Confidential Information Memorandum

This Information Memorandum has been prepared in connection with a contemplated bond offering by

Arion Banki hf

with total gross proceeds of NOK 500 million at an interest rate of 3 month Nibor + 5.00% at an issue price of 100%

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Arion Banki hf (the "**Issuer**", the "**Bank**" or "**Arion Bank**") proposes to issue NOK 500 of 3 month Nibor+5.00% senior unsecured bonds (the "**Bonds**") on 4 March 2013 (the "**Issue Date**") (the "**Bond Issue**"). The Bonds will mature on 4 March 2016 (the "**Maturity Date**"). The issuer shall take all reasonable measures to have the Bonds listed on Oslo Stock Exchange within 4 months from Issue Date.

The Bonds will constitute direct, unconditional, unsubordinated and unsecured obligations of the Issuer. The Bonds will at all times rank *pari passu* among themselves.

Investing in the Bonds involves a high degree of risk, see section 8 – "Risk factors".

Interest on the Bonds is payable quarterly in arrears in June, September, December and March in each year commencing on 4 June 2013. The net proceeds of the Bond Issue (as defined below) shall be used by Arion Bank towards general corporate purposes.

*The Bonds have not been and will not be registered under the United States Securities Act of 1933, as amended, (the **"Securities Act"**) or under the applicable securities laws of any state of the United States and may not be offered or sold, directly or indirectly, within the United States except pursuant to an applicable exemption from, or in a transaction not subject to, the registration requirements of the Securities Act.*

*The Bonds will only be offered or sold within the United States to Qualified Institutional Buyers (**"QIBs"**) as defined in Rule 144A under the Securities Act.*

This confidential information memorandum (the **"Information Memorandum"**) does not constitute a prospectus as defined in the Directive 2003/71/EC (the "Prospectus Directive"), and no prospectus relating to the Bond has been registered under any law or regulation. The Information Memorandum has not been prepared to comply with the Prospectus Directive or the EC Commission Regulation nr. 809/2004, nor with any national rules and regulations relating to prospectuses. The offer contemplated in this confidential Information Memorandum is thus made in reliance upon an exemption from prospectus requirements under the Prospectus Directive and the offering of the Bonds contemplated herein is only being made in accordance therewith and is not being made to persons whose participation requires a prospectus, registration measures or other similar measures.

The acceptance of the offer contemplated in this confidential Information Memorandum shall not be capable of being accepted by anyone other than by the party or parties to whom such offer is made and shall not be renounceable in favour of parties other than the party or parties to whom such offer is made and the Bonds may not be offered, sold or delivered to any person located or resident in any jurisdiction where such actions are unlawful without further measures being taken.

NO ACTION HAS BEEN OR WILL BE TAKEN IN ANY JURISDICTION BY THE ISSUER OR THE LEAD MANAGER AND ISSUING AGENT (AS DEFINED BELOW) THAT WOULD PERMIT AN OFFERING OF THE BONDS, OR THE POSSESSION OR DISTRIBUTION OF ANY DOCUMENTS RELATING THERETO, OR ANY AMENDMENT OR SUPPLEMENT THERETO, IN ANY COUNTRY OR JURISDICTION WHERE SPECIFIC ACTION FOR SUCH PURPOSE IS REQUIRED. ACCORDINGLY, THIS INFORMATION MEMORANDUM MAY NOT BE USED FOR THE PURPOSE OF, AND DOES NOT CONSTITUTE, AN OFFER TO SELL OR ISSUE, OR A SOLICITATION OF AN OFFER TO BUY OR APPLY FOR, ANY SECURITIES IN ANY JURISDICTION IN ANY CIRCUMSTANCES IN WHICH SUCH OFFER OR SOLICITATION IS NOT LAWFUL OR AUTHORIZED. IN PARTICULAR, THIS INFORMATION MEMORANDUM MAY NOT BE DISTRIBUTED IN, OR TO ANY PERSON RESIDENT IN CANADA, AUSTRALIA, JAPAN, THE REPUBLIC OF CYPRUS, THE UNITED KINGDOM OR THE UNITED STATES OR TO, OR FOR THE ACCOUNT OR BENEFIT OF, ANY U.S. PERSON (AS SUCH TERMS ARE DEFINED IN REGULATION S OF THE SECURITIES ACT ("REGULATION S")), EXCEPT AS SET FORTH HEREIN AND PURSUANT TO APPROPRIATE EXEMPTIONS UNDER THE LAWS OF ANY SUCH JURISDICTION. FAILURE TO COMPLY WITH THESE RESTRICTIONS MAY CONSTITUTE A VIOLATION OF APPLICABLE SECURITIES LEGISLATION. PERSONS INTO WHOSE POSSESSION THIS INFORMATION MEMORANDUM MAY COME ARE REQUIRED BY THE ISSUER AND THE LEAD MANAGER AND ISSUING AGENT TO INFORM THEMSELVES ABOUT, AND TO OBSERVE, SUCH RESTRICTIONS. NEITHER THE ISSUER NOR THE LEAD MANAGER AND ISSUING AGENT SHALL BE RESPONSIBLE OR LIABLE FOR ANY VIOLATION OF SUCH RESTRICTIONS BY POTENTIAL INVESTORS. SPECIFICALLY, THE BONDS HAVE NOT BEEN AND WILL NOT BE REGISTERED UNDER THE SECURITIES ACT, OR WITH ANY SECURITIES REGULATORY AUTHORITY OF ANY STATE OR OTHER JURISDICTION IN THE UNITED STATES. ACCORDINGLY, THE BONDS MAY NOT BE OFFERED OR SOLD, DIRECTLY OR INDIRECTLY, WITHIN THE UNITED STATES, OR TO, OR FOR THE ACCOUNT OR BENEFIT OF, U.S. PERSONS, EXCEPT PURSUANT TO AN APPLICABLE EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT. THE BONDS ARE BEING OFFERED AND SOLD ONLY (1) OUTSIDE THE UNITED STATES TO PERSONS OTHER THAN "U.S. PERSONS" ("NON-U.S. PURCHASERS", WHICH TERM SHALL INCLUDE DEALERS OR OTHER PROFESSIONAL FIDUCIARIES IN THE UNITED STATES ACTING ON A DISCRETIONARY BASIS FOR NON-U.S. BENEFICIAL OWNERS (OTHER THAN AN ESTATE OR TRUST)) IN RELIANCE UPON REGULATION S AND (2) IN THE UNITED STATES TO QIBS IN RELIANCE ON AN EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT. AS USED HEREIN, THE TERMS "UNITED STATES" AND "U.S. PERSON" HAVE THE MEANINGS GIVEN TO THEM IN RULE 902 OF REGULATION S UNDER THE SECURITIES ACT. PLEASE SEE FURTHER DETAILS UNDER "IMPORTANT INFORMATION" BELOW.

ANY INVESTOR INVESTING IN THE BONDS IS BOUND BY THE FINAL TERMS AND CONDITIONS FOR THE BONDS. THE FINAL TERMS AND CONDITIONS FOR THE BONDS, WHICH THE INVESTOR ACKNOWLEDGES HAVING ACCEPTED BY INVESTING IN THE BONDS, WILL BE MADE AVAILABLE BY THE LEAD MANAGER AND ISSUING AGENT UPON WRITTEN REQUEST.

Lead Manager and Issuing Agent

Pareto Öhman

20 February 2013

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Important Information

This Information Memorandum has been prepared by the Company and the Issuer. The Information Memorandum is being furnished for limited distribution through the Manager, as the exclusive authorized representatives for the Issuer for informational purposes and solely for use by prospective investors who have expressed an interest in an investment in the Bonds to be issued by the Issuer. Only the Company, the Issuer and the Manager is entitled to provide information in respect of matters described in this Information Memorandum. Information that might be provided by any other persons is of no relevance to the contents of this Information Memorandum and must not be relied upon.

The information contained herein has been prepared to assist interested parties in making their own evaluation of the Issuer and its creditworthiness and does not purport to be all-inclusive or to contain all information that prospective investors may desire or that may be required in order to properly evaluate the business, prospects or value of the Issuer. In all cases, interested parties should conduct their own investigation and analysis of the Issuer and the data set forth in this Information Memorandum. The Manager has not independently verified any of the information contained herein, and neither the Manager, any of its advisors nor any of their respective affiliates, make any representation or warranty (expressed or implied) as to the accuracy or completeness of this Information Memorandum or any statements, estimates or projections contained herein, or the legality of any prospective investor´s investment in the Bonds issued by the Issuer. Neither the Manager, any of its advisors, nor any of their respective affiliates, have any liability for the recipient's use of this Information Memorandum or any other oral, written or other communications transmitted to the recipient in the course of its evaluation of the Issuer.

This Information Memorandum may contain certain tables and other statistical analyses (the "Statistical Information"). Numerous assumptions were used in preparing the Statistical Information, which may or may not be reflected herein. As such, no assurance can be given as to the Statistical Information's accuracy, appropriateness or completeness in any particular context; nor as to whether the Statistical Information and/or the assumptions upon which they are based reflect present market conditions or future market performance. The contents of this Information Memorandum including the Statistical Information are not to be construed as legal, credit, business or tax advice. Each prospective investor should consult with its own legal, credit, business or tax adviser as to legal, credit, business and tax advice. By receiving this Information Memorandum you acknowledge that you will be solely responsible for your own assessment of the market and the market position of the Issuer and that you will conduct your own analysis and are solely responsible for forming your own opinion of the potential future performance of the Issuer's business.

In making an investment decision, investors must rely on their own examination of the Issuer, including the merits and risks involved.

This Information Memorandum does not constitute an offer to sell or a solicitation of an offer to buy the Bonds by any person in any jurisdiction where it is unlawful to make such an offer or solicitation. The distribution of this Information Memorandum and the offer or sale of the Bonds in certain jurisdictions is restricted by law. This Information Memorandum may not be used for, or in connection with, and does not constitute, any offer to, or solicitation by, anyone in any jurisdiction or under any circumstance in which such offer or solicitation is not authorised or is unlawful. In particular, this Information Memorandum does not constitute an offer of securities to the public in the United Kingdom. No prospectus has been or will be approved in the United Kingdom in respect of the Bonds. Consequently this document is being distributed only to, and is directed at (a) persons who have professional experience in matters relating to investments falling within article 19(1) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities falling within article 49(2)(a) to (d) of the Order, and other persons to whom it may be lawfully communicated, falling within article 49(1) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this document or any of its contents. Persons into whose possession this Prospectus may come are required by the Issuer and the Manager to inform themselves about and to observe such restrictions. Further information with regard to restrictions on offers, sales and deliveries of the Bonds and the distribution of this Prospectus and other offering material relating to the Bonds is set out under "Eligible subscribers and minimum subscription".

The Bonds have not been approved or disapproved by the United States Securities and Exchange Commission or any other securities commission or other regulatory authority in the United States, nor have the foregoing authorities approved this Information Memorandum or confirmed the accuracy or determined the adequacy of the information contained in this Information Memorandum. Any representation to the contrary is unlawful.

This Information Memorandum does not constitute a prospectus as defined in the Prospectus Directive (Directive 2003/71/EC), and has not been prepared to comply with the Prospectus Directive or the EC Commission Regulation nr. 809/2004, nor with any national rules and regulations relating to prospectuses, including but not limited to Chapter 7 of the Norwegian Securities Trading Act of 29 June 2007 no. 75. This Information Memorandum has not been reviewed by or approved by any public authority including the Oslo Stock Exchange, and is intended to be read by the addressee only.

The Bonds being offered hereby are being offered on a private basis to investors who satisfy criteria outlined in this Information Memorandum.

This Information Memorandum was prepared solely for the recipient and other selected potential investors interested. This Information Memorandum is personal to the recipient to whom it has been delivered by the Manager and does not constitute an offer to any other person or a solicitation of the public in general to subscribe for, or otherwise acquire, the Bonds. This Information Memorandum may not be distributed by the recipient to anyone other than (i) the recipient's legal, credit, business or tax advisors, nor may the recipient make copies of this Information Memorandum or any other document the recipient may receive in connection with the Bond Issue, except to the extent necessary to consult with his, her or its legal, credit, business or tax advisors (and only so long as such legal, credit, business or tax advisors agrees to hold all information contained in this Information Memorandum confidential and not use it for purposes other than for providing advice in connection herewith); or (ii) persons approved in writing by the Manager and the Issuer.

The Loan Agreement will be made available upon written request. By accepting receipt of this Information Memorandum, each recipient acknowledges that they have received the information set out herein and that they accept the terms of the Bond Issue as set out herein, as well as in the Term Sheet and/or the Loan Agreement. In case of any discrepancy between the Loan Agreement and the Term Sheet, the provisions of the Loan Agreement shall prevail.

This Information Memorandum is subject to Norwegian law, unless otherwise explicitly stated. Any dispute arising in respect of this Information Memorandum is subject to the exclusive jurisdiction of the Norwegian courts.

Certain statements in this Information Memorandum are forward-looking. Such forward-looking statements and information are based on the beliefs of the Issuer's management or assumptions based on information available to the Issuer. When used in this document, the words "anticipate", "believe", "estimate" and "expect" and similar expressions, as they relate to the Group, the Issuer or its management, are intended to identify forward-looking statements. Such forward-looking statements reflect the current views of the Issuer or its management with respect to future events and are subject to certain risks, uncertainties and assumptions. The Issuer can give no assurance as to the correctness of such forward-looking statements. Many factors could cause the actual results, performance and achievements of the Issuer to be materially different from any future results, performance or achievements that may be expressed or implied by such forward-looking statements, including among others, risks or uncertainties associated with the Issuer's products, technological development, growth management, relations with customers and, more generally economic and business conditions, changes in domestic and foreign laws and regulations (including those of the European Union), taxes, changes in competition and pricing environments, and other factors whether referenced in this document or not. Some of these factors are discussed in more detail under section 8 – "RISK FACTORS". Should one or more of these or other risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this document as anticipated, believed, estimated or expected. Except as required by applicable law, the Issuer does not intend, and does not assume any obligation, to update the forward-looking statements included in this Information Memorandum as at the date hereof.

This Information Memorandum has not been and will not be registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this Information Memorandum and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the Bonds may not be circulated or distributed, nor may the Bonds be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under

Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the "SFA"), (ii) to a relevant person pursuant to Section 275 (1) of the SFA, or to any person pursuant to Section 275 (1A) of the SFA and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of any other applicable provisions of the SFA.

U.S. Information

The Bonds may be offered or sold within the United States only to “qualified institutional buyers” within the meaning of Rule 144A of the Securities Act (“QIBs”) or to “accredited investors” (as defined in Rule 501(a)(1), (2), (3) or (7) under the Securities Act that are institutions (“Institutional Accredited Investors”), in either case in transactions exempt from registration under the Securities Act). Each U.S. purchaser of the Bonds is hereby notified that the offer and sale of any Bonds to it may be being made in reliance upon the exemption from the registration requirements of the Securities Act provided by Rule 144A under the Securities Act (“Rule 144A”).
TO ENSURE COMPLIANCE WITH U.S. INTERNAL REVENUE SERVICE CIRCULAR 230, PROSPECTIVE INVESTORS ARE HEREBY NOTIFIED THAT: (A) ANY DISCUSSION OF FEDERAL TAX ISSUES CONTAINED OR REFERRED TO IN THIS INFORMATION MEMORANDUM IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED BY PROSPECTIVE INVESTORS FOR THE PURPOSE OF AVOIDING PENALTIES THAT MAY BE IMPOSED ON THEM UNDER THE INTERNAL REVENUE CODE; (B) SUCH DISCUSSION IS WRITTEN IN CONNECTION WITH THE PROMOTION OR MARKETING BY THE ISSUER OF THE TRANSACTIONS OR MATTERS ADDRESSED HEREIN; AND (C) PROSPECTIVE INVESTORS SHOULD SEEK ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISER.

Notice to New Hampshire residents

NEITHER THE FACT THAT A REGISTRATION STATEMENT OR AN APPLICATION FOR A LICENSE HAS BEEN FILED UNDER CHAPTER 421 B OF THE NEW HAMPSHIRE REVISED STATUTES (“RSA 421-B”) WITH THE STATE OF NEW HAMPSHIRE NOR THE FACT THAT A SECURITY IS EFFECTIVELY REGISTERED OR A PERSON IS LICENSED IN THE STATE OF NEW HAMPSHIRE CONSTITUTES A FINDING BY THE SECRETARY OF STATE OF NEW HAMPSHIRE THAT ANY DOCUMENT FILED UNDER RSA 421 B IS TRUE, COMPLETE AND NOT MISLEADING. NEITHER ANY SUCH FACT NOR THE FACT THAT AN EXEMPTION OR EXCEPTION IS AVAILABLE FOR A SECURITY OR A TRANSACTION MEANS THAT THE SECRETARY OF STATE HAS PASSED IN ANY WAY UPON THE MERITS OR QUALIFICATIONS OF, OR RECOMMENDED OR GIVEN APPROVAL TO, ANY PERSON, SECURITY OR TRANSACTION. IT IS UNLAWFUL TO MAKE, OR CAUSE TO BE MADE, TO ANY PROSPECTIVE PURCHASER, CUSTOMER OR CLIENT ANY REPRESENTATION INCONSISTENT WITH THE PROVISIONS OF THIS PARAGRAPH.

Available information

The Issuer is not currently required to file periodic reports under Sections 13 or 15 of the Exchange Act with the U.S. Securities and Exchange Commission. To permit compliance with Rule 144A in connection with resales and transfers of Bonds, the Issuer has agreed that, for so long as any of the Bonds are “restricted securities” within the meaning of Rule 144(a)(3) under the Securities Act, the Issuer will provide to any holder or beneficial owner of such restricted securities, or to any prospective purchaser of such restricted securities designated by a holder or beneficial owner, upon the request of such holder, beneficial owner or prospective purchaser, the information required to be provided by Rule 144A(d)(4) under the Securities Act, if at the time of such request the Issuer is not a reporting company under Section 13 or Section 15(d) of the Exchange Act or exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act.

Enforcement of foreign judgements

The Issuer is a public limited company organised under the laws of Iceland and its directors and all other principal officers of the Issuer are residents of Iceland. All or a substantial portion of the assets of the Issuer and of each of such persons are located Iceland. As a result, it may not be possible (a) to effect service of process upon the Issuer or any such person outside Iceland, (b) to enforce against any of them, in courts of jurisdictions other than Iceland, judgments obtained in such courts that are predicated upon the laws of such other jurisdictions or (c) to enforce against any of them, in Icelandic courts, judgments obtained in jurisdictions other than the Iceland, including judgments obtained in the United States predicated upon the civil liability provisions of the federal securities laws of the United States.

The Bonds and the Loan Agreement are governed by Norwegian law and the Issuer has agreed in the Bonds and the Loan Agreement that disputes arising thereunder are subject to the jurisdiction of the Norwegian courts. The Icelandic courts will enforce any judgment obtained in the Courts of Norway.

Transfer restrictions

The Bonds are being offered and sold in the United States only to qualified institutional buyers within the meaning of and in reliance on Rule 144A. Because of the following restrictions, purchasers of Bonds offered in the United States in reliance on Rule 144A are advised to consult legal counsel prior to making any offer, resale, pledge or transfer of such Bonds.

Each purchaser of Bonds offered hereby pursuant to Rule 144A will be required to execute and Investor Representation Letter (See “Appendix I – Application Form”), pursuant to which such purchaser will acknowledge and will represent to and agree with the Company, among other things, that (terms used herein that are defined in Rule 144A are used herein as defined therein):

(i) the purchaser (a) is a qualified institutional buyer within the meaning of Rule 144A, (b) is acquiring the Bonds for its own account or for the account of such a qualified institutional buyer and (c) such person is aware that the sale of the Bonds to it is being made in reliance on Rule 144A;

(ii) the Bonds are being offered only in a transaction not involving any public offering in the United States within the meaning of the Securities Act, and the Bonds offered hereby have not been and will not be registered under the Securities Act and may not be reoffered, resold, pledged, or otherwise transferred except in accordance with the legend set out below

Statements of responsibility

This Information Memorandum has been prepared for the purpose of providing a description of Arion Bank's business in connection with the Bond Issue.

Unless otherwise stated, the Issuer is the source of all data contained in this Information Memorandum and the Lead Manager and Issuing Agent has conducted no efforts to confirm or verify the information supplied by the Issuer and make no representation or warranty, explicit or implied as to the accuracy or completeness of the information provided herein. The Chairman of the Board, Chief Executive Officer, Chief Risk Officer, Chief Financial Officer of Arion Bank confirm that, having taken all reasonable care to ensure that such is the case, the information presented herein, to the best of their knowledge, is in accordance with actual conditions and contains no omissions which may serve to render the information in this Information Memorandum misleading or incorrect in any material way and which may materially affect the assessment of the issuer, including its creditworthiness. This Information Memorandum contains summaries believed to be accurate with respect to certain documents, but such summaries are subject always to the actual content of such documents. Except to the extent expressly set out in this Information Memorandum, neither the contents of the Bank's or the Group's website (or any other website) nor the content of any website accessible from hyperlinks on the Bank's or the Group's website (or any other website) is incorporated into, or forms part of, this Information Memorandum.

Statements in the Information Memorandum about current and future market conditions and prospects for Arion Bank have been made on a best judgement basis. Any forward looking statements or predictions are subject to substantial uncertainty and risk.

Reykjavik, Iceland, 20 February 2013

The Chairman of the Board, Chief Executive Officer, Chief Risk Officer, Chief Financial Officer of Arion Bank

Definitions, terms and abbreviations

AML	Anti-money laundering
Article 84	Article 84 of the Act on Financial Undertakings
Audited financial statements	The Bank's audited consolidated financial statements as of and for the for the years ended 31 December 2011, 2010 and 2009
Basel Committee	Basel Committee on Banking Supervision is an institution created by the central bank governors of the group of ten nations ("**G10**"), which has developed a set of recommended market practices of financial risk management in the banking sector, security and minimal capital requirements for banks. The Basel Committee's most important documents are the Capital Accord of 1988 and its expanded and updated version known as Basel II International Convergence of Capital Measurement and Capital Standard
Basel II	New Capital Accord published by the Basel Committee in 2006
CAGR	Compound annual growth rate
Central Bank	Seðlabanki Íslands, the Central Bank of Iceland
Credit committees	The credit committees of the Bank
EEA	The European Economic Area
EU	European Union
Euros, Euro, €	The lawful currency of the European Economic and Monetary Union
Financial statements	The Audited Financial Statements and the Interim Financial Statements
FME	Fjármálaeftirlitið, the Financial Supervisory Authority on Iceland
GDP	Gross domestic product
Group	The Issuer and its subsidiaries
HF	Hlutafélag, in Iceland, a Public limited company
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
ISK	Icelandic króna, the lawful currency on Iceland
KYC	Know your customer
N.A.	Not Available or Not Applicable
NOK	Norwegian krone, the lawful currency of the Kingdom of Norway
NPL	Non-Performing Loan
Qualified Institutional Buyers, QIBs	Qualified Institutional Buyers as defined in Rule 144A
Regulation S	Regulation S under the US Securities Act
ROE	Return on equity
ROAE	Return on average equity, an adjusted version of the ROE measure of profitability, in which the denomination is average shareholders' equity rather than shareholders' equity
Rule 144A	Rule 144A under the US Securities Act
SME	Small and medium enterprise
U.S. Dollars, dollars, USD	The US dollar, the lawful currency of the United States of America
VPS	VPS (“Verdipapirsentralen ASA”) is the central securities depository in Norway
YoY	Year-over-year
YTD	Year-to-date

1. The Bond Issue and the Bonds

1.1 The Issuer

Arion Bank is a public limited company established at the end of 2008 for an unlimited duration and operating under Icelandic law. It is registered with the registrar of companies in Iceland and its registration number is 581008-0150. The registered office of the Issuer is at Borgartun 19, 105 Reykjavik, Iceland, tel. +354 444 7000. The operations of the Issuer are, among other things, subject to the provisions of Act No. 2/1995 on Public Limited Companies, as amended, and Act No. 161/2002 on Financial Undertakings, as amended. The Issuer is subject to the supervision of the Icelandic Financial Supervisory Authority.

1.2 Lead Manager

Pareto Öhman has been appointed as Lead Manager for the Bond Issue. Pareto Öhman is a Swedish private limited company having its business address at Berzelii Park 9, 111 47 Stockholm, Sweden with organization number 556206-8956 in the Swedish Register of Business Enterprises.

1.3 Use of proceeds

The Net Proceeds shall be used by the Bank towards general corporate purposes.

1.4 Minimum subscription

The minimum permissible investment upon issuance of the Bonds is NOK 1,000,000.

1.5 Subscription period

The Subscription Period will commence on 18 February 2013 and end on 22 February 2013 at 18.00 CET. The Issuer may (in cooperation with the Manager) at its sole discretion decide to close the subscription period at an earlier time, or extend the subscription period. For details about the subscription, see the Application Form.

1.6 Allocation

Following the end of the Subscription Period, the Manager will allocate the Bonds within the limits of each subscriber's subscription. Following the allocation, the Manager will send out allocation letters and/or a trade note to subscribers following the allocation, including payment instructions.

1.7 Issuance of the Bonds

The Bonds will be registered and issued with VPS. In order to receive the Bonds, the investor must open a VPS account or have an agreement with a nominee at VPS that can hold the Bonds on behalf of the investor.

The Bonds will be transferred to the investors' VPS account upon the later of the date of the completion of the Bond Issue and the receipt of full payment for allocated Bonds.

The issuer shall take all reasonable measures to have the Bonds listed on Oslo Stock Exchange within 4 months from Issue Date.

1.8 Regulation of the Bonds

The Bonds will be registered in VPS in accordance with the Norwegian Central Securities Depository **(**No: *Verdipapirregisterloven*) and be registered on behalf of the investors on a VPS account. The Bond agreement will be governed by Norwegian law.

1.9 Terms and Conditions of the Bond Issue

The following provides a brief summary of the expected key terms and conditions of the Bond Issue. For further information about the Bond Issue and a description of the Terms and Conditions, please see the Term Sheet. For complete information in relation to the terms and conditions for the Bond Issue, please refer to the Terms and Conditions.

The Terms and Conditions, which the investor acknowledges having accepted by investing in the Bonds, will be made available by the Manager upon written request.

Bonds:	NOK 500 Senior Unsecured 3 month Nibor+5.00% Bonds 2013/2016, being debt instruments registered in VPS pursuant to the Norwegian Central Securities Depository act (No: *Verdipapirregisterloven*), issued by the Issuer under the Terms and Conditions.
Currency:	NOK.
Bond Issue:	NOK 500 million, limited issue.
Interest rate:	The Bonds shall carry interest at a floating rate of 3 month Nibor+5.00% p.a., quarterly interest payments.
Issue date:	Expected to be 4 March 2013. Notice is expected to be given to subscribers at least two banking days prior to Issue Date.
Final redemption date:	4 March 2016 (three years after Issue Date) at a price equal to 100.00% of the Nominal Amount.
Interest payment dates:	June, September, December and March each year (with the first Interest Payment Date on 4 June 2013 and the last Interest Payment Date being the Final Redemption Date).
Price:	100% of the Nominal Amount for Bonds issued on the Issue Date. Bonds issued on a subsequent date may be sold at another price than the Nominal Amount.
Nominal amount:	The nominal amount of each Bond will be NOK 1,000,000.
Minimum investment:	The minimum permissible investment upon issuance of the Bonds is NOK 1,000,000.
Purpose of the Bond Issue:	The Net Proceeds shall be used by the Issuer towards general corporate purposes.
Status of the Bonds:	The Bonds constitute direct, unconditional, unsubordinated and unsecured obligations of the Issuer and shall at all times rank *pari passu* with all direct, unconditional, unsubordinated and unsecured obligations of the Issuer, except those obligations which are mandatorily preferred by law, and without any preference among them.
Covenants	Compliance with FME requirements, Issuer to gross-up payments to compensate for withholding tax, Issuer to be rated by S&P or Moody's within a year – If (if applicable) the S&P long term foreign currency issuer credit rating falls below BB- or (if applicable) the Moody´s long term issuer rating falls below Ba3 an additional margin of 50bps is payable.
Paying agent:	DNB Bank ASA.

2. Executive summary

2.1 Introductions

Arion Bank is the entity to which certain assets and liabilities of Kaupthing Bank hf. (Kaupthing) were transferred following the assumption of control of Kaupthing by the Icelandic government towards the end of 2008. The Bank was established on 18 October 2008 and is incorporated in Reykjavik and domiciled in Iceland. Arion Bank is the second largest bank on Iceland measured by total assets.

The Bank has focused on restructuring its loan portfolio and expanding its sources of funding as well as reducing other mismatches and maintaining high levels of liquidity and capital. Looking ahead, a new strategic plan was finalised in October 2010 which seeks to position the Bank as a universal bank providing a range of quality services and focuses on improving the Bank's competitiveness.

The Bank has divided its operations into the four different divisions; corporate banking, retail banking, asset management and investment banking.

Arion Bank currently has a strong wholesale funding position with no significant redemption until 2020. On the same note, the Bank, on 17 February 2012, issued its first covered bonds under its EUR 1 billion Covered Bond Programme. The issue was ISK 2.5 billion inflation linked, with a final maturity in 2034, targeted towards Icelandic institutional investors.

2.2 The Icelandic economy and banking sector

Towards the end of 2008, Iceland suffered a currency and banking crisis. The government of Iceland was forced to step in and take control of the three major Icelandic banks, Kaupthing Bank hf., Landsbanki Íslands hf. and Glitnir Bank hf., which had been very active in the international financial market, to shore up confidence in the financial sector, protect domestic deposits and maintain the orderly function of the payment system.

In principle, Iceland did not take on the liabilities of the former financial sector. Icelandic assets and liabilities were transferred into new banks and the Icelandic State Financial Investments was formed to manage government equity stakes in the new banks. The creditors of Kaupthing Bank hf., Landsbanki Íslands hf. and Glitnir Bank hf. control 87%, 95% and 19% in the new banks; Arion Bank, Islandsbanki and Landsbankinn while the remainder is controlled by the Icelandic State Financial Investments.

Following the crisis, the Icelandic government has successfully turned the economy from subtraction in 2009 and 2010 into real growth in 2011 and 2012. The unemployment level peaked in early 2010, after which it started to turn around and current unemployment levels are rather modest compared to relevant European peers. Furthermore, the Icelandic government has issued two international USD bonds post-crisis.

Figure 1 – Real GDP growth (year-over-year)[1]

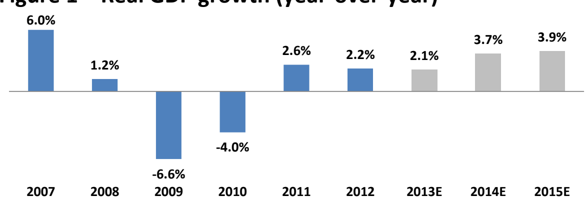


Figure 2 – Unemployment rate[2]

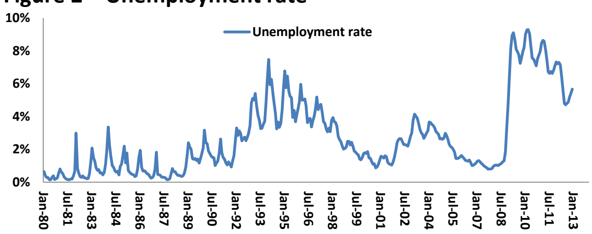


Figure 3 – Icelandic sovereign bonds[3]

Issue date	Maturity	USD million	Coupon	Current yield	Moody's	Standard and Poor's	Fitch Ratings
Jun-2011	Jun-2016	1,000	4.875%	2.910%	Baa3	BBB-	BBB
May-2012	May-2022	1,000	5.875%	4.260%	Baa3	BBB-	BBB

[1] Central Bank of Iceland
[2] Director of Labour, Iceland
[3] Bloomberg as at 5 February 2013

Figure 4 – 5-year Credit default swap (basis points), Iceland versus other sovereigns[1]

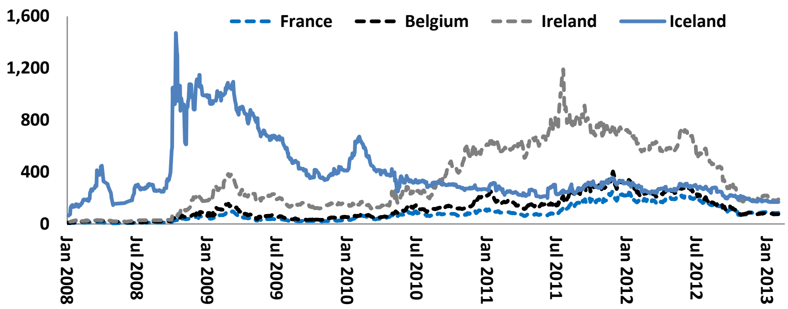


Figure 5 – Iceland compares strongly with other economies[2]

Selected economies forecast for 2013 (IMF)
Annual % change unless noted otherwise

	Real GDP	Consumer prices	Current account balance	Unemployment	5yr CDS (bps)	Net government debt (2012 % of GDP)	Rating (Moody's/S&P/Fitch)
Iceland	2.6	4.4	-2.1	5.7	165.0	67.0	Baa3/BBB-/BBB
Euro area	0.2	1.6	1.3	11.5	n.a	73.0	n.a.
Emerging Europe	2.6	4.4	-4.9	n.a.	n.a	n.a	n.a.
United Kingdom	1.1	1.9	-2.7	8.1	52.2	84.0	Aaa/AAA/AAA
Sweden	2.2	2.0	7.8	7.7	19.7	-17.0	Aaa/AAA/AAA
Denmark	1.2	2.0	4.6	5.3	31.9	4.0	Aaa/AAA/AAA
Ireland	1.4	1.0	2.7	14.4	203.9	103.0	Ba1/BBB+/BBB+
Spain	-1.3	2.4	-0.1	25.1	290.9	79.0	Baa3/BBB-/BBB
Portugal	-1.0	0.7	-1.7	16.0	410.4	113.0	Ba3/BB/WD
United States	2.1	1.8	-0.3	8.1	42.7	84.0	Aaa/AA+/AAA

2.3 Key financials

The Bