	2025	At maturity	Fixed, CPI linked, 3.00%	40,213	39,333
ARION CBI 26 ISK 12,960 million	2019	2026	At maturity	Fixed, CPI linked, 2.00%	12,320	-
ARION CBI 29, ISK 25,220 million	2014	2029	At maturity	Fixed, CPI linked, 3.50%	27,689	27,029
ARION CBI 48 ISK 11,680 million	2018	2048	Amortizing	Fixed, CPI linked, 2.50%	10,647	10,606
Statutory covered bonds					145,369	121,910
ARION CB 2, ISK 51,125 million	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	-	79,399
Structured Covered bonds					-	79,399
Total Covered bonds					145,369	201,309
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	-	19,376
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	-	1,037
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	-	3,601
SEK 100 million	2017	2019	At maturity	Fixed, 0.29%	-	1,310
NOK 800 million	2015	2020	At maturity	Floating, NIBOR +2.95%	11,143	10,846
NOK 320 million	2016	2020	At maturity	Floating, NIBOR +1.95%	4,439	4,326
EUR 300 million *	2017	2020	At maturity	Fixed, 0.75%	5,635	40,034
SEK 300 million	2017	2020	At maturity	Floating, 3 month STIBOR +1.35%	2,598	3,936
SEK 250 million	2017	2020	At maturity	Floating, 3 month STIBOR +0.75%	3,241	3,276
EUR 500 million *	2016	2021	At maturity	Fixed, 1.625%	67,713	65,845
EUR 13 million	2019	2021	At maturity	Floating, 3. EURIBOR +0.58%	1,765	-
NOK 750 million	2019	2022	At maturity	Floating, NIBOR +1.82%	10,382	-
SEK 150 million	2019	2022	At maturity	Floating, 3 month STIBOR +1.33%	1,949	-
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,512	3,423
EUR 300 million *	2018	2023	At maturity	Fixed, 1.00%	41,601	40,328
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,521	3,432
Senior unsecured bonds					157,499	200,770
Bills issued					1,680	15,505
Other borrowings					197	198
Other loans / bills					1,877	15,703
Borrowings					304,745	417,782

* The Group applies fair value hedge accounting to these bond issuances and uses certain foreign currency denominated interest rate swaps as hedging instruments, see Note 24.

The book value of listed bonds was ISK 303 billion at the end of the year (2018: ISK 402 billion). The market value of those bonds was ISK 315 billion (2018: ISK 411 billion). The Group repurchased own debts during the year for the amount of ISK 39 billion (2018: ISK 22 billion) with a net loss of ISK 300 million recognized in the Income Statement.

33. Subordinated liabilities

Currency, original nominal value	Issued	Maturity	Maturity type	Terms of interest	2019	2018
SEK 500 million *	2018	2028	At maturity	Floating, 3 month STIBOR +3.10% .	6,472	6,532
NOK 300 million	2019	2029	At maturity	Floating, NIBOR +3.65%	4,183	-
SEK 225 million	2019	2029	At maturity	Floating, 3 month STIBOR +3.70% .	2,918	
ARION T2I 30 ISK 4.800 million	2019	2030	At maturity	Fixed, CPI linked, 3.875%	4,913	-
ARION T2 30 ISK 880 million	2019	2030	At maturity	Fixed, 6.75%	907	-
EUR 5 million	2019	2031	At maturity	Fixed, 3.24%	690	-
Subordinated liabilities					20,083	6,532

* The notes are eligible as Tier 2 capital under the Icelandic Financial Undertakings Act No. 161/2002. The notes are callable by the issuer on 22 November 2023 and on every interest payment date thereafter.

Amounts are in ISK millions

34. Pledged assets

Pledged assets against liabilities	2019	2018
Assets, pledged as collateral against borrowings	186,902	239,164
Assets, pledged as collateral against loans from credit institutions and short positions	6,023	5,927
Pledged assets against liabilities	192,925	245,091

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 187 billion at the end of the year (2018: ISK 239 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 145 billion at the end of the year (2018: ISK 201 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.

35. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 1,814 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.

	Share capital	Share premium	2019	Share capital	Share premium	2018
Shares outstanding at the beginning of the year	1,814	57,196	59,010	2,000	73,861	75,861
Purchase of treasury stock	(41)	(3,242)	(3,283)	(190)	(16,949)	(17,139)
Employees stock grant	-	(12)	(12)	4	284	288
Shares outstanding at the end of the year	1,773	53,942	55,715	1,814	57,196	59,010
Own shares at year-end	41			186		
- as proportion of issued share capital	2.3%			9.3%		

At the Annual General Meeting of Arion Bank hf. on 20 March 2019 a motion was passed to reduce the company's share capital by ISK 186 million at nominal value, by cancelling the company's own shares. The reduction took place in April 2019. The company's share capital was reduced from ISK 2,000 million to ISK 1,814 million at nominal value, divided into an equal number of shares and with one vote attached to each share.

The meeting also authorized the Board of Directors to acquire, on behalf of the Bank, up to 10% of issued share capital in the Bank. The authorization remains in effect until the Bank's Annual General Meeting in 2020 or 15 September 2020, whichever occurs first. In 2019 the Board of Directors authorized the Bank to initiate the share buy-back programs in Iceland and Sweden. The purpose of the programs is to reduce the Bank's share capital (in line with the Bank's dividend policy). The Bank may purchase up to 59,000,000 shares in total under the programs, corresponding to 3.25% of the issued share capital, or for up to ISK 4.5 billion market value. In January 2020 the FSA approved the further buy-back of own shares for up to ISK 3.5 billion. The buy-back program will continue until the AGM in March 2020.

In 2018 Arion Bank acquired own shares following the decision to accept an offer from Kaupskil ehf., a subsidiary of Kaupthing ehf., to buy back 9.5% of issued share capital in Arion Bank, or 190 million shares. Arion Bank paid ISK 90.087 a share, a total of ISK 17,139 million.

According to a decision made by the Board of Directors, own shares were allocated to employees in connection with the Bank's IPO and listing in 2018. In total approximately 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees' stock grant programme, an employee who resigns within the vesting period of two years, returns the shares to the Bank.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

Other information

36. Shareholders of Arion Bank

	2019	2018
Taconic Capital (through TCA New Sidecar s.á.r.l.)	23.53%	9.99%
Sculptor Capital Management	9.53%	6.58%
Gildi lífeyrissjódur	8.79%	2.52%
Lansdowne partners	5.02%	2.95%
Stodir hf.	4.96%	0.61%
Goldman Sachs International	3.72%	3.47%
Lífeyrissjódur verzlunarmanna	3.67%	0.38%
Lífeyrissjódur starfsmanna ríkisins	3.47%	0.53%
Eaton Vance funds	3.23%	3.35%
Stefnir rekstrarfélag hf.	2.46%	0.51%
Arion banki hf.	2.27%	9.31%
Frjálsi lífeyrissjódurinn	2.18%	0.09%
Stapi lífeyrissjódur	1.89%	1.37%
Hvalur hf.	1.45%	0.00%
Birta lífeyrissjódur	1.32%	0.21%
Júpíter rekstrarfélag hf.	1.10%	0.99%
MainFirst Bank AG	1.09%	0.63%
Íslandsbanki hf.	1.00%	0.88%
Artemis	0.41%	1.69%
Attestor Capital	0.00%	7.35%
Miton Asset Management funds	0.00%	1.37%
Kaupskil ehf. (a subsidiary of Kaupthing hf.)	0.00%	32.67%
Other shareholders with less than 1% shareholding	18.91%	12.56%
	100.00%	100.00%

At year end 2018 Kaupskil ehf. was the largest shareholder of Arion Bank with a shareholding of 32.67% and Taconic Capital the second largest shareholder with a 9.99% shareholding. In 2019 Kaupskil ehf. sold its entire shareholding. Taconic Capital increased its shareholding in 2019 and is at year end the largest shareholder of Arion Bank.

37. Legal matters

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

Contingent liabilities

Legal proceedings regarding damages

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., has filed two cases against the Bank with a claim for damages in the amount of more than ISK 4 billion, plus interest. The plaintiffs maintain that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagid Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. In April 2018 the District Court of Reykjavík dismissed one of the cases. The plaintiffs appealed the judgment to the Court of Appeal. In June 2018 the Court of Appeal annulled the judgment of the District Court and ordered the District Court to hear the case again. The District Court acquitted the Bank of all claims with a judgment in September 2018. The plaintiffs appealed the judgment to the Court of Appeal. In December 2019 the Court of Appeal confirmed the District Court’s judgment. The plaintiffs have requested to appeal the case before the Supreme Court. The second case awaits the result of this first case. The Bank believes that it will be acquitted of the plaintiffs' claims in both cases and has therefore not made any provision.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

37. Legal matters, continued

In a lawsuit brought in June 2013, Kortathjónustan hf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and the Bank's subsidiary Valitor hf. in the amount of ISK 1.2 billion plus interest, as a result of damage Kortathjónustan hf. contended the five parties caused the company due to violations of the Competition Act. In June 2017 the Supreme Court dismissed the case on procedural grounds. Kortathjónustan hf. brought a new lawsuit in September 2017 regarding the same matter of dispute, claiming damages in the amount of ISK 922 million plus interest from the same defendants. The Court of Appeal dismissed the case in May 2018. Kortathjónustan tried to appeal the dismissal to the Supreme Court but the court dismissed the case as there was no right of complaint. In November 2018 EC-Clear brought a new lawsuit against the same defendants regarding the same matter of dispute, demanding the acknowledgement of liability for damages. EC-Clear was the largest shareholder in Kortathjónustan and according to the writ EC-Clear is now the owner of alleged liability claims against the defendants. The District Court dismissed the case in February 2019. EC-Clear appealed the dismissal to the Court of Appeal, which dismissed the case with a ruling in April 2019. In October 2019 EC-Clear brought a new lawsuit against the same defendants regarding the same matter of dispute, claiming damages in the amount of ISK 922 million plus interest from the same defendants, and demanding the acknowledgement of liability for damages. In December 2019 the case was dismissed as EC-Clear did not provide an insurance for legal expenses. Should the defendants be found liable for damages, they would be jointly responsible. Therefore the Bank has not made any provision.

Other legal matters

United Silicon

The company United Silicon was granted a moratorium on payments on 14 August 2017 and filed for bankruptcy on 22 January 2018. The Bank had collateral in the company's assets and the estate transferred the assets to the Bank. The trustee in the estate approved the Bank's secured claims but two unsecured creditors lodged a protest against the Bank's lien on the assets of United Silicon. The trustee in the bankruptcy referred the disagreement to the District Court of Reykjanes. The Bank examined these protests and rejected them all. In January 2020 the dispute was settled between the parties with minor effect on the Bank's value of the assets.

Legal matters concluded

Datacell case

In January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed a suit against Valitor hf. (a subsidiary of Valitor Holding hf.) for compensatory damages amounting to approximately ISK 8.1 billion plus interest relating to Valitor hf.'s termination 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 the authority to terminate the agreement. Following several rulings through the court system, during the last few years, a trial for the damages claim was held on 27 March 2019. On 24 April 2019 the District Court of Reykjavik issued a judgment. The conclusion was that Valitor should pay Sunshine Press Production ISK 1,140 million and Datacell ISK 60 million in damages, a total of ISK 1,200 million plus interest from 24 April 2019. All parties appealed the judgment to the Court of Appeal but the appeal was later withdrawn as part of a settlement between the parties, whereas Valitor agreed to pay Datacell and Sunshine Press Productions, according to the judgment. When Arion Bank acquired a 38.62% shareholding in Valitor Holding hf. in 2014, the Bank signed an agreement with the seller (Landsbankinn) which stipulated that the seller would bear a part of the liability which Valitor might potentially sustain in relation to the compensatory damages described above. Hence, Landsbankinn has taken on a part of the liability involved. Following the judgment, the Group made a provision of ISK 600 million in Q1 2019, after taking into accounts tax effects and aforementioned share of Landsbankinn. The Group will not have to make further provision after having entered into the above described settlement.

Settlement with the Financial Supervisory Authority

The Financial Supervisory Authority informed Arion Bank in April 2018 that it was looking into the Bank's handling of conflicts of interest in respect of the Bank’s role in the financing of the United Silicon plant at Helguvík. The Financial Supervisory Authority concluded its investigation in November 2019 by means of a settlement in which Arion Bank recognized that the Bank failed to keep a formal and systematic record of its analysis of conflicts of interest concerning the investment by pension funds in bonds in 2015 and their participation in share capital increases of Sameinað Sílikon hf. in 2016 and 2017. Matters of this nature may be brought to a conclusion by means of settlement as it does not constitute a serious offence, and Arion Bank agreed to pay a fine of ISK 21 million.

38. Events after the reporting period

No event has arisen after the reporting period and up to the approval of these Consolidated Financial Statements that require additional disclosures.

Off balance sheet information

39. Commitments

Financial guarantees, unused credit facilities and undrawn loan commitments	2019	2018
Financial guarantees	15,097	15,124
Unused overdrafts	44,923	48,320
Undrawn loan commitments	54,101	79,130
Financial guarantees, unused credit facilities and undrawn loan commitments	114,121	142,574

40. Assets under management and under custody

Assets under management	1,013,101	970,633
Assets under custody	1,370,946	1,422,327

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.

Related party

41. Related party

The Group has a related party relationship with an entity with an influence over the Group as the largest shareholder of Arion Bank, which is at year end 2019 Taconic Capital (23.53%). On 31 December 2018 Kaupskil ehf. (32.67%) and Taconic Capital (9.99%), the Board of Directors of Kaupskil ehf. and Kaupthing ehf., being the parent company of Kaupskil ehf. and legal entities controlled by them, were defined as related parties.

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

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.

Balances with related parties

2019	Assets	Liabilities	Net balance
Board of Directors and key Management personnel	184	(252)	(68)
Associates and other related parties	-	(59)	(59)
Balances with related parties	184	(311)	(127)
2018			
Shareholders with influence over the Group	70	(1,022)	(952)
Board of Directors and key Management personnel	246	(257)	(11)
Associates and other related parties	21	(71)	(50)
Balances with related parties	337	(1,350)	(1,013)

Transactions with related parties

2019	Interest income	Interest expense	Other income	Other expense
Shareholders with influence over the Group	34	(73)	4	(37)
Board of Directors and key Management personnel	6	(17)	17	(331)
Associates and other related parties	-	-	28	(1,631)
Transactions with related parties	40	(90)	49	(1,999)
2018				
Shareholders with influence over the Group	47	(94)	112	-
Board of Directors and key Management personnel	12	(16)	7	(347)
Associates and other related parties	-	-	21	(1,110)
Transactions with related parties	59	(110)	140	(1,457)

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

Risk management disclosures

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

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 its 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 controls 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 liquidity 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 allocation. The Underwriting and Investment Committee (UIC) decides on underwriting and principal investments. The Data Committee (DC) is responsible for ensuring that data is managed properly; and the Security Committee (SC) is responsible for security matters, both information security and physical security. The Bank operates three 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 Group's own funds, and the 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 Board Audit Committee (BAC).

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 three units: 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 responsible for the Bank's ICAAP and ILAAP; and Operational Risk which monitors risks associated with the daily operation of the Bank. The Bank's Security Officer and Data Officer is a part of the Risk Management division.

Arion Bank is a small bank in an international context, which nevertheless is classified as systemically important, operating in a small economy which is subject to sectoral concentration, fluctuations in capital flows, and exchange rate volatility. The Group’s most significant risks are credit risk, liquidity risk, interest rate risk, concentration risk, cyber risk and business 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.

Credit risk is one of the Group's primary risk factors. As a financial institution engaged in lending to individuals and companies, the Group faces possible failure of repayment by the borrower and/or the loans not being secured sufficiently. The collateral coverage ratio of loans to customers at year end 2019 was 89.6%.

Liquidity risk is a significant 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 73.5% is on-demand or with less than 30 day term.

The Group's operations are subject to interest rate risk associated with mismatches in the fixing period of interest rates between assets and liabilities. Prepayment risk has been considerable in the past years due to favorable refinancing conditions.

Concentration risk arises from concentration to a single counterparty, a group of connected counterparties, industry sectors and geography.

The Group's operations are subject to interest rate risk associated with mismatches in the fixing period of interest rates between assets and liabilities. Prepayment risk has been considerable in the past years due to favorable refinancing conditions.

Cyber risk refers to the risk of financial loss, disruption or damage to the reputation of an organization from some sort of failure of its information technology systems. With an expanding threat landscape, increasing frequency and complexity of cyber-crime this risk class is of increasing concern for financial institutions. The Group is subject to cyber risk.

The Group faces business risk in the form of onerous taxes which are exclusive to financial institutions in Iceland. The excessive taxation places an increased cost burden on the Group and subject it to a competitive disadvantages relative to other lenders that are not subject to such taxes and fewer regulations.

The Bank and its subsidiaries face legal risk arising from its operations as well as risk to its reputation.

Further information on risk management and capital adequacy is provided in the Pillar 3 Risk Disclosures for 2019. The Pillar 3 Risk Disclosures 2019 will be published in conjunction with the Financial Statements and be available on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not subject to external audit.

42. 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 derivatives, and off balance sheet items such as commitments and guarantees.

Managing and analyzing 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.

Exposure to credit risk

The table below shows the maximum exposure to credit risk for the components of the Statement of Financial Position before the effect of mitigation due to collateral agreements or other credit enhancements. The table also shows related collateral and 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. The quality of collateral is evaluated in the lending process with regards to specialization, location, age and condition and possibilities for reuse.

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. Collateral values are capped by the related exposure amount.

Maximum exposure to credit risk and collateral held against different types of financial instruments subject to the impairment requirements of IFRS 9

		Collateral				
2019	Maximum exposure	Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	95,717	-	-	-	-	-
Loans to credit institutions	17,947	-	-	-	-	-
Loans to customers at amortized cost	773,955	20,792	544,723	54,601	73,091	693,207
Individuals	*368,569*	*198*	*328,243*	*13*	*10,996*	*339,450*
Corporates	*405,386*	*20,594*	*216,480*	*54,588*	*62,095*	*353,757*
Real estate activities and construction	*129,856*	*1,972*	*113,465*	*55*	*8,022*	*123,514*
Fishing industry	*82,941*	*17*	*12,365*	*54,121*	*9,946*	*76,449*
Information and communication technology	*19,102*	*375*	*3,529*	-	*4,308*	*8,212*
Wholesale and retail trade	*54,989*	*375*	*32,508*	*7*	*15,980*	*48,870*
Financial and insurance activities	*33,669*	*17,726*	*7,254*	-	*7,622*	*32,602*
Industry, energy and manufacturing	*39,909*	*60*	*28,183*	-	*6,711*	*34,954*
Transportation	*11,066*	-	*1,048*	*313*	*3,285*	*4,646*
Services	*17,580*	*61*	*9,137*	*92*	*5,669*	*14,959*
Public sector	*8,617*	*4*	*2,194*	-	*289*	*2,487*
Agriculture and forestry	*7,657*	*4*	*6,797*	-	*263*	*7,064*
Other assets with credit risk	8,675	-	-	-	-	-
Financial guarantees	15,097	2,232	6,322	1,403	2,262	12,219
Undrawn loan commitments and unused overdrafts	99,024	-	-	-	-	-
Fair value through OCI	48,894	-	-	-	-	-
Government bonds	*41,417*	-	-	-	-	-
Corporate and finance bonds	*7,477*	-	-	-	-	-
Balance at the end of the year	1,059,309	23,024	551,045	56,004	75,353	705,426

Amounts are in ISK millions

42. Credit risk, continued

2018	Maximum exposure	Collateral Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	83,139	-	-	-	-	-
Loans to credit institutions	56,322	-	-	-	-	-
Loans to customers at amortized cost	829,014	18,324	590,513	59,143	83,469	751,449
Individuals	*400,483*	*837*	*363,615*	*18*	*11,027*	*375,497*
Corporates	*428,531*	*17,487*	*226,898*	*59,125*	*72,442*	*375,952*
Real estate activities and construction	*140,955*	*1,280*	*136,935*	*22*	*2,484*	*140,721*
Fishing industry	*84,128*	*11*	*9,452*	*57,978*	*10,771*	*78,212*
Information and communication technology	*20,635*	*550*	*3,562*	-	*6,618*	*10,730*
Wholesale and retail trade	*65,824*	*349*	*29,196*	*15*	*29,257*	*58,817*
Financial and insurance activities	*38,806*	*15,152*	*6,470*	*685*	*9,001*	*31,308*
Industry, energy and manufacturing	*35,406*	*61*	*23,801*	-	*7,520*	*31,382*
Transportation	*11,958*	*17*	*1,055*	*307*	*1,673*	*3,052*
Services	*16,531*	*64*	*7,407*	*118*	*4,535*	*12,124*
Public sector	*6,829*	*3*	*2,031*	-	*315*	*2,349*
Agriculture and forestry	*7,459*	-	*6,989*	-	*268*	*7,257*
Other assets with credit risk	5,807	-	-	-	-	-
Financial guarantees	15,124	1,574	4,408	1,949	4,652	12,583
Undrawn loan commitments and unused overdrafts	127,450	-	-	-	-	-
Fair value through OCI	53,788	-	-	-	-	-
Government bonds	*44,084*	-	-	-	-	-
Corporate and finance bonds	*9,704*	-	-	-	-	-
Balance at the end of the year	1,170,644	19,898	594,921	61,092	88,121	764,032

LTV ratio for residential mortgage lending

The following table describes the loan to value (LTV) and impairment status of the Group's mortgage loan book. LTV is calculated as the ratio of the gross amount of the loan to the value of the collateral without adjusting for possible costs of obtaining and selling the collateral. The collateral value is based on the value at origination, the most recent appraisal or official property valuation from the Icelandic Property Registry. For credit impaired loans the value of collateral is based on the most recent appraisal.

	2019 Gross carrying amount	Thereof credit impaired	2018 Gross carrying amount	Thereof credit impaired
Less than 50%	119,734	1,283	148,995	1,516
50-70%	130,257	2,546	132,893	2,499
70-90%	63,099	1,131	58,422	1,209
90-100%	7,369	170	12,773	482
100-110%	2,658	60	3,904	97
More than 110%	10,873	698	9,543	656
Not classified	47	-	6	-
Balance at the end of the year	334,037	5,888	366,536	6,459

At the end of the year the gross carrying amount of assets in stage 3 are ISK 20,155 million (31.12.2018: ISK 18,175 million) with ISK 13,618 million in collateral (31.12.2018: ISK 12,881 million), there of ISK 11,791 million in real estates (31.12.2018: 11,045 million).

Collateral repossessed

During the year the Group took possession of assets due to foreclosures. The total amounts of real estates the Group took possession of during the year and still holds at the end of the year amount to ISK 501 million (31.12.2018: ISK 827 million) and in other assets ISK 9 million (31.12.2018: ISK 31 million). The assets are held for sale, see Note 29.

Amounts are in ISK millions

42. Credit risk, continued

Credit quality

The Group uses internal credit ratings and external credit ratings if available to monitor credit risk. The Group's internal credit rating system rates customers through application of statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgment for large corporate exposures. Six exposure type models rate individuals' exposures – mortgages, consumer loans, auto loans, guarantees, loans to individuals for work purposes and other loans. The models are updated at least annually and recalibrated with current data with the aim of maintaining their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement. All internal models were updated during 2019 and new models and model structure first deployed at the end of 2019. External ratings are primarily used for marketable securities and loans to credit institutions. For further information on the rating scales used, see Note 56.

The following tables show financial instruments subject to the impairment requirements of IFRS 9 broken down by rating scale, where risk class 5, DD denotes, the highest risk. Assets carried at fair value through profit and loss are not subject to the impairment requirements of IFRS 9. The tables below sum up the gross carrying amount of assets by rating class and current impairment stage. The gross carrying amount net of loss allowance shows the book value of the underlying assets.

Exposures that are 'Unrated' are typically due to newly formed entities, entities for which the Bank's rating models are not applicable or no external rating is available.

Credit quality profile by rating class

2019	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI
Loans to credit institutions, securities and cash			
Investment grade	95,717	16,099	48,900
Non-investment grade	-	1,864	-
Gross carrying amount	95,717	17,963	48,900
Loss allowance	-	(16)	(6)
Book value	95,717	17,947	48,894

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 0 to 1 (Grades AAA to BBB-)	369,623	981	-	-	370,604
Risk class 2 (Grades BB+ to BB-)	196,133	35,291	-	81	231,505
Risk class 3 (Grades B+ to B-)	94,515	37,100	-	39	131,654
Risk class 4 (Grades CCC+ to CCC-)	11,669	15,828	-	114	27,611
Risk class 5 (DD)	2	-	20,158	503	20,663
Unrated	661	426	2	-	1,089
Gross carrying amount	672,603	89,626	20,160	737	783,126
Loss allowance	(974)	(921)	(7,067)	(209)	(9,171)
Book value	671,629	88,705	13,093	528	773,955

Loans to customers - Individuals					
Risk class 0 to 1 (Grades AAA to BBB-)	272,967	723	-	-	273,690
Risk class 2 (Grades BB+ to BB-)	60,165	2,257	-	81	62,503
Risk class 3 (Grades B+ to B-)	13,882	3,125	-	39	17,046
Risk class 4 (Grades CCC+ to CCC-)	4,156	6,573	-	114	10,843
Risk class 5 (DD)	-	-	6,450	503	6,953
Unrated	25	54	2	-	81
Gross carrying amount	351,195	12,732	6,452	737	371,116
Loss allowance	(418)	(319)	(1,601)	(209)	(2,547)
Book value	350,777	12,413	4,851	528	368,569

Amounts are in ISK millions

42. Credit risk, continued

Loans to customers - Companies and sovereign	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 0 to 1 (Grades AAA to BBB-)	96,656	258	-	-	96,914
Risk class 2 (Grades BB+ to BB-)	135,968	33,034	-	-	169,002
Risk class 3 (Grades B+ to B-)	80,633	33,975	-	-	114,608
Risk class 4 (Grades CCC+ to CCC-)	7,513	9,255	-	-	16,768
Risk class 5 (DD)	2	-	13,708	-	13,710
Unrated	636	372	-	-	1,008
Gross carrying amount	321,408	76,894	13,708	-	412,010
Loss allowance	(556)	(602)	(5,466)	-	(6,624)
Book value	320,852	76,292	8,242	-	405,386

Loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Risk class 0 to 1 (Grades AAA to BBB-)	53,650	1	-	53,651
Risk class 2 to 4 (Grades BB+ to CCC-)	43,205	8,349	1,790	53,344
Unrated	5,688	1,438	-	7,126
Gross carrying amount	102,543	9,788	1,790	114,121
Loss allowance	(165)	(244)	(73)	(482)
Book value	102,378	9,544	1,717	113,639

Amounts are in ISK millions

42. Credit risk, continued

2018	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI
Loans to credit institutions, securities and cash			
Investment grade	83,141	55,954	53,795
Non-investment grade	-	403	-
Gross carrying amount	83,141	56,357	53,795
Loss allowance	(2)	(35)	(7)
Book value	83,139	56,322	53,788

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 0 to 1 - (Grades AAA to BBB-)	370,832	78	-	-	370,910
Risk class 2 - (Grades BB+ to BB-)	265,361	18,521	-	41	283,923
Risk class 3 - (Grades B+ to B-)	107,897	24,582	-	87	132,566
Risk class 4 - (Grades CCC+ to CCC-)	15,287	11,318	-	48	26,653
Risk class 5 - (DD)	-	-	18,175	3,640	21,815
Unrated	1,977	1,061	-	-	3,038
Gross carrying amount	761,354	55,560	18,175	3,816	838,905
Loss allowance	(1,415)	(931)	(6,301)	(1,244)	(9,891)
Book value	759,939	54,629	11,874	2,572	829,014
Loans to customers - Individuals					
Risk class 0 to 1 (Grades AAA to BBB-)	222,003	-	-	-	222,003
Risk class 2 (Grades BB+ to BB-)	118,271	4,831	-	41	123,143
Risk class 3 (Grades B+ to B-)	32,562	3,255	-	87	35,904
Risk class 4 (Grades CCC+ to CCC-)	8,368	5,390	-	48	13,806
Risk class 5 (DD)	-	-	8,467	815	9,282
Unrated	32	3	-	-	35
Gross carrying amount	381,236	13,479	8,467	991	404,173
Loss allowance	(739)	(311)	(2,408)	(233)	(3,691)
Book value	380,497	13,168	6,059	758	400,482
Loans to customers - Companies and sovereign					
Risk class 0 to 1 (Grades AAA to BBB-)	148,829	78	-	-	148,907
Risk class 2 (Grades BB+ to BB-)	147,090	13,690	-	-	160,780
Risk class 3 (Grades B+ to B-)	75,335	21,327	-	-	96,662
Risk class 4 (Grades CCC+ to CCC-)	6,919	5,928	-	-	12,847
Risk class 5 (DD)	-	-	9,708	2,825	12,533
Unrated	1,945	1,058	-	-	3,003
Gross carrying amount	380,118	42,081	9,708	2,825	434,732
Loss allowance	(676)	(620)	(3,893)	(1,011)	(6,200)
Book value	379,442	41,461	5,815	1,814	428,532

Loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Risk class 0 to 1 - (Grades AAA to BBB-)	78,151	1	-	78,152
Risk class 2 to 4 - (Grades BB+ to CCC-)	55,751	6,589	1,676	64,016
Unrated	368	38	-	406
Gross carrying amount	134,270	6,628	1,676	142,574
Loss allowance	(147)	(485)	(57)	(689)
Book value	134,123	6,143	1,619	141,885

Amounts are in ISK millions

42. Credit risk, continued

The following tables reconciles the opening and closing allowance balance for loans to customers and debt securities at amortized cost and FVOCI and loan commitments, guarantees and unused credit facilities by their impairment requirements.

The reconciliation includes:

Transfers of financial assets between impairment requirements: include transfers to 12 month expected credit losses, to lifetime expected credit losses and credit impaired financial assets. All transfers are presumed to occur before any corresponding remeasurement of the loss allowance.

Net remeasurement of loss allowance: comprise the impact of changes in model inputs or assumptions, including changes in forward-looking macroeconomic conditions, partial repayments and additional draws on existing facilities, inflation, changes in the measurement following a transfer between stages, impairment of interest income due to impaired debt instruments and unwinding of the time value discount due to the passage of time.

New financial assets: include purchases and originations and reflect the allowance related to assets newly recognized during the period.

Derecognitions and maturities, reflect the allowance related to assets derecognized during the period without a credit loss being incurred, including those assets that were derecognized following a modification of terms.

Write-offs: the amount after net remeasurements of loss allowance written off during the year.

Foreign exchange: the effects of foreign exchange on the loss allowance between years.

During the fourth quarter new PD and LGD models were implemented into the expected credit loss calculations. The effect of implementing the new models was a decrease in impairments of approximately of ISK 250 million. The effects is measured under net remeasurement. For further information on the models, see Note 56.

2019

*Impairment loss allowance **	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	1,607	1,416	6,358	1,244	10,625
Transfers of financial assets:					
Transfers to Stage 1 (12-month ECL)	2,193	(1,761)	(432)	-	-
Transfers to Stage 2 (lifetime ECL)	(675)	779	(104)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(136)	(1,139)	1,275	-	-
Net remeasurement of loss allowance **	(2,291)	1,945	3,181	650	3,485
New financial assets, originated or purchased	1,037	325	1,488	-	2,850
Derecognitions and maturities	(544)	(392)	(1,696)	(1,675)	(4,307)
Write-offs ***	(20)	-	(2,987)	(102)	(3,109)
Foreign exchange difference	13	(8)	57	92	154
Impairment loss allowance ******	**1,184**	**1,165**	**7,140**	**209**	**9,698**
Impairment loss allowances for assets only carrying 12-month ECL	22	-	-	-	22
Total impairment loss allowance	1,206	1,165	7,140	209	9,720

* These amounts are a combination of all impairments, including an allowance for loan commitments and guarantees presented as a liability in these Financial Statements.

** During the year the loss allowance balance for stage 3 loans was raised by ISK 789 million due to unwinding of interest income.

*** During the year an amount of ISK 2,672 million was written off but is still subject to enforcement activities subject to Icelandic law.

**** Loss allowance for all assets other than cash, bonds and loans to credit institutions.

Impairment loss allowance for loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	1,415	931	6,301	1,244	9,891
Transfers of financial assets:					
Transfers to Stage 1 (12-month ECL)	1,939	(1,507)	(432)	-	-
Transfers to Stage 2 (lifetime ECL)	(624)	728	(104)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(133)	(675)	808	-	-
Net remeasurement of loss allowance	(1,981)	1,542	2,754	650	2,965
New financial assets, originated or purchased	637	85	1,462	-	2,184
Derecognitions and maturities	(270)	(168)	(788)	(1,675)	(2,901)
Write-offs	(17)	(7)	(2,991)	(102)	(3,117)
Foreign exchange differences	8	(8)	57	92	149
Total loss allowance for loans to customers	974	921	7,067	209	9,171

Amounts are in ISK millions

42. Credit risk, continued

2019

Impairment loss allowance for loans to customers - Individuals	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	740	313	2,406	232	3,691
Transfers of financial assets					
Transfers to Stage 1 (12-month ECL)	1,195	(948)	(247)	-	-
Transfers to Stage 2 (lifetime ECL)	(341)	423	(82)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(96)	(393)	489	-	-
Net remeasurement of loss allowance	(1,197)	993	415	75	286
New financial assets, originated or purchased	246	3	13	-	262
Derecognitions and maturities	(112)	(66)	(210)	-	(388)
Write-offs	(17)	(7)	(1,198)	(99)	(1,321)
Foreign exchange differences	-	1	15	1	17
Total loss allowance for individuals	418	319	1,601	209	2,547

Impairment loss allowance for loans to customers - Companies and sovereign	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	675	618	3,895	1,012	6,200
Transfers of financial assets					
Transfers to Stage 1 (12-month ECL)	744	(559)	(185)	-	-
Transfers to Stage 2 (lifetime ECL)	(283)	305	(22)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(37)	(282)	319	-	-
Net remeasurement of loss allowance	(784)	549	2,339	575	2,679
New financial assets, originated or purchased	391	82	1,449	-	1,922
Derecognitions and maturities	(158)	(102)	(578)	(1,675)	(2,513)
Write-offs	-	-	(1,793)	(3)	(1,796)
Foreign exchange differences	8	(9)	42	91	132
Total loss allowance for companies and sovereign	556	602	5,466	-	6,624

Impairment loss allowance for loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Balance at the beginning of the year	147	485	57	689
Transfers				
Transfers to 12-month ECL	254	(254)	-	-
Transfers to lifetime ECL	(51)	51	-	-
Transfers to credit impaired	(3)	(464)	467	-
Net remeasurement of loss allowance	(310)	403	427	520
New financial commitments originated	400	240	26	666
Derecognitions and maturities	(274)	(224)	(908)	(1,406)
Foreign exchange differences	(3)	7	4	8
Other	5	-	-	5
Total loss allowance for loan commit., guarantees and unused credit facilities	165	244	73	482

Large exposures

A large exposure is defined as an exposure to a group of financially related borrowers which is equal to or exceeds 10% of the Group's eligible capital according to Financial Undertakings Act No. 161/2002 and Regulation No. 233/2017 on prudential requirements. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible credit risk mitigation.

The Group has two large exposures at year end 2019, one of which is an exposure against a rated bank with better credit rating than the Icelandic Government, totaling ISK 36.8 billion (21.3% of eligible capital) before taking into account eligible credit risk mitigation (31.12.2018: no large exposure). The total exposure is ISK 36.6 billion (21.2% of eligible capital) after taking into account eligible credit risk mitigation.

Amounts are in ISK millions

43. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates adversely affect the Group's earnings and equity position due to changes to the value and cash flows of its assets and liabilities.

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 market making 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 aims to manage and limit market exposures and imbalances between assets and liabilities in accordance with its risk appetite and strategic goals for net profit.

Interest rate risk

Interest rate risk arises from the possibility that changes in market rates adversely affect net interest income and fair value of interest-bearing instruments on the Group's balance sheet. The Group's operations are subject to interest rate risk due to mismatches in the fixing of interest rates between assets and liabilities, 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 interest rate risk for foreign currencies is limited as foreign denominated assets predominantly have short fixing periods and the Group generally applies cash flow hedging for its foreign denominated fixed rate borrowings. For domestic rates, longer fixing periods are more common. The sale of the Arion Bank Mortgage Institutional Fund mortgage portfolio, executed in October 2019, with resulting full prepayment of the remaining matched structural covered bonds issuance, significantly shortens the interest fixing profile of the Bank for indexed rates.

Due to favorable refinancing spreads, prepayments and/or refinancing of loans have been considerable over the past few years, resulting in reduced average duration of fixed rates for the Bank's assets. Prepayment risk is mitigated by prepayment fees and the Group's own prepayment options. The Group's prepayment of structured covered bonds is a reaction to mortgage prepayments and mortgage refinancing. Decreasing domestic interest rates furthermore put pressure on the Group's net interest income as a result of tighter margins for deposit funding.

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 24, and are therefore different from the amounts shown in these Consolidated Financial Statements. The fair value reflects the likelihood of prepayment. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category. The assets and liabilities of Valitor holding hf. are not included in the figures as they are classified as held for sale.

2019 *Assets*	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	91,511	-	-	-	-	91,511
Loans to credit institutions	17,947	-	-	-	-	17,947
Loans to customers	497,936	84,260	148,015	9,076	38,033	777,320
Financial instruments	24,470	9,625	9,743	1,150	3,925	48,913
Assets	631,864	93,885	157,758	10,226	41,958	935,691
Liabilities						
Due to credit institutions and Central Bank	5,984	-	-	-	-	5,984
Deposits	449,627	30,875	9,826	1,474	1,114	492,916
Borrowings	35,359	5,668	174,814	89,264	11,484	316,589
Subordinated loans	13,975	-	-	6,202	-	20,177
Liabilities	504,945	36,543	184,640	96,940	12,598	835,666
Derivatives and other off-balance sheet items (net position)	(102,295)	25	104,180	869	-	2,779
Net interest gap	24,624	57,367	77,298	(85,845)	29,360	102,804

Amounts are in ISK millions

43. Market risk, continued

2018	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Assets						
Balances with Central Bank	78,081	-	-	-	-	78,081
Loans to credit institutions	56,322	-	-	-	-	56,322
Loans to customers	498,065	88,553	148,853	7,794	93,888	837,153
Financial instruments	9,543	10,941	30,847	664	2,015	54,010
Assets	642,011	99,494	179,700	8,458	95,903	1,025,566
Liabilities						
Due to credit institutions and Central Bank	9,204	-	-	-	-	9,204
Deposits	430,260	20,277	13,156	1,383	991	466,067
Borrowings	37,497	33,242	190,111	44,425	121,115	426,390
Subordinated loans	6,532	-	-	-	-	6,532
Liabilities	483,493	53,519	203,267	45,808	122,106	908,193
Derivatives and other off-balance sheet items (net position)	(185,255)	40,259	150,397	(2,484)	-	2,917
Net interest gap	(26,737)	86,234	126,830	(39,834)	(26,203)	120,290

Sensitivity analysis of interest rate risk in the banking book

The following table shows the sensitivity of the Group's net present value (NPV) of interest-bearing assets and liabilities and variation of annual net interest income (NII), due to changes in interest rates by currencies. The variation is calculated on the basis of simultaneous parallel shifts upwards or downwards of yield curves. The choice of shifts is not an estimate of risk likelihood. Behavioral maturities are taken into account in the NPV calculations, including prepayment likelihood and expected behavior of non-maturing deposits. The change to NII is however primarily based on contractual interest rate adjustments where it is simplistically assumed that all rates are equally sensitive to the presumed change in market rates. Behavioral maturity assumptions are however applied for non-maturing deposits and a zero percentage floor is applied to krona deposit interest rates

	2019		2018	
NPV change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(3,198)	2,651	(4,544)	4,872
ISK, Non index-linked	(135)	210	624	(139)
Foreign currencies	365	(392)	700	(708)
NII change				
ISK, CPI index-linked	(751)	719	(828)	828
ISK, Non index-linked	(1,078)	434	(90)	90
Foreign currencies	200	(200)	232	(232)

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.

	2019		2018	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	83	(74)	123	(111)
ISK, Non index-linked	107	(100)	62	(54)
Foreign currencies	(77)	73	13	(13)

Amounts are in ISK millions

43. Market risk, continued

Indexation risk

A significant part of the Group's balance sheet is linked to the Icelandic Consumer Price Index (CPI). For index-linked instruments, principal and interest payments are adjusted proportionally to the CPI. The Group is exposed to indexation risk as indexed assets exceed indexed liabilities. Financial instruments held for liquidity or market making purposes are assumed to be on demand.

Book value and maturity profile of indexed assets and liabilities

2019	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	18,945	57,405	207,514	283,864
Financial instruments	13,647	-	-	13,647
Assets, CPI index-linked	32,592	57,405	207,514	297,511
Liabilities, CPI index-linked				
Deposits	75,944	13,381	2,582	91,907
Borrowings	269	11,329	89,644	101,242
Subordinated liabilities	-	-	4,913	4,913
Other	1,046	210	1,427	2,683
Off-balance sheet position	1,036	6,675	125	7,836
Liabilities, CPI index-linked	78,295	31,595	98,691	208,581
Net on-balance sheet position	(44,667)	32,485	108,948	96,766
Net off-balance sheet position	(1,036)	(6,675)	(125)	(7,836)
CPI Balance	(45,703)	25,810	108,823	88,930
CPI Balance for prudential consolidation, which excludes insurance operations *	(52,586)	26,020	109,256	82,689

2018	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	30,455	79,761	246,605	356,821
Financial instruments	12,791	-	-	12,791
Off-balance sheet position	532	(995)	-	(463)
Assets, CPI index-linked	43,778	78,766	246,605	369,149
Liabilities, CPI index-linked				
Deposits	72,766	12,735	2,367	87,868
Borrowings	6,482	17,567	147,209	171,258
Other	875	208	1,420	2,503
Off-balance sheet position	895	4,999	1,082	6,976
Liabilities, CPI indexed linked	81,018	35,509	152,078	268,605
Net on-balance sheet position	(36,877)	49,251	95,609	107,983
Net off-balance sheet position	(363)	(5,994)	(1,082)	(7,439)
CPI Balance	(37,240)	43,257	94,527	100,544
CPI Balance for prudential consolidation, which excludes insurance operations *	(36,662)	42,540	91,304	97,182

* Consolidated situation as per EU Regulation No 575/2013 (CRR)

Amounts are in ISK millions

43. 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

2019

Financial assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	94,363	534	286	173	65	53	243	95,717
Loans to credit institutions	2,024	5,845	4,835	1,355	628	656	2,604	17,947
Loans to customers	608,144	116,793	35,113	3,956	4,578	2	5,369	773,955
Financial instruments	73,482	18,253	22,618	35	2	2,868	148	117,406
Other financial assets	5,354	160	3,096	-	22	4	39	8,675
Financial assets	783,367	141,585	65,948	5,519	5,295	3,583	8,403	1,013,700
Financial liabilities								
Due to credit inst. and Central Bank	2,548	1,748	1,675	13	-	-	-	5,984
Deposits	424,136	28,730	30,729	2,071	2,504	2,900	1,846	492,916
Financial liabilities at fair value	1,665	561	66	17	-	192	69	2,570
Other financial liabilities	4,178	335	967	201	371	53	303	6,408
Borrowings	147,245	116,712	-	-	-	32,999	7,789	304,745
Subordinated liabilities	5,820	690	-	-	-	4,183	9,390	20,083
Financial liabilities	585,592	148,776	33,437	2,302	2,875	40,327	19,397	832,706
Net on-balance sheet position	197,775	(7,191)	32,511	3,217	2,420	(36,744)	(10,994)	
Net off-balance sheet position	(2,575)	1,522	(36,242)	(4,825)	(4,694)	36,252	10,562	
Net position	195,200	(5,669)	(3,731)	(1,608)	(2,274)	(492)	(432)	
Non-financial assets								
Investment property	7,119	-	-	-	-	-	-	7,119
Investments in associates	852	-	-	-	-	-	-	852
Intangible assets	8,367	-	-	-	-	-	-	8,367
Tax assets	2	-	-	-	-	-	-	2
Assets and disposal groups held for sale	20,632	13,080	1,302	5,637	1,206	307	1,462	43,626
Other non financial assets	7,963	119	27	56	1	18	5	8,189
Non-financial assets	44,935	13,199	1,329	5,693	1,207	325	1,467	68,155
Non-financial liabilities and equity								
Tax liabilities	4,404	-	-	-	-	-	-	4,404
Liabilities associated with disposal groups held for sale	11,442	8,667	71	2,849	2,597	496	2,509	28,631
Other non-financial liabilities	26,097	141	46	-	5	-	-	26,289
Shareholders' equity	189,644	-	-	-	-	-	-	189,644
Non-controlling interest	181	-	-	-	-	-	-	181
Non-financial liabilities and equity	231,768	8,808	117	2,849	2,602	496	2,509	249,149
Intangible assets of Valitor in foreign operation excluded *	1,534	-	-	(1,455)	(79)	-	-	
Management reporting of currency risk **	9,901	(1,278)	(2,519)	(219)	(3,748)	(663)	(1,474)	

* Based on an authorization from the Icelandic FSA to exclude Valitor's intangible assets in the currency balance.

** The net position of the currency risk is presented in accordance with IFRS. The management monitors currency risk with more assets and liabilities underlying, such as tax assets and liabilities and intangible assets, as it is considered to be a more accurate measurement of the Group's currency exposure. The net position, as seen by the management, is the position used for managing the currency imbalance.

Amounts are in ISK millions

43. Market risk, continued

2018								
Financial assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	81,245	833	222	168	179	59	433	83,139
Loans to credit institutions	3,158	16,418	14,055	1,484	1,191	15,722	4,294	56,322
Loans to customers	680,413	103,775	33,473	3,290	6,912	692	5,271	833,826
Financial instruments	53,852	30,915	26,930	771	189	1,649	251	114,557
Other financial assets	5,381	318	54	-	48	4	2	5,807
Financial assets	824,049	152,259	74,734	5,713	8,519	18,126	10,251	1,093,651
Financial liabilities								
Due to credit inst. and Central Bank	7,144	945	1,109	4	-	1	1	9,204
Deposits	398,789	35,773	22,615	2,110	1,632	1,954	3,194	466,067
Financial liabilities at fair value	1,281	494	383	54	-	39	69	2,320
Other financial liabilities	3,599	353	1,458	148	333	41	198	6,130
Borrowings	218,049	165,583	-	-	-	22,027	12,123	417,782
Subordinated liabilities	-	-	-	-	-	-	6,532	6,532
Financial liabilities	628,862	203,148	25,565	2,316	1,965	24,062	22,117	908,035
Net on-balance sheet position	195,187	(50,889)	49,169	3,397	6,554	(5,936)	(11,866)	
Net off-balance sheet position	5,071	44,881	(48,840)	(7,403)	(10,536)	5,963	10,864	
Net position	200,258	(6,008)	329	(4,006)	(3,982)	27	(1,002)	
Non-financial assets								
Investment property	7,092	-	-	-	-	-	-	7,092
Investments in associates	810	8	-	-	-	-	-	818
Intangible assets	6,397	-	-	-	-	-	-	6,397
Tax assets	90	-	-	-	-	-	-	90
Assets and disposal groups								-
held for sale	23,959	9,849	1,010	7,603	4,003	532	1,628	48,584
Other non financial assets	7,536	107	19	8	2	23	-	7,695
Non-financial assets	45,884	9,964	1,029	7,611	4,005	555	1,628	70,676
Non-financial liabilities and equity								
Tax liabilities	5,119	-	-	-	-	-	-	5,119
Liabilities associated with disposal								
groups held for sale	19,843	1,254	793	3,378	577	400	92	26,337
Other non-financial liabilities	23,883	70	20	-	1	-	3	23,977
Shareholders' equity	200,729	-	-	-	-	-	-	200,729
Non-controlling interest	130	-	-	-	-	-	-	130
Non-financial assets	249,704	1,324	813	3,378	578	400	95	256,292
Management reporting								
of currency risk *	(3,562)	2,632	545	227	(555)	182	531	

* The net position of the currency risk is presented in accordance with IFRS. The management monitors currency risk with more assets and liabilities underlying, such as tax assets and liabilities and intangible assets, as it is considered to be a more accurate measurement of the Group's currency exposure. The net position, as seen by the management, is the position used for managing the currency imbalance.

Amounts are in ISK millions

43. Market risk, continued

Sensitivity analysis for currency risk

The table below indicates the currencies to which the Group had significant exposure at the end of the period. 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 Consolidated Interim Income Statement (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 Consolidated Interim Income Statement 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).

	2019		2018	
Currency	-10%	+10%	-10%	+10%
EUR	128	(128)	(263)	263
USD	252	(252)	(55)	55
GBP	22	(22)	(23)	23
DKK	375	(375)	56	(56)
NOK	66	(66)	(18)	18
Other	147	(147)	(53)	53

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 30 and 23 respectively.

Sensitivity analysis for equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices that affect the Consolidated Financial Statements. A negative amount in the table reflects a potential net reduction in the Consolidated Income Statement or equity, while a positive amount reflects a potential net increase. Investments in associates are excluded. The result of value-at-risk calculations for the trading book are shown in the Group's Pillar 3 Disclosures.

	2019		2018	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(301)	301	(231)	231
Banking book - listed	(486)	486	(487)	487
Banking book - unlisted	(296)	296	(617)	617

Derivatives

Derivatives are a part of the Group's customer product offering. The types of derivatives currently offered are forward contracts, swaps and options. Eligible underlying market factors are interest rates, foreign exchange rates, equities and commodities. Exposure limits, hedging requirements and collateral requirements are determined in accordance with the Group's risk appetite and monitored by Risk Management on a daily basis. The Group also uses derivatives to hedge market risk on its balance sheet. Note 24 provides a breakdown of the Group's derivative positions by type.

Amounts are in ISK millions

44. 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.

A primary source of funding for the Group is from 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 71% 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 set by the Board of Directors. 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 on a daily basis.

The Group's strategy in relation to liquidity risk is to actively manage its liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. The Group seeks to maintain a stable funding profile which supports its business strategy and liquidity profile, ensuring that the Group can withstand periods of market turbulence, without reliance on volatile funding or external support.

Maturity analysis of assets and liabilities

The maturity analysis is based on contractual cash flows. The amounts are not discounted and include future interest payments, but CPI-linked amounts do not include accrued indexation due to future inflation. The total amount for each item is higher than the corresponding amount on the Bank's balance sheet, since the amounts on the balance sheet are either at amortized cost and do not contain future interest payments, or at fair value where future cash flows have been discounted.

Contractual cash flows differ in many ways from expected cash flows. The difference is most significant for deposits on the liability side and bonds on the asset side. Deposits are always assumed to be withdrawn at the earliest possible date, despite the fact that a large part of the deposit base is considered to be stable funding where behavioral maturity considerably exceeds contractual maturity. Furthermore, although contractual cash flows are presented for bonds held by the Bank, a large portion of the bonds are a part of the Bank's liquidity buffer and are considered to be highly liquid and can be sold and/or pledged to the Central Bank of Iceland and thus converted into cash at very short notice.

Contractual cash flow of assets and liabilities

2019	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Book value
Financial assets								
Cash and balances with CB	6,352	84,434	5,059	-	-	-	95,845	95,717
Loans to credit institutions	15,652	2,295	-	-	-	-	17,947	17,947
Loans to customers	6,191	124,040	105,974	299,695	578,647	-	1,114,547	773,955
Financial instruments	16,381	28,346	11,451	22,612	10,238	34,063	123,091	117,406
Derivatives - assets leg	-	*69,432*	*12,020*	*48,571*	*357*	-	*130,380*	*124,911*
Derivatives - liabilities leg	-	*(66,935)*	*(11,006)*	*(43,875)*	*(294)*	-	*(122,110)*	*(118,295)*
Other financial instruments	*16,381*	*25,849*	*10,437*	*17,916*	*10,175*	*34,063*	*114,821*	*110,790*
Other financial assets	577	4,618	2,656	824	-	-	8,675	8,675
Financial assets	45,153	243,733	125,140	323,131	588,885	34,063	1,360,105	1,013,700
Financial liabilities								
Due to credit inst. and Central Bank	5,997	-	26	-	-	-	6,023	5,984
Deposits	350,451	78,459	42,423	14,318	9,279	-	494,930	492,916
Financial liabilities at fair value	-	1,506	1,318	1,812	44	-	4,680	2,570
Derivatives - assets leg	-	*(48,335)*	*(6,983)*	*(8,218)*	*(1,360)*	-	*(64,896)*	*(63,456)*
Derivatives - liabilities leg	-	*49,326*	*8,301*	*10,030*	*1,404*	-	*69,061*	*65,510*
Short position bonds and derivatives	-	*408*	-	-	-	-	*408*	*409*
Short position securities used for economic hedging	-	*107*	-	-	-	-	*107*	*107*
Other financial liabilities	141	3,856	119	559	1,733	-	6,408	6,408
Borrowings	-	7,416	32,028	202,725	101,862	-	344,031	304,745
Subordinated liabilities	-	479	566	3,316	23,908	-	28,269	20,083
Financial liabilities	356,589	91,716	76,480	222,730	136,826	-	884,341	832,706
Net position for assets and liab.	(311,436)	152,017	48,660	100,401	452,059	34,063	475,764	180,994
Off-balance sheet items								
Financial guarantees	554	2,617	1,202	3,560	7,164	-	15,097	15,097
Unused overdraft	-	44,923	-	-	-	-	44,923	44,923
Undrawn loan commitments	-	43,406	9,455	1,240	-	-	54,101	54,101
Off-balance sheet items	554	90,946	10,657	4,800	7,164	-	114,121	114,121
Net contractual cash flow	(311,990)	61,071	38,003	95,601	444,895	34,063	361,643	66,873

Amounts are in ISK millions

44. Liquidity and Funding risk, continued

2018	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Book value
Financial assets								
Cash and balances with CB	-	77,854	5,373	-	-	-	83,227	83,139
Loans to credit institutions	34,635	20,714	585	403	-	-	56,337	56,322
Loans to customers	2,937	116,527	126,990	332,488	655,349	-	1,234,291	833,826
Financial instruments	17,081	7,375	15,674	44,436	8,768	26,856	120,190	114,557
Derivatives - assets leg	-	*41,746*	*23,340*	*45,303*	*3,184*	-	*113,573*	*105,449*
Derivatives - liabilities leg	-	*(41,110)*	*(21,143)*	*(39,681)*	*(3,039)*	-	*(104,973)*	*(99,209)*
Other financial instruments	*17,081*	*6,739*	*13,477*	*38,814*	*8,623*	*26,856*	*111,590*	*108,317*
Other financial assets	393	1,921	2,592	896	5	-	5,807	5,807
Financial assets	55,046	224,391	151,214	378,223	664,122	26,856	1,499,852	1,093,651
Financial liabilities								
Due to credit inst. and Central Bank	9,230	-	27	-	-	-	9,257	9,204
Deposits	335,644	83,059	32,413	13,316	2,527	-	466,959	466,067
Financial liabilities at fair value	-	1,133	1,036	3,256	270	-	5,695	2,320
Derivatives - assets leg	-	*(22,574)*	*(2,823)*	*(19,861)*	*(6,733)*	-	*(51,991)*	*(49,578)*
Derivatives - liabilities leg	-	*23,182*	*3,859*	*23,117*	*7,003*	-	*57,161*	*51,374*
Short position bonds and derivatives	-	*487*	-	-	-	-	*487*	*487*
Short position securities used for economic hedging	-	*36*	-	-	-	-	*36*	*37*
Other financial liabilities	45	3,680	1,652	753	-	-	6,130	6,130
Borrowings	-	19,568	42,677	248,808	198,821	-	509,874	417,782
Subordinated liabilities	-	44	146	782	7,509	-	8,481	6,532
Financial liabilities	344,919	107,484	77,951	266,915	209,127	-	1,006,396	908,035
Net position for assets and liab.	(289,873)	116,907	73,263	111,308	454,995	26,856	493,456	185,616
Off-balance sheet items								
Financial guarantees	4,130	1,712	4,288	3,204	1,790	-	15,124	15,124
Unused overdraft	-	48,320	-	-	-	-	48,320	48,320
Undrawn loan commitments	95	53,531	21,333	4,171	-	-	79,130	79,130
Off-balance sheet items	4,225	103,563	25,621	7,375	1,790	-	142,574	142,574
Net contractual cash flow	(294,098)	13,344	47,642	103,933	453,205	26,856	350,882	43,042

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. 1032/2014. 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. The NSFR for foreign currency shall exceed 100%.

At year-end the NSFR calculations are based on figures solely for the Bank as following the sale of Arion Bank Mortgages Institutional Investor Fund (ABMIIF) the Bank's subsidiaries have negligible impact on the funding ratio. At year-end calculations of the NSFR are based on consolidated figures for the Bank and ABMIIF. When calculating the ratio for foreign currencies, a negative foreign currency balance is subtracted from the numerator and a positive balance is subtracted from the denominator. The foreign currency balance used is different from that of this Consolidated Financial Statement due to the sub-consolidation applied.

2019	ISK	Foreign currency	Total
Available stable funding	640,719	182,728	823,447
Required stable funding	566,797	141,533	708,330
Foreign currency balance		(4,122)	
Net stable funding ratio	113%	126%	116%

2018	ISK	Foreign currency	Total
Available stable funding	681,074	215,434	896,508
Required stable funding	615,717	134,082	749,799
Foreign currency balance		(7,102)	
Net stable funding ratio	111%	155%	120%

Amounts are in ISK millions

44. Liquidity and Funding risk, continued

Liquidity coverage ratio

The Liquidity Coverage Ratio (LCR) is one 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 precisely, 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, traded on an active market and not issued by the Group or related entities.

The Bank complies with the Central Bank of Iceland's liquidity rules No. 266/2017, which effectively adopt the liquidity rules of the EU Capital Requirements Regulation (CRR). The Bank is required to maintain a 100% minimum LCR ratio for both the aggregate position in all foreign currencies and all currencies.

The following table shows the breakdown for the Group's LCR calculations broken down by currencies. All amounts are weighted by their respective LCR weights. For year-end the calculations are based on consolidated figures for the Bank and Valitor Holding hf., whereas at year-end the consolidation also includes the Arion Bank Mortgages Institutional Investor Fund, which was liquidated in 2019.

2019	ISK	Foreign currency	Total
Liquid assets level 1 *	107,918	28,973	136,891
Liquid assets level 2	291	-	291
Liquid assets	108,209	28,973	137,182
Deposits	89,609	23,655	113,264
Borrowings	2,081	10	2,091
Other cash outflows	7,479	11,082	15,610
Cash outflows	99,169	34,747	130,965
Short-term deposits with other banks **	-	18,185	18,185
Other cash inflows	30,743	9,201	39,944
Cash inflows	30,743	27,386	58,129
Liquidity coverage ratio (LCR) ***	158%	334%	188%

2018	ISK	Foreign currency	Total
Liquid assets level 1 *	75,340	48,806	124,146
Liquid assets level 2	-	-	-
Liquid assets	75,340	48,806	124,146
Deposits	91,008	33,983	124,991
Borrowings	4,413	109	4,522
Other cash outflows	9,229	10,347	19,576
Cash outflows	104,650	44,439	149,089
Short-term deposits with other banks **	4,011	56,527	60,538
Other cash inflows	10,719	2,314	13,033
Cash inflows	14,730	58,841	73,571
Liquidity coverage ratio (LCR) ***	84%	439%	164%

* Level 1 assets include the Group's cash and balances with the Central Bank, domestic bonds eligible as collateral at the Central Bank and foreign government bonds which receive 100% weight. Under Rules No. 266/2017 the Group's foreign covered bonds also classify as Level 1 assets and receive 93% weight.

** Short-term deposits with 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.

Amounts are in ISK millions

44. Liquidity and Funding risk, continued

Composition of liquid assets

The following table shows the composition of the Group's liquidity buffer.

2019	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	103,726	286	534	534	105,080
Short-term deposits in other banks	-	5,410	5,771	7,004	18,185
Domestic bonds eligible as collateral at the Central Bank	11,878	-	-	-	11,878
Foreign government bonds	-	13,930	12,234	1,373	27,537
Liquidity reserve	115,604	19,626	18,539	8,911	162,680
2018					
Cash and balances with Central Bank	88,687	222	833	838	90,580
Short-term deposits in other banks	4,012	14,141	16,265	26,120	60,538
Domestic bonds eligible as collateral at the Central Bank	4,844	-	-	-	4,844
Foreign government bonds	-	21,152	21,961	757	43,870
Covered bonds with a minimum rating of AA-	-	-	1,340	1,625	2,965
Liquidity reserve	97,543	35,515	40,399	29,340	202,797

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 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.

LCR categorization - amounts and LCR outflow weights	Deposits maturing within 30 days					
	Less				Term	Total
2019	Stable	Weight (%)	Stable	Weight (%)	deposits*	deposits
Individuals	130,942	10%	52,735	5%	74,580	258,257
Small and medium enterprises	50,339	10%	4,998	5%	6,156	61,493
Corporations	56,694	40%	829	20%	7,170	64,693
Sovereigns, central banks and PSE	13,501	40%	-	-	716	14,217
Pension funds	34,024	100%	-	-	16,431	50,455
Domestic financial entities	20,857	100%	-	-	27,051	47,908
Foreign financial entities	1,877	100%	-	-	-	1,877
Total	308,234		58,562		132,104	498,900
2018						
Individuals	126,196	11%	51,232	5%	69,000	246,428
Small and medium enterprises	48,961	11%	4,836	5%	5,417	59,214
Corporations	48,033	40%	852	20%	7,605	56,490
Sovereigns, central banks and PSE	14,052	40%	-	-	5,067	19,119
Pension funds	45,671	100%	-	-	10,038	55,709
Domestic financial entities	22,494	100%	-	-	12,630	35,124
Foreign financial entities	3,187	100%	-	-	-	3,187
Total	308,594		56,920		109,757	475,271

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

Amounts are in ISK millions

45. Capital management

Capital adequacy

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

The Group's capital ratios are calculated in accordance with the Icelandic Financial Undertakings Act No. 161/2002 and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR), but has temporarily excluded Article 501 on capital requirements relief for small and medium enterprises. On 1 January 2020, CRR was however incorporated into the EEA Agreement, introducing the SME supporting factor for capital adequacy for Icelandic institutions. The Group's capital ratio for 1 January 2020 is shown below. The Group applies the standardized approach to calculate capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

The Group's consolidated situation as stipulated in CRR is the Group's accounting consolidation excluding insurance subsidiaries. The capital position and solvency requirements of Vördur tryggingar hf. should be viewed independently from capital adequacy for the Group's consolidated situation.

Valitor Holding hf. has been classified as held for sale in these Consolidated Financial Statements. This does not affect the Group's capital adequacy calculations. For disclosure, assuming a cash sale of the subsidiary at book value, the Group's capital adequacy ratio would increase from 24.0% to 25.3%. The sale of Valitor would result in reduction in the Group's regulatory own funds adjustments, with positive effect on capital adequacy.

Own funds	2019	2018
Total equity	189,825	200,859
Deductions related to the consolidated situation	(10,159)	(8,986)
Non-controlling interest not eligible for inclusion in CET1 capital	(181)	(130)
Common Equity Tier 1 capital before regulatory adjustments	179,485	191,743
Intangible assets	(10,604)	(12,152)
Tax assets	(296)	(191)
Indirect holdings of own CET1 instruments	-	(190)
Cash flow hedges	(1,616)	(1,221)
Additional value adjustments	(125)	(126)
Foreseeable dividend *	(14,153)	(9,069)
Common equity Tier 1 capital	152,691	168,794
Non-controlling interest not eligible for inclusion in CET1 capital	181	130
Tier 1 capital	152,872	168,924
Subordinated liabilities	20,083	6,532
Tier 2 capital	20,083	6,532
Total own funds	172,955	175,456
Risk-weighted assets		
Credit risk, loans	561,602	639,788
Credit risk, securities and other	49,163	50,112
Counterparty credit risk	3,347	4,405
Market risk due to currency imbalance	10,070	4,280
Market risk, other	10,609	8,928
Credit valuation adjustment	1,477	2,228
Operational risk	83,487	86,957
Total risk-weighted assets	719,755	796,698
Capital ratios		
CET1 ratio	21.2%	21.2%
Tier 1 ratio	21.2%	21.2%
Capital adequacy ratio	24.0%	22.0%
Capital ratio 1.1.2020 with application of SME supporting factor		
Total risk weighted assets 1.1.2020	707,817	
Capital adequacy ratio 1.1.2020	24.4%	

* On 31 December 2019, the foreseeable dividend is the aggregation of the Bank's own shares buy-back and dividend distribution. The on-going program of own shares buy-back was approved by the Board and the FSA in 2019 and in January 2020. The dividend distribution is proposed by the Board of Directors and is adjusted for the Bank's own shares. On 31 December 2018, the foreseeable dividend corresponds to the ISK 10 billion dividend payment proposed by the Board of Directors on 13 February 2019 adjusted for the Bank's 9.31% own shares.

Amounts are in ISK millions

45. Capital management, continued

Capital ratios of the parent company	2019	2018
CET1 ratio	23.5%	23.5%
Tier 1 ratio	23.5%	23.5%
Capital adequacy ratio	26.2%	24.3%

The following table outlines the implementation of the capital buffer requirements in accordance with the Icelandic Financial Undertakings Act No. 161/2002, as prescribed by the Financial Stability Council (FSC) and approved by the FSA.

Capital buffer requirement, % of RWA	31.12.2019	1.2.2020
Capital conservation buffer	2.50%	2.50%
Capital buffer for systematically important institutions	2.00%	2.00%
Systemic risk buffer *	3.00%	3.00%
Countercyclical capital buffer *	1.75%	2.00%
Combined capital buffer requirement	9.25%	9.50%

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 FSA 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 own funds exceeds the FSA'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.

Capital requirement, % of RWA, current

2019	CET1	Tier 1	Total
Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.7%	2.3%	3.1%
Combined buffer requirement *	9.0%	9.0%	9.0%
Regulatory capital requirement	15.2%	17.3%	20.1%
Available capital	21.2%	21.2%	24.0%

Capital requirement, % of RWA, 1.2.2020

Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.7%	2.3%	3.1%
Combined buffer requirement *	9.2%	9.2%	9.2%
Regulatory capital requirement	15.5%	17.6%	20.3%
Available capital	21.2%	21.2%	24.0%

* The effective countercyclical capital buffer is determined by calculating the weighted average of the corresponding buffer levels of each country, the weights being the total risk weighted exposures for credit risk against counterparties residing in those countries. The systemic risk buffer only applies to domestic exposures and is calculated using the same weighting method.

** The SREP result based on the Group's Financial Statement at 31.12.2018. The Pillar 2 requirement is 3.1% of risk-weighted assets based on the Group's prudential consolidation under CRR, which excludes Vördur tryggingar hf.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

45. Capital management, continued

Leverage ratio

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The ratio is calculated on the basis of the Group's consolidated situation as per the CRR, which excludes the Group's insurance subsidiaries. The minimum leverage ratio requirement is 3% as stated in the Icelandic Financial Undertakings Act No. 161/2002.

	2019	2018
On-balance sheet exposures	1,022,521	1,106,368
Derivative exposures	10,217	8,239
Securities financing transaction exposures	577	8,194
Off-balance sheet exposures	52,299	68,316
Total exposure	1,085,614	1,191,117
Tier 1 capital	152,872	168,924
Leverage ratio	14.1%	14.2%

Solvency II

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vördur Group was ISK 4,580 million at the end of the year (31.12.2018: ISK 3,679 million) and calculated solvency of Vördur Group was ISK 6,610 million (31.12.2018: ISK 5,418 million). The solvency ratio, which is the ratio of calculated solvency to the solvency requirements was 144% at the end of the year (31.12.2018: 147%).

46. 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. The 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 for the calculation of capital requirements for operational risk.

Amounts are in ISK millions

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 Annual Financial Statements for the year ended 31 December 2018 except for new and amended IFRS adopted by the European Union, that became effective as of 1 January 2019, see Note 2, and amendments to Icelandic Annual Accounts Act, Financial undertakings Act and Rules on Accounting for credit institutions.

47. 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 Consolidated Financial Statements are prepared on a going concern basis.

48. Principles underlying the consolidation

Subsidiaries

Subsidiaries are entities controlled by the Group. The Financial Statements of subsidiaries are included in the Consolidated 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. 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 Income Statement 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.

Notes to the Consolidated Financial Statements

48. 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 Consolidated Financial Statements. This also applies to subsidiaries classified as disposal groups held for sale.

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 Consolidated 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.

49. 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 Income statement as an impairment loss. Impairment losses are subsequently reversed through the Income Statement if the reasons for the impairment loss no longer apply.

Notes to the Consolidated Financial Statements

50. Foreign currency

Items included in the Consolidated 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 Income Statement. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

51. Interest

Interest income and expense are recognized in the Income Statement 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 Income Statement include Income and expenses of assets and liabilities carried at:

- amortized cost;
- fair value through profit and loss (FVTPL); and
- fair value through other comprehensive income (FVOCI).

52. 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, i.e. point in time. Fees earned from transaction type services are recognized when the service has been completed, i.e. point in time. Fees that are performance linked are recognized when the performance criteria are fulfilled, i.e. point in time.

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.

53. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and liabilities at fair value and 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, 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 Consolidated 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.

54. Net insurance income

Premiums recognized as income comprise the premiums contracted during the fiscal year including premiums transferred from last years but excluding next periods premiums, which are recognized as provision for unearned premiums. Provision for unearned premiums is a part of the technical provision in the Statement of Financial Position.

Claims recognized in the Income Statement are the periods claims including increases or decreases due to claims from previous fiscal years. Outstanding claims included in technical provision in the Statement of Financial Position are the total amount of reported but unpaid claims as well as actuarial provision for claims occurred but unreported.

55. Income tax expense

Tax expense comprises current and deferred tax. Income tax for the year has been calculated and recognized in the Consolidated 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. Taxable profit may differ from earnings before tax as reported in the Income Statement as it may exclude income or expense that is deductible in other years and it excludes income or expense that are never taxable or deductible.

Current and deferred tax relating to items recognized directly in equity is recognized in equity and not in the statement of profit or loss.

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. Such deferred tax assets and liabilities are not recognized if the temporary difference arises from the initial recognition (other than in a business combination) of assets and liabilities in transaction that affects neither the taxable profit nor the accounting profit. In addition, tax liabilities are not recognized if the temporary difference arises from the initial recognition of goodwill.

56. Financial assets and financial liabilities

Recognition and initial measurement

The Group initially recognizes financial assets and financial liabilities on the date that they are originated at the fair value of consideration paid. Regular-way purchases and sales of financial assets are recognized on the trade date at which the Group commits to purchase or sell assets. 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 and for an item not at fair value through profit or loss, transaction cost that are directly attributable to its acquisition or issue.

Derecognition

Financial assets are derecognized when the rights to receive cash flows from the financial assets have expired or when 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.

Debt instruments

Debt instruments, including loans and debt securities, are classified into one of the following measurement categories:

- amortized cost;
- fair value through profit and loss (FVTPL); or
- fair value through other comprehensive income (FVOCI).

A debt instrument is measured at amortized cost only if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to collect contractual cash flows; and
- its contractual cash flows are solely payments of principal and interest on the principal amount outstanding (here after SPPI).

A debt instrument is measured at FVOCI only if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to collect contractual cash flows and selling financial assets; and
- its contractual cash flows are SPPI.

All other debt instruments are carried at FVTPL.

56. Financial assets and financial liabilities, continued

Business model assessment

Business model assessment involves determining whether financial assets are managed in order to generate cash flows from collection of contractual cash flows, selling financial assets or both. The Group assesses the business model at a portfolio level reflective of how groups of assets are managed together to achieve a particular business objective. For the assessment of business models the Group takes into consideration the following factors:

- how the performance of assets in a portfolio is evaluated and reported to group heads and other key decision makers within the Group's business lines;
- the risks that affect the performance of assets held within a business model and how those risks are managed;
- whether the assets are held for trading purposes, i.e. assets that the Group acquires or incurs principally for the purpose of selling or repurchasing in the near term, or holds as part of a portfolio that is manage together for short-term profit or position taking;
- how compensation is determined for the Group's business lines' management that oversee the assets; and
- the frequency and volume of sales in prior periods and expectations about future sales activity.

Cash flow characteristics assessment

The contractual cash flow characteristics assessment involves assessing the contractual features of an instrument to determine if they give rise to cash flows that are consistent with a basic lending arrangement. Contractual cash flows that are consistent with a basic lending arrangement are considered SPPI.

Interest is defined as consideration for the time value of money, the banks funding costs, the credit risk associated with the principal amount outstanding and other costs (e.g liquidity risk and administrative costs), as well as a profit margin. Indexation of loans to the Consumer Price Index (CPI) are considered part of interest as CPI guarantees the time value of money of the original outstanding balance. Principal may change over the life of the instruments due to repayments. Indexation on principal accumulates over time.

In performing this assessment, the Group takes into consideration contractual features that could change the amount or timing of contractual cash flows, such that the cash flows are no longer consistent with a basic lending arrangement. If the Group identifies any contractual features that could modify the cash flows of the instruments such that they are no longer consistent with a basic lending arrangement, the related financial assets is classified at FVTPL.

Debt instruments measured at amortized cost

Debt instrument are measured at amortized cost if they are held within a business model whose objective is to hold for collection of contractual cash flows where those cash flows represent solely payments of principal and interest. After initial measurement, debt instruments in this category are carried at amortized cost using the effective interest rate method. The effective interest rate is the rate that discounts contractual cash payments or receipt through the contractual lifetime of the financial asset to the gross carrying amount of a financial asset. Amortized cost is calculated taking into account any discount or premium on acquisition, transaction cost and fees that are an integral part of the effective interest rate. Amortization is included in interest income in the Consolidated Income Statement.

Impairment on debt instruments measured at amortized cost is calculated using the expected credit loss (ECL) approach. Loans and debt securities measured at amortized cost are presented net of allowance for credit losses in the Consolidated Statement of Financial Position.

Debt instruments measured at FVOCI

Debt instrument are measured at FVOCI if they are held within a business model whose objective is to hold for collection of contractual cash flows and/or selling financial assets, where the assets' cash flows represent payments that are solely payments of principal and interest. Subsequent to initial recognition, unrealized gains and losses on debt instruments measured at FVOCI are recorded in Other Comprehensive Income (OCI). At realization the accumulated profit or loss recognized in OCI in previous periods is recycled to the Consolidated Income Statement. Foreign exchange gains and losses of the debt instrument are recognized in the Consolidated Income Statement. Interest income from received payments are recognized in interest income in the Consolidated Income Statement upon payment.

Impairment on debt instruments measured at FVOCI is calculated using the expected credit loss approach. The ECL on debt instruments measured at FVOCI does not reduce the carrying amount of the asset in the Statement of Financial Position, which remains at its fair value. Instead, an amount equal to the allowance that would arise if the assets were measured at amortized cost is recognized in OCI with a corresponding charge to net impairment in the Consolidated Statement of Comprehensive Income. The accumulated allowance recognized in OCI is recycled to the Consolidated Statement of Comprehensive Income upon derecognition of the debt instrument.

56. Financial assets and financial liabilities, continued

Debt instruments measured at FVTPL

Debt instrument are measured at FVTPL if they are held for short term gain before maturity, held as part of a portfolio managed on a fair value basis or the cash flows do not represent payments that are solely payments of principal and interest. These instruments are measured at fair value in the Consolidated Statement of Financial Position. Realized and unrealized gains and losses are recognized as part of Net financial income in the Consolidated Income Statement.

Purchased loans

All purchased loans are initially measured at fair value on the date of acquisition. As a result no allowance for credit losses would be recorded in the Consolidated Statement of Financial Positions on the date of acquisition. Purchased loans may fit into either of the two categories: Performing loans or Purchased or Originated Credit Impaired (POCI) loans.

Purchased performing loans are reflected in Stage 1 and will follow the same accounting as other performing loans. They will be subject to a 12-month allowance for credit losses which is recorded as provision for credit losses in the Consolidated Income Statement. The fair value adjustments set up for these loans on the date of acquisition is amortized into interest income over the life of these loans.

POCI loans do not have allowance at initial recognition but subsequently the allowance will reflect the changes in the lifetime expected losses. At recognition the discount of each POCI loan is split up into two categories, impairment discount and interest discount or premium. Interest is calculated with a credit adjusted effective interest rate and is posted to interest income. Periodically the Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original credit adjusted effective interest rate, any changes in the expected cash flows since the date of acquisition are recorded as a charge/recovery in net impairment in the Consolidated Income Statement at the end of all reporting periods subsequent to the date of acquisition.

Equity instruments

Equity instruments are measured at FVTPL unless an election is made to designate them at FVOCI at initial recognition.

For equity instruments measured at FVTPL, changes in fair value are recognized as part of Financial income in the Consolidated Income Statement.

The Group can elect to classify non-trading equity instruments at FVOCI. This election will be used for certain equity instruments for strategic or longer term investment purposes. The FVOCI election is made upon initial recognition, on an instrument-by-instrument basis and once made is irrevocable. Gains and losses on these instruments including when derecognized/sold are recorded in OCI and are not subsequently reclassified to the Consolidated Income Statement. Dividends received are recorded in Financial income in the Consolidated Income Statement. Any transaction costs incurred upon purchase of the security are added to the cost basis of the security and are not reclassified to the Consolidated Income Statement of the security.

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.

56. Financial assets and financial liabilities, continued

Expected credit losses

Expected credit loss (ECL) is established for all financial assets, except for financial assets classified or designated as FVTPL and equity instruments designated as FVOCI, which are not subject to impairment assessment. Assets subject to impairment assessment are primarily debt instruments (including loans to customers) measured at amortized cost or FVOCI. ECL on financial assets is presented in Net impairment. Other financial assets carried at amortized cost are presented net of ECL in the Group's Consolidated Statement of Financial Position. Off-balance sheet items subject to impairment assessment include financial guarantees and undrawn loan commitments. ECL for Off-balance sheet items is separately calculated and included in Other Liabilities.

The Group measures the ECL on each balance sheet date according to a three-stage expected credit loss impairment model:

Stage	Criteria	rates.
1	Exposures not impaired and with no significant increase in credit risk	12 month expected credit loss is recorded. The expected credit loss is computed using a probability of default occurring over the next 12 months. For those instruments with a remaining maturity of less than 12 months, a probability of default corresponding to remaining term to maturity is used. The effective interest rate is calculated on the gross carrying amount.
2	Exposures not impaired with significant increase in credit risk subsequent to origination.	Lifetime expected credit loss is recorded, based on the probability of default over the remaining estimated life of the financial instrument. Effective interest rate is calculated on the gross carrying amount.
3	Exposures in default / Credit impaired	Lifetime expected credit loss is recorded. Effective interest rate is calculated on the book value.

The ECL is an unbiased discounted probability-weighted estimate of the cash shortfalls expected to result from defaults occurring in the next 12 months or, in cases where credit risk has significantly increased, in the expected lifetime of an exposure. For guarantees and loan commitments, credit loss estimates consider the portion of the commitment that is expected to be paid out or expected to be drawn over the relevant time period, contingent on significant financial difficulty.

Increases or decreases in the required ECL attributable to purchases and new originations, derecognitions or maturities, and remeasurements due to changes in loss expectations or state migrations are recorded in net impairment. Write-offs and recoveries of amounts previously written off are recorded against ECL.

The ECL represents an unbiased estimate of expected credit losses on our financial assets as at the balance sheet date. Judgement is required in making assumptions and estimations when calculating the ECL, including movements between the three stages and the application of forward looking scenarios. The underlying assumptions and estimates may results in changes to the provisions from period to period that significantly affect our results of operations.

Definition of default

The Group considers a financial assets to be in default when:

- the borrower is more than 90 days past due, or
- the borrower is considered to be unlikely to pay.

In assessing whether a borrower is unlikely to pay, the Group considers both qualitative and quantitative indicators, e.g. overdue status, debt and equity ratios, market circumstances and other data developed internally or obtained from external sources.

For corporate counterparties it is assumed that if one exposure is in default, all other exposures to that counterparty are also in default (cross-default). For individuals however, each exposure portfolio is assessed separately, meaning that if an individual is in default on a loan belonging to one portfolio, e.g. mortgages, his other exposures, belonging to other portfolios, e.g. consumer loans, are not assumed to be in default, and vice versa. A default event for a mortgage can however be an indicator for the likelihood of default for the borrower's other exposures, and vice versa. The Bank now defines six different exposure portfolios for individuals and has different statistical credit risk model for each of them - mortgages, consumer loans, auto loans, guarantees, loans to individuals for work purposes and other loans.

Frequent default events within a year are treated as a single default event. A defaulted exposure is considered to be cured if all the exposure belonging to certain portfolio has returned to non-default state, with no amount in arrears, within 18 months from default and without any incurred loss for the Group.

Probability of default and credit risk rating

The Group allocates to each exposure a credit risk rating (e.g. A+, A, A-, BBB+, etc.) based on the calculated 12 month probability of default ('the PD'). The PD is assessed through the Group's credit rating models or based on external ratings if available. The Group's credit rating models are statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgement for large corporate exposures. Factors vary depending on the nature of the exposure and the profile of the borrower. The PD estimates used for the purpose of calculating IFRS 9 impairments are point-in-time, i.e. dependent on the economic cycle. The Group's credit rating models are subject to annual performance tests and are recalibrated on a regular basis if needed.

56. Financial assets and financial liabilities, continued

The Group's rating scale is shown below, including mapping of external ratings. The lower bounds are inclusive.

Risk class	Rating	Lower PD	Upper PD	S&P / Fitch	Moody's	Description
0	AAA	0.000%	0.006%	AAA	Aaa	Investment Grade
	AA+	0.006%	0.018%	AA+	Aa1	
	AA	0.018%	0.029%	AA	Aa2	
	AA-	0.029%	0.045%	AA-	Aa3	
1	A+	0.045%	0.070%	A+	A1	Investment Grade
	A	0.070%	0.110%	A	A2	
	A-	0.110%	0.170%	A-	A3	
	BBB+	0.170%	0.260%	BBB+	Baa1	
	BBB	0.260%	0.410%	BBB	Baa2	
	BBB-	0.410%	0.640%	BBB-	Baa3	
2	BB+	0.640%	0.990%	BB+	Ba1	Non-investment Grade
	BB	0.990%	1.540%	BB	Ba2	
	BB-	1.540%	2.400%	BB-	Ba3	
3	B+	2.400%	3.730%	B+	B1	Non-investment Grade
	B	3.730%	5.800%	B	B2	
	B-	5.800%	9.010%	B-	B3	
4	CCC+	9.010%	14.000%			Non-investment Grade
	CCC	14.000%	31.000%			
	CCC-	31.000%	99.990%			
5	DD	99.99%	100.00%	D	C	Default / Impaired

The Group uses external ratings for counterparties that receive such ratings from recognized rating agencies such as Moody's, Standard & Poor's and Fitch. The Group's internal rating scale was originally calibrated to match historical default rates shown in publications of the aforementioned rating agencies and using smoothing techniques. External ratings are primarily used to assess expected losses for counterparties of marketable securities, money market and deposit accounts positions which fall under the Impairment requirements of IFRS 9. The Bank's ECL is broken down by investment grade and non-investment grade classes for such exposures, as per the definition of the corresponding rating agency.

Each exposure is allocated a credit risk rating at initial recognition. The calculations are based on rules and available information at the time of origination. Exposures are continuously monitored and revaluated, which may result in transitions between risk ratings. The monitoring typically involves the use of credit history, audited financial statements, management accounts, budgets, KPI's, projections, quality of management, data from credit reference agencies, overdue status and other qualitative and quantitative information available.

Probability of default

The Group's PDs and PD term structures are based on both quantitative and qualitative factors and in some cases external ratings are used. PD's are re-assessed on a regular basis with different frequencies depending on the type of counterparty and/or exposure.

In addition to calculating PD and allocating a credit risk rating to each exposure, the Group calculates the lifetime probability of default (LPD), which is an assessment of the probability that a default event occurs over the lifetime of the exposure. The LPD incorporates management's view of possible future macroeconomic developments and the likelihood of rating transitions over the lifetime of the exposure. For the determination of LPD, the Bank calculates PD term structures – which effectively provides the probability of default for any given time period, one for each rating grade, PD model and economic scenario. The annualized lifetime probability of default (ALPD) of an exposure is the fixed 12 month PD (without transitions) that corresponds to the exposure's LPD. The credit risk rating that corresponds to the ALPD is defined as the lifetime credit risk rating.

The assessed 12 months PDs are the basis for the determination of the term structure of PDs for exposures. The Group applies transition models, developed on the basis of historical data, to predict the development of risk grades for periods that exceed one year. The Group has separated transition behavior due to specific and general risk and applies its macro-economic forecasts to the latter. The analysis of credit rating transitions due to general risk includes the identification and calibration of relationships between changes in default rates and changes in key macro-economic factors. Unemployment rate is the predominant predictive variable. Among other indicators examined are GDP growth and benchmark interest rates.

Assumptions on key macro-economic indicators are on an ongoing basis estimated based on internal and external information available at each time. The Group formulates a 'base case' view of the future direction of relevant economic variables as well as a representative range of other possible forecast scenarios. The Group uses these forecasts to adjust its estimates of lifetime probability of default and other factors that affect the lifetime expected credit loss.

56. Financial assets and financial liabilities, continued

A new internal credit model structure was introduced in 2019 - new PD models were created and other updated. The Bank now has six different exposure specific PD models for individuals replacing the two model for prime mortgages and other exposure - mortgages, consumer loans, auto loans, guarantees, loans to individuals for work purposes and other loans. The Bank now has a different model or rating logic for the following corporate portfolios – large corporates, retail SMEs, holding companies, financial institutions (external ratings), municipalities, state related entities, organizations and cooperatives.

Loss given default

Each credit facility is assigned an LGD. The LGD is an assessment of loss conditional on a default occurrence. The Group splits LGD into three components; the probability of cure, the expected recovery from liquidation of collateral, and the recovery rate for the unsecured part of the exposure. The cure rate is modeled on the groups historical data of assets returning to performing status after being in default without loss. The expected recovery is the outcome of The Group's collateral allocation algorithm which takes into account the seniority of debt and collateral type. Haircuts are applied to different types of collaterals based on expert judgment, supported by historical data, and takes into account costs and the time value of money. Different haircuts are applied for different macro-economic scenarios in the ECL calculations. In some instances assets are considered to be fully covered by collateral after haircut application and therefore carry no ECL. The recovery rate for the unsecured part of the exposure is based on expert judgment taking into account historical loss experience.

The internal cure rate models were updated in 2019 using a new definition of cure. The cut-off period for cure has been increased from 12 months to 18 months from default, which means that a return to non-default after that period is not considered a cure. Furthermore, cure is now defined on a portfolio level instead of on a loan level i.e. the same level as the PD models. In this version statistical cure rate models were created for the largest portfolios – mortgages, consumer loans and large corporates and retail SMEs. As the explanatory variables in the statistical cure rate models can be related to variables in PD models, this change prompts a consideration of PD-cure correlation. The correlation effects are taken into account in the Bank's ECL calculations. Furthermore, long-run average cure rate models using macro-economic variables have been created. The model can be used to assess cure rate under different economic conditions to be able to apply different cure rates for different economic scenarios given different economic conditions.

Exposure at default

The EAD represents the expected exposure at the event of a default. For a given exposure, the Group derives the EAD from the contractual amortization schedule and taking into account the likelihood of pre-payments, drawdowns, rollovers, extensions and use of unused allowance in the period leading up to default. These behavioral estimates, which are based on historical observations and forward-looking forecasts, apply differently to each type of exposure.

Significant increase in credit risk

The assessment of significant increase in credit risk requires significant judgment. In determining whether the risk of default for an exposure has increased significantly since initial recognition, the Group considers relevant, reasonable and supportable information on an ongoing basis. Assumptions are drawn based on the Group's historical experience and expert judgement including forward-looking expectations. If a debt investment security has low credit risk and is considered investment grade at the reporting date, the Group will determine that the credit risk on the asset has not increased significantly since initial recognition.

For a given exposure, the Group considers a significant increase in credit risk to have occurred if one of the following holds:

- the exposure's credit risk rating on reporting date is not in risk class 0 or 1 and has deteriorated by more than one risk rating compared to the credit risk rating at origination;
- the exposure's lifetime credit risk rating on reporting date is not in risk class 0 or 1 and has deteriorated by more than one risk grade (two or more) compared to the lifetime credit risk rating at origination. As the Group does not have the benefit of hindsight, this comparison is only used for exposures that originate on or after 1 January 2018;
- the number of days in arrears exceeds 30 days; or
- the exposure is on the Group's watch list.

The Group monitors the effectiveness of the criteria used to identify significant increases in credit risk by regular reviews to confirm that the criteria is capable of identifying significant increases in credit risk before an exposure is in default and there is no unwarranted volatility in loss allowance from transfers between 12-month ECL (stage 1) and lifetime ECL (stage 2).

56. Financial assets and financial liabilities, continued

Exposures in default

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. When estimating impairments the following is 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. In some instances exposures do not require impairment due to collateral coverage.

Impairment losses are recognized in net impairment, see note 42. 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 net impairment.

Expected credit loss measurement

The expected credit loss (ECL) calculations are based on three main components:

- probability of default (PD),
- loss given default (LGD); and
- exposure at default (EAD).

Each component is derived from internally generated models, apart from external credit ratings. The models are developed with statistical methods and/or expert judgement supported by historical data and adjusted for expected macro-economic effects.

The Group measures ECL considering the risk of default over the maximum contractual period (including any extension periods) over which it is exposed to credit risk. The maximum contractual period extends to the date at which the Group has the right to require repayment of an advance or terminate a loan commitment or guarantee. However, for overdrafts and credit card facilities that include both a loan and an undrawn commitment component, the Group measures ECL over a period longer than the maximum contractual period if the Group’s contractual ability to demand repayment and cancel the undrawn commitment does not limit the Group’s exposure to credit losses to the contractual notice period. These facilities do not have a fixed term or repayment structure. The Group can cancel them with immediate effect but this contractual right is not enforced in the normal day-to-day management, but only when the Group becomes aware of an increase in credit risk at the facility level. This longer period is estimated taking into account the credit risk management actions that the Group expects to take and that serve to mitigate ECL. These include a reduction in limits, cancellation of the facility and/or turning the outstanding balance into a loan with fixed repayment terms. The ECL calculations involve discounting using the exposures' effective interest rates.

Forward looking scenarios

The ECL for an exposure is the weighted average of the expected credit loss for different macro-economic scenarios provided by the Group's management. The Group currently considers three scenarios: 'base case', 'optimistic' and 'pessimistic' and assign its best estimate of likelihood of occurrence to each one. The development of macro-economic variables and the corresponding weights are based on expert judgement supported by historical data. The Group incorporates forward-looking macro-economic information into both its assessment of whether the credit risk of an instrument has increased significantly since its initial recognition (via the lifetime credit risk rating comparison) and its measurement of ECL as the PD term structures, LGD and EAD include macro-economic adjustments for each of the scenarios.

The predominant macro-economic variable used across all portfolios is the unemployment rate in Iceland, as measured by the Directorate of Labor. The default rate observed for the Group's exposures has been shown to be highly correlated with unemployment rate. The average cure is also correlated with unemployment rate, depending on portfolio, and collateral haircuts are adjusted for different scenarios. Exit and pre-payment rates, which affects EAD, are dependent on refinancing spreads and due to the correlation between interest rates and unemployment rate they are adjusted for different scenarios.

Write-off of loans

Loans are written off, either partially or in full, when there is no realistic prospect of recovery i.e. the bankruptcy of the borrower or an ineffective attachment or distraint. Collateralized loans are generally written of when the realization of collateral have been received. After write-off, exposures continue to be subject to collection activities in accordance with Icelandic law.

56. Financial assets and financial liabilities, continued

Modifications

The original terms of a financial asset may be renegotiated or otherwise modified, resulting in changes to the contractual terms of the financial asset that affect the contractual cash flow. The treatment of such modifications is primarily based on the process undertaken to execute the renegotiation and the nature and extent of changes made. Modifications which are performed for credit reasons, primarily related to troubled debt restructurings, are generally treated as modifications of the original financial asset unless modifications are significant. Significant modifications are generally considered to be an expiry of the original cash flows; accordingly, such renegotiations are treated as a derecognition of the original financial asset and recognition of a new financial asset.

If a modification of terms does not result in derecognition of the financial asset, the carrying amount of the financial asset is recalculated as the present value of the renegotiated or modified contractual cash flows, discounted at the original effective interest rate and gain or loss is recognized. The financial asset continues to be subject to the same assessments for significant increase in credit risk relative to initial recognition and credit-impairment, as described above. A modified financial asset will migrate out of Stage 3 if the conditions that led to it being identified as credit-impaired are no longer present and relate objectively to an event occurring after the original credit-impairment was recognized. A modified financial asset will migrate out of Stage 2 when it no longer satisfies the relative thresholds set to identify significant increase in credit risk, which are based on changes in its PD, lifetime PD, days past due and other qualitative considerations.

If a modification of terms results in derecognition of the original financial asset and recognition of the new financial asset, the new financial asset will generally be recorded in Stage 1, unless it is determined to be credit-impaired at the time of renegotiation. For the purposes of assessing for significant increase in credit risk, the date of initial recognition for the new financial asset is the date of modification.

57. Hedge accounting

From the applying of IFRS 9 from 1 January 2018, the Group has chosen to continue to apply the hedge accounting requirements of IAS 39, in line with exemption from IFRS 9. However, the Group will provide the expanded disclosures on hedge accounting introduced by IFRS 9's amendments to IFRS 7, as the accounting policy election does not provide an exemption from the new disclosure requirements under IFRS 7.

The Group applies fair value hedge accounting with respect to designated hedging relationship of certain fixed-rate foreign currency denominated notes issued by the Bank as the hedged items and certain foreign currency denominated interest rate swaps as the hedging instruments. The Group recognizes the changes in fair value of the interest rate swaps together with changes in the fair value of bonds attributable to interest rate risk immediately in profit or loss in the line item of Note 10, Net gain on fair value hedge of interest rate swap. Calculated accrued interest on both swaps and bonds are included in the line item of Note 7, Interest expense.

Other derivatives, not designated in a qualifying hedge relationship, are used to manage its exposure to foreign currency, interest rate, equity market and credit risk. The financial instruments used include, but are not limited to, interest rate swaps, cross-currency swaps, forward contracts, futures, options, credit swaps and equity swaps.

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80–125%.

If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. Any adjustments, up to the point of discontinuation, to a hedged item for which the effective interest method is used, is amortized to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

58. 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.

59. 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 Consolidated Financial Statements.

60. 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 Income Statement. 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.

61. Intangible assets

Goodwill and infrastructure

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

Customer relationship and related agreements

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 Income Statement 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

62. 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 Income Statement.

63. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than assets held for sale, 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.

64. Deposits

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

65. Borrowings

Borrowings are measured at amortized cost with any difference between cost and redemption amount being recognized in the Income Statement over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

66. 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 2. 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 Income Statement based on the contractual terms of the borrowing.

67. Assets and disposal groups held for sale

The Group classifies a 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, 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 Income Statement, 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, Assets or disposal groups does not exceed the carrying amount that would have been determined had no impairment loss been recognized in prior years.

68. 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 Income Statement 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:

Real estates	33 years
Equipment	3-7 years

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

Right-of-use asset and lease liability

The Group assesses whether a contract is or contains a lease, at inception of the contract. The Group recognises a right-of-use asset and a corresponding lease liability with respect to all lease arrangements in which it is the lessee, except for short-term leases and leases of low value assets. For these leases, the Group recognises the lease payments as an operating expense on a straight-line basis over the term of the lease. The lease liability is initially measured at the present value of the lease payments that are not paid at the commencement date, discounted by using the Group's incremental borrowing rate. The right-of-use assets comprise the initial measurement of the corresponding lease liability. They are subsequently measured at cost less accumulated depreciation.

Other assets and other liabilities

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

Technical provision

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.

69. Equity

Dividends

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

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.

Reserve due to capitalized development cost

According to the Financial Statements Act No. 3/2006 entities that capitalize development costs shall transfer a corresponding amount from retained earnings to a separate reserve. The reserve is not subject to dividend payments. The reserve shall be eliminated in an amount corresponding to the annual depreciation of the capitalized development cost. The reserve shall be released if the asset is sold or fully depreciated.

Financial assets at fair value through OCI

Unrealized fair value changes net of tax for assets held at fair value through other comprehensive income. The fair value reserve is released in correlation with realization of gains or losses of financial assets at derecognition.

Notes to the Consolidated Financial Statements

69. Equity, continued

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.

Foreign currency translation reserve

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

70. 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.

71. 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 Consolidated 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 Income Statement, 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 Income Statement. The premium received is recognized in the Income Statement in Net fees and commission income on a straight line basis over the life of the guarantee.

72. 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.

73. 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 Income Statement when they become due. The Group does not operate any pension fund which confers pension rights.

74. Standards issued but not yet effective

New standards, amendments to standards and interpretations have been issued but are not yet effective for the year ended 31 December 2019, and have not been applied in preparing these Consolidated Financial Statements. Relevant to the Group's reporting is IFRS 17 Insurance contracts.

IFRS 17 Insurance Contracts

IFRS 17 Insurance Contracts, is comprehensive new accounting standard for insurance contracts covering recognition and measurement, presentation and disclosure. IFRS 17 applies to all types of insurance contracts (i.e., life, non-life, direct insurance and re-insurance). The overall objective of IFRS 17 is to provide an accounting model for insurance contracts that is more useful and consistent for insurers. IFRS 17 is effective for reporting periods beginning on or after 1 January 2022, with comparative figures required. This standard will be applicable to the Group‘s subsidiary Vördur, which is currently assessing the potential effect of the standard.

5-year overview

Income Statement

	2019	2018	2017	2016	2015
Net interest income	30,317	29,319	28,920	29,900	26,992
Net fee and commission income	9,950	10,350	10,211	13,978	14,484
Net insurance income	2,886	2,589	2,093	1,395	760
Net financial income	3,212	2,302	4,045	5,162	12,844
Share of profit of associates and net impairment	756	27	(927)	908	29,466
Other operating income	877	1,584	2,521	3,203	2,074
Operating income	47,998	46,171	46,863	54,546	86,620
Salaries and related expense	(14,641)	(14,278)	(13,602)	(16,659)	(14,892)
Other operating expense	(12,222)	(12,000)	(9,291)	(13,881)	(12,919)
Operating expenses	(26,863)	(26,278)	(22,893)	(30,540)	(27,811)
Bank levy	(2,984)	(3,386)	(3,172)	(2,872)	(2,818)
Net impairment	(382)	(3,525)	312	7,236	(3,087)
Earnings before income tax	17,769	12,982	21,110	28,370	52,904
Income tax expense	(3,714)	(4,046)	(5,966)	(6,631)	(3,225)
Net earnings from continuing operations	14,055	8,936	15,144	21,739	49,679
Discontinued operations, net of tax	(12,955)	(1,159)	(725)	-	-
Net earnings	1,100	7,777	14,419	21,739	49,679

Statement of Financial Position

Assets

	2019	2018	2017	2016	2015
Cash and balances with Central Bank	95,717	83,139	139,819	87,634	48,102
Loans to credit institutions	17,947	56,322	86,609	80,116	87,491
Loans to customers	773,955	833,826	765,101	712,422	680,350
Financial instruments	117,406	114,557	109,450	117,456	133,191
Investment property	7,119	7,092	6,613	5,358	7,542
Investments in associates	852	818	760	839	27,299
Intangible assets	8,367	6,397	13,848	11,057	9,285
Tax assets	2	90	450	288	205
Assets and disposal groups held for sale	43,626	48,584	8,138	4,418	5,082
Other assets	16,864	13,502	16,966	16,436	12,496
Total Assets	1,081,855	1,164,327	1,147,754	1,036,024	1,011,043

Liabilities and Equity

	2019	2018	2017	2016	2015
Due to credit institutions and Central Bank	5,984	9,204	7,370	7,987	11,387
Deposits	492,916	466,067	462,161	412,064	469,347
Financial liabilities at fair value	2,570	2,320	3,601	3,726	7,609
Tax liabilities	4,404	5,119	6,828	7,293	4,922
Liabilities associated with disposal groups held for sale	28,631	26,337	-	-	-
Other liabilities	32,697	30,107	57,062	54,094	49,461
Borrowings	304,745	417,782	384,998	339,476	256,058
Subordinated liabilities	20,083	6,532	-	-	10,365
Total liabilities	892,030	963,468	922,020	824,640	809,149
Shareholders' equity	189,644	200,729	225,606	211,212	192,786
Non-controlling interest	181	130	128	172	9,108
Total equity	189,825	200,859	225,734	211,384	201,894
Total Liabilities and Equity	1,081,855	1,164,327	1,147,754	1,036,024	1,011,043

Valitor Holding hf. was classified as disposal group held for sale in 2018, see Note 29. Comparative figures for 2015 and 2016 have not been restated.

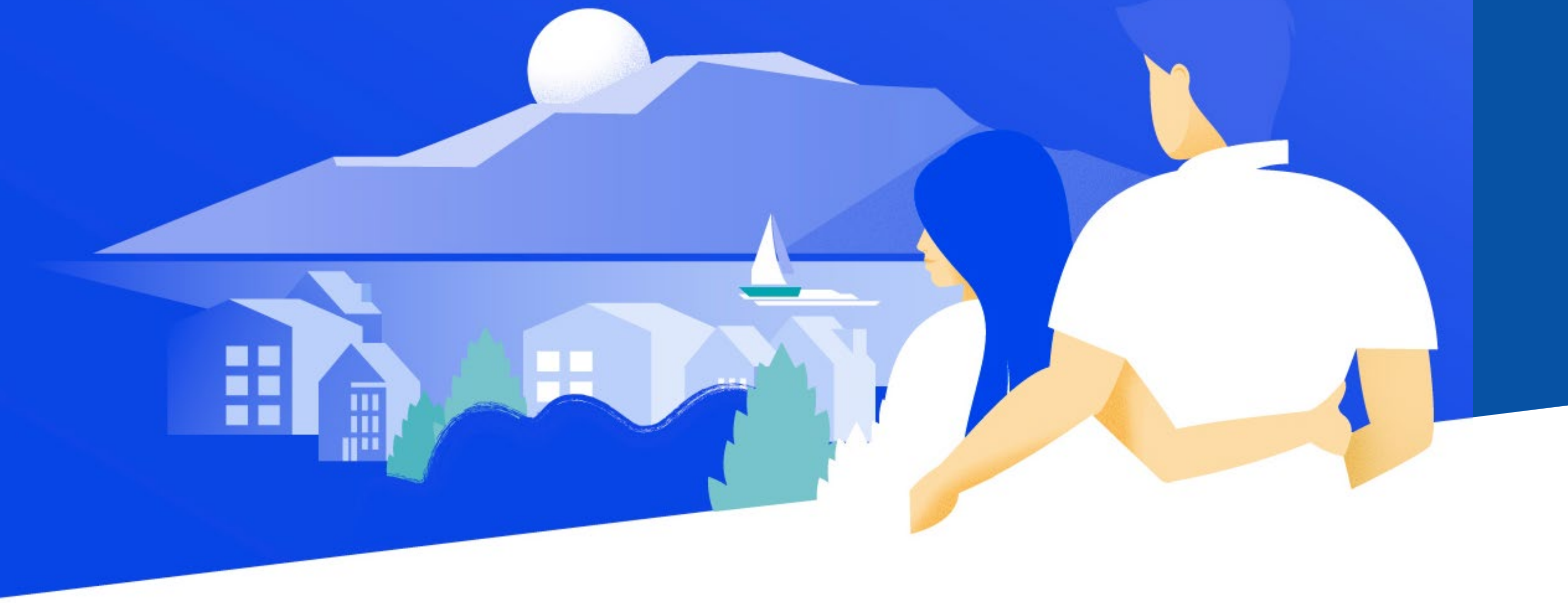
Arion Bank Consolidated Financial Statements 2019 85 Amounts are in ISK millions

Appendix

Unaudited

Corporate Governance Statement of Arion bank

for 2019



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 regularly 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

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, initially in December 2015 and again in April 2019. This recognition was granted following an in-depth assessment by an independent party 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 at a time

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 with one deviation.

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 with respect to their nature.

The role of the Nomination Committee at Arion Bank is to promote good corporate governance and to facilitate informed decision-making by shareholders when selecting Board members to ensure that Board members have wide and versatile qualifications and experience. The Committee has an advisory role regarding the election of Board members and makes a proposal on their remuneration. At the Bank's Annual General Meeting on 20 March 2019 two members of the Nomination Committee were elected, Christopher Felix Johannes Guth and Keith Magliana. At a shareholders' meeting on 9 August 2019 Júlíus Þorfinnsson was elected to replace Christopher Felix Johannes Guth on the Nomination Committee. The third Nomination Committee member is appointed by the Board in accordance with the rules of procedure of the Nomination Committee. The third member is Herdís Dröfn Fjeldsted, Vice Chairman of the Board of Directors.

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 also apply to the Bank's operations include e.g. the Securities Transactions Act No. 108/2007, Act on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment Funds No. 128/2011, Act on Payment Services No. 120/2011, Act on Measures Against Money Laundering and Terrorist Financing No. 140/2018, Act on Consumer Mortgages No. 118/2016, Consumer Loans Act No. 33/2013, Competition Act No. 44/2005 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 was listed on Nasdaq Iceland and Nasdaq Sweden on 15 June 2018. The Bank has also issued financial instruments which have been admitted for trading on regulated securities markets in Iceland, Norway and Luxembourg. The Bank is therefore subject to the disclosure requirements of issuers pursuant to the Securities Transactions Act and the rules of the relevant stock exchanges.

Financial Supervisory Authority of the Central Bank of Iceland, which from 1 January 2020 is part of the Central Bank of Iceland, 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 Central Bank's website, www.cb.is. Numerous other pieces of legislation to the operations of financial undertakings.

Internal controls, auditing and accounting

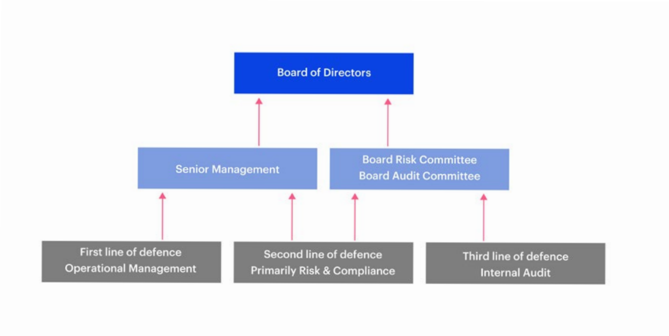
Internal control

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

Compliance is an independent control function which reports directly to the CEO and works in accordance with a special charter from the Board.

The main role of Compliance is to ensure that the Bank has in place proactive measures to reduce the risk of rules being breached in the course of its activities. Compliance is also responsible for coordinating the Bank's measures against money laundering and terrorist financing to reduce the risk of the Bank's services being used for illegal purposes. In September 2019 the Compliance Officer also took over the role of Data Protection Officer. Arion Bank cares about data protection and our customers' personal data we aim to ensure that personal data is processed legally, fairly and transparently. The Bank has adopted a data protection policy which can be seen on the Bank's website.

The duties of Compliance are carried out under a risk-based compliance plan approved by the Board of Directors, including a monitoring and training schedule for employees which addresses the laws and rules under which the Bank operates. Compliance provides the Board of Directors with a quarterly report on its activities.

Further information can be found on the Bank's website.

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 three 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 and the Bank's risk 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 sets out the responsibilities associated with the position and the scope of the work. The role 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. Internal Audit is governed by the audit charter, the FME's guidelines on the internal audit function in financial institutions and international standards on internal auditing.

Accounting and auditing

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.

Cornerstones and code of ethics

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 and 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.

Sustainability

Arion Bank's sustainability policy bears the title "Together we make good things happen" and signifies that the Bank wants to act as a role model in responsible and profitable business practices, taking into account the environment, the economy and the society in which we live and work.

Arion Bank shows its commitment to sustainable banking by making a difference to our customers and performing our role as a financial institution conscientiously and responsibly. 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. We place great importance on doing things fairly with the interests of our customers, employees, investors and the community at heart.

Arion Bank has been a partner of Festa, the Icelandic Center for Corporate Social Responsibility, for several years and since 2014 has been a signatory to the CEO

Statement of Support for the Women's Empowerment Principles (UN Women and UN Global Compact). In 2015 the Bank signed the City of Reykjavík and Festa's Declaration on Climate Change and has published its environmental accounts since 2016. Arion Bank has been a signatory to the UN Global Compact, the UN's initiative to encourage businesses to adopt sustainable and socially responsible practices, since the end of 2016. The Bank has also complied with the UN's Principles for Responsible Banking (UN PRI) since the end of 2017. In September 2019 the Bank became a signatory to the UN Principles for Responsible Banking (UN PRB), the goal of which is to align banking with international goals and commitments such as the UN Sustainable Development Goals and the Paris Climate Agreement.

Arion Bank's activities are governed by the provisions of the Annual Accounts Act on non-financial reporting, which, among other things, apply to the status and influence of the company in respect of environmental, social and human resources issues. Non-financial reporting in the annual report is based on the Global Reporting Initiative, GRI Core and the ESG reporting guide for the Nasdaq Nordic and Baltic exchanges.

In December 2019 the Board of Directors adopted a new environment and climate policy. Under the new policy the Bank will focus its attention on financing projects on sustainable development and green infrastructure, require that suppliers take into account the environmental and climate impact of their activities and reduce its own greenhouse gas emissions by 40% by 2030.

Further information on sustainability at Arion Bank can be found in the Bank's 2019 Annual Report. Further information can be found on the Bank's website.

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 Bank's Articles of Association. 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 Bank's Annual General Meeting. At Arion Bank's annual general meeting on 20 March 2019, six Directors and three Alternates were elected to the Board of Directors. At a shareholders' meeting on 9 August 2019, two Directors were elected to the Board, Paul Horner and Gunnar Sturluson. Benedikt Gíslason, who had been a Director since 2018, resigned from the Board when he was appointed CEO of Arion Bank.

The elected Board Directors have diverse backgrounds and extensive skills, experience and expertise. 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 three women.

Information on the independence of Directors is published on the Bank's website before the annual general meeting or a shareholders' meeting where a Board member is to be elected. The minutes of the annual general meeting and shareholders' meetings are also published on the Bank's website.

The Board of Directors meets at least ten times a year. In 2019 the Board met on 14 occasions. The Chairman of the Board is responsible for ensuring that the Board performs its role in an efficient and organized manner. 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. No later than one month following the annual general meeting 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, Heimir Þorsteinsson, is not a Board member and is independent of the Bank and its shareholders. The Board sub-committees are as follows:

- **Board Audit Committee (BAC)**: Its main task is, inter alia, to guarantee the quality of the financial statement and other financial information from the Bank and the independence of its auditors. The Committee also assists the Board in meeting its responsibility to ensure an effective system of internal controls and compliance and for meeting its external financial reporting obligations under applicable laws and regulations. The Committee met six times in 2019.
- **Board Risk Committee (BRIC)**: 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. Committee members should have the qualifications and experience necessary to be able to discharge their duties including forming the Bank's risk policy and risk appetite. The Committee met eight times in 2019 and a joint meeting was held with the Board Remuneration Committee.
- **Board Credit Committee (BCC)**: Its main task is to attend to credit issues which exceed the credit limits of its sub-committees. The Committee met 16 times in 2019.
- **Board Remuneration Committee (BRC)**: 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. The Committee met four times in 2019 and a joint meeting was held with the Board Risk Committee.

Sub-committees regularly inform the Board of their activities. Furthermore, the Board has access to all material used by the sub-committees and their minutes.

Below is an overview of the attendance of individual Directors and committee member.

Director	Period	Board (14)	BAC (6)	BRIC (9)	BCC (16)	BRC (5)
Eva Cederbalk[1]	1 Jan– 20 Mar	4	-	-	3	-
Brynjólfur Bjarnason	1 Jan– 31 Dec	14	3	-	15	2
Herdís D. Fjeldsted	1 Jan– 31 Dec	14	6	-	-	5
Benedikt Gíslason[2]	5 Sep– 26 Jun	5	-	3	-	3
Gunnar Sturluson	9 Aug– 31 Dec	4	-	-	5	-
Liv Fiksdahl	20 Mar – 31 Dec	9	-	-	-	2
Måns Höglund[3]	1 Jan– 20 Mar	4	-	4	3	-
Renier Lemmes	20 Mar– 31 Dec	9	2	3	-	-
Paul Horner	9 Aug – 31 Dec	4	-	3	-	-
Steinunn Kr. Þórðardóttir	1 Jan – 31 Dec	14	-	9	15	-
Ólafur Ö. Svansson	1 Jan – 31 Dec	7	-	1	1	3
Sigurbjörg Á. Jónsdóttir	1 Jan – 31 Dec	1	-	-	-	-
Þórarinn Þorgeirsson	1 Jan – 20 Mar	-	-	-	-	-
Þröstur Ríkharðsson	20 Mar – 31 Dec	1	-	-	-	-
Heimir Þorsteinsson	26 July – 31 Dec	-	6	-	-	-

The Board carries out an annual performance appraisal, at which it assesses its work, the necessary number of Board Directors, the Board composition with respect to experience and skills, working procedures and methods, the performance of the CEO, their achievements and the work of the subcommittees with respect to the aforementioned. This appraisal was last performed by the Board during the period October 2019 to January 2020.

[1] Eva Cederbalk stepped down from the Board of Directors on 20 March 2019.

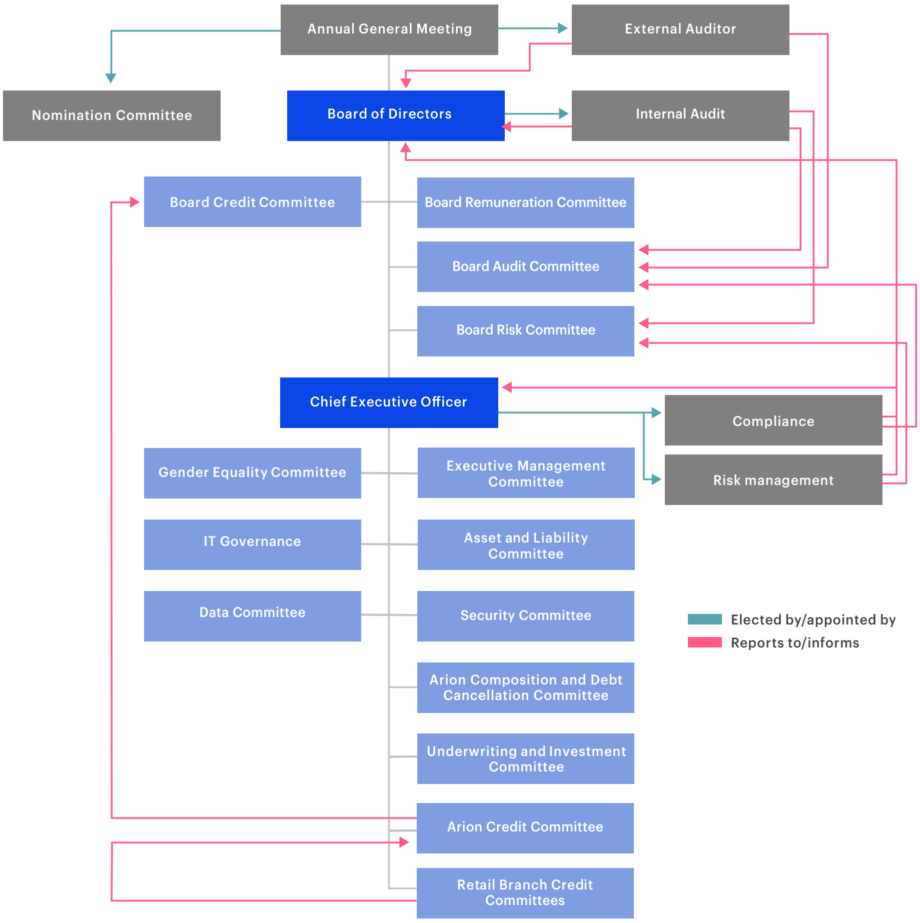
[2] Benedikt Gíslason stepped down from the Board of Directors on 26 June 2019 and took over as CEO on 1 July 2019.

[3] Måns Höglund stepped down from the Board of Directors on 20 March 2019.

The Board of Directors of Arion bank

Brynjólfur Bjarnason
Herdís Dröfn Fjeldsted
Gunnar Sturluson
Liv Fiksdahl
Paul Horner
Renier Lemmens
Steinunn Kristín Þórðardóttir

Arion Bank Governance Overview



Brynjólfur Bjarnason, Chairman

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 the Chairman of the Board, Chairman of the Board Remuneration Committee and Chairman 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 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 of them.

Brynjólfur is an Alternate on the Board of Fergusson ehf. and a board member of Marinvest ehf. and ISAL hf.

Herdís Dröfn Fjeldsted, Vice Chairman

Herdís was born in 1971. She was first elected as a Director at Arion Bank's annual general meeting on 15 March 2018. She is not a shareholder in Arion Bank and is an independent Director. Herdís is Vice Chairman of the Board, Chairman of the Board Audit Committee and a member of the Board Remuneration Committee. Herdís is Chairman of the Board of Directors of Valitor, Arion Bank's subsidiary, and Chairman of the Board Remuneration Committee at Valitor.

Herdís graduated with a BSc in business administration with an emphasis on international marketing from the Technical University of Iceland in 2004 and a Master's degree in corporate finance from Reykjavik University in 2011. Herdís is also a certified stockbroker.

Herdís was the CEO of The Icelandic Enterprise Investment Fund (Framtakssjódur Íslands– FSÍ) from 2014 and before that worked as an investment manager at FSÍ. Before joining The Icelandic Enterprise Investment Fund, Herdís worked as a senior investment analyst at Thule Investments. Herdís has served on numerous boards of directors, e.g. as the Chairman of VÍS hf., Chairman of Icelandic Group, Vice-Chairman of Promens and as a board member of Invent Farma, Medicopack A/S, Icelandair Group and Copeinca AS. Herdís is also a member of Exedra. Today, Herdís is a board member at The Icelandic-Canadian Chamber of Commerce.

Gunnar Sturluson

Gunnar was born in 1967. He was first elected as a Director at a shareholders' meeting on 9 August 2019. He is not a shareholder of Arion Bank and is an independent Director. Gunnar is a member of the Board Credit Committee.

Gunnar graduated as Cand. Jur from the University of Iceland in 1992, gained an LL.M. degree in Law from the University in Amsterdam in 1995 and received a license to practice before the District Court in Iceland in 1993 and before the Supreme Court in 1999.

Gunnar practiced law at the law firm Málflutningsskrifstofan in 1992–1999 and became partner in 1995. He joined Logos Legal Services in 2000 as a partner and was managing partner in 2001–2013. Gunnar lectured in competition law in 1995–2007 at the University of Iceland, Faculty of Law.

Gunnar has held various directorships, including the board of directors at Gamma hf. in 2017–2019, chairman of the board of directors of the Icelandic National Broadcasting Service (RÚV) 2016–2017, director at the Nordic Arbitration Center, president of the International Federation of Icelandic Horse Associations, chairman of the board of directors of the Icelandic Dance Company 2013–2016 and was voted by the Icelandic parliament to serve on the National Electoral Commission in 2013–2017.

Liv Fiksdahl

Liv was born in 1965. She was first elected as a Director at Arion Bank's Annual General Meeting on 20 March 2019. She is not a shareholder of Arion Bank and is an independent Director. Liv is a member of the Board Remuneration Committee.

Liv holds a degree in finance and management from Trondheim Business School (today NTNU) in 1986. In 2018, Liv completed programs at Stanford University in big data, strategic decisions and analysis, and the innovative technology leader. She has also completed an advanced management program for executives in management, innovation and technology at Massachusetts Institute of Technology.

Liv is currently a vice president (associated) within Financial Services at Capgemini Invent, Norway and serves on the boards of Scandinavian Airlines SAS AB, Posten Norge AS and Intrum AB. Liv has held various senior roles at DNB and was part of the executive management team for 10 years, and her most recent role was as the Group EVP, CIO/COO, for IT & Operations. Liv has broad experience from DNB, and has held different positions within the bank. Before DNB she had key account roles for the corporate clients within Danske Bank/Fokus Bank, and Svenska Handelsbanken. Liv has served on numerous boards, including BankAxept, Sparebankforeningen, Doorstep, Finans Norge and Trondheim Kommune Bystyret.

Paul Horner

Paul was born in 1962. He was first elected as a Director at a shareholders' meeting on 9 August 2019. He is not a shareholder of Arion Bank and is an independent Director. Paul is a member of the Board Risk Committee.

Paul graduated with M.A. Honours in music from the University of Oxford in 1983 and is an associate of the UK Chartered Institute of Bankers.

Paul held various executive and risk management roles at Barclays PLC between 1988 and 2003. In 2003 Paul joined The Royal Bank of Scotland Group and served as an executive and senior manager of Royal Bank of Scotland PLC. He also held various senior risk and general management roles until June 2019.

In 2012 to 2017, Paul was the Chief Risk Officer of Coutts & Co Ltd. and CEO of Coutts & Co Ltd, Zurich, in 2016–2017. Paul was Director of Risk at Ulster Bank DAC, Dublin, and is presently a non-executive director at Coutts & Co Ltd. in Zurich.

Renier Lemmens

Renier was born in 1964. He was first elected as a Director at Arion Bank's Annual General Meeting on 20 March 2019. He is not a shareholder of Arion Bank and is an independent Director. Renier is a member of the Board Audit Committee and the Board Risk Committee. Renier is member of the board of directors of Arion Bank's subsidiary Valitor and chairman of the board risk and monitoring committee at Valitor.

Renier has an MBA from INSEAD and an MSc in computer science from Delft University of Technology.

Renier is currently professor of fintech and innovation at the London Institute of Banking and Finance and the chairman of the board of TransferGo and Divido. Renier previously worked as CEO of Viadeo SA, was partner at Ramphastos Investments, CEO EMEA at PayPal, CEO of Amodo Consumer Finance, COO of international retail & commercial banking at Barclays Bank, consumer finance officer at GE Capital and a partner at McKinsey & Company. Renier has also served on numerous boards, including Revolut, Zenith Bank Ltd., Novum Bank Ltd. as chairman, Antenna Company Ltd., Robin Mobile BV, VoiceTrust BV, Krefima NV as chairman, Arenda BV as chairman, ZA Life Assurance NV, First Caribbean International Bank and chairman and CEO of Budapest Bank.

Steinunn Kristín Þórðardóttir

Steinunn was born in 1972. She was first elected as a Director at Arion Bank's shareholders' meeting on 30 November 2017. She is not a shareholder of Arion Bank and is an independent Director. Steinunn has a Master's degree in international management from Thunderbird, Arizona and a BA in international business and politics from University of South Carolina.

Steinunn was previously a partner and CEO of Beringer Finance Norway and global head of food and seafood. She founded Akton AS, a management consulting company in Norway in 2010 where she worked as a managing director until 2015. Steinunn worked at Íslandsbanki (later Glitnir) as executive director of International Corporate Credit and later as managing director and head of the bank's UK operations. Steinunn has previously held several Directorships in Europe and was a board member of the Icelandic State Financial Investment (ISFI). Steinunn is the chairman of the board of Acton Capital AS and Akton AS and a board member of Cloud Insurance AS. She is also a board member of the Norwegian-Icelandic Chamber of Commerce. Steinunn is a member of the nomination committee of Síminn.

Alternate directors:

Ólafur Örn Svansson, Supreme Court attorney, Sigurbjörg Ásta Jónsdóttir, lawyer and Þröstur Ríkharðsson, Supreme Court attorney.

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

Communication between the shareholders and the Board of Directors

The main venue at which the Board and the Bank report information to the shareholders and propose decisions to be made is at legally convened shareholders' meetings. The Bank provides an effective and accessible arrangement for communications between shareholders and the Board of Directors between those meetings. Any information sensitive to the market will be released through a MAR press release. As part of the investor relations programme, Arion Bank has also arranged quarterly meetings where the CEO, CFO and Investor Relations present the interim financial results.

The Bank has a strong capital position despite substantial dividends and share buybacks totaling ISK 33 billion during the year. The Bank's listing on Nasdaq Iceland and Nasdaq Stockholm took place on 15 June following an initial public offering of 28.7% of shares in the Bank placed with investors in Iceland, Scandinavia, UK, Continental Europe and the US. This is the first listing of an Icelandic bank on the main market in Iceland since 2008. The IPO represents a significant step in the development of Arion Bank and the Bank welcomes the new shareholders. Following the IPO in June this year there have been no major changes to the largest shareholdings. At the end of the year, Kaupskil ehf. is the largest shareholder with a 32.67% shareholding. Today the total number of shareholders is more than 6000.

Chief Executive Officer[4]

Benedikt Gíslason

Benedikt was born in 1974. Benedikt was appointed CEO on 1 July 2019.

Benedikt joined FBA (later Íslandsbanki) in 1998, held a variety of managerial positions at Straumur-Burðarás, was managing director of capital markets at FL Group and was managing director of the investment banking division of MP Bank. Benedikt worked as a senior advisor for Iceland's Ministry of Finance and Economic Affairs and was vice-chairman of a government task force on the liberalization of the capital controls between 2013 and 2016. He served on the board of directors of Kaupthing from 2016 to 2018 and was an advisor to Kaupthing on matters relating to Arion Bank. Benedikt was elected to the Board of Directors of Arion Bank in September 2018 and served on the Board until his appointment as CEO.

Benedikt gained a C.Sc. in mechanical and industrial engineering from the University of Iceland in 1998.

[4] Höskuldur H. Ólafsson served as CEO until 30 April 2019

Executive Committee[5]

The Bank's Executive Committee consists of the following people and the CEO:

- Ásgeir H. Reykfjörð Gylfason, Deputy CEO and Managing Director of Corporate and Investment Banking
- Gísli S. Óttarsson, Chief Risk Officer
- Ida Brá Benediktsdóttir, Managing Director of Retail Banking
- Margrét Sveinsdóttir, Managing Director of Markets
- 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 and legal cases.

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 the main legal cases relating to Arion Bank and a settlement with the Financial Supervisory Authority can be found in the notes to the annual financial statement.

The Board of Directors annually reviews and approves the Corporate Governance Statement.

This Corporate Governance Statement was examined and approved at a meeting of the Board of Directors on 12 February 2020.

[5] Jónína S. Lárusdóttir was managing director of the Legal division until 16 September 2019. Rakel Óttarsdóttir was managing director of Information Technology until 20 September 2019.

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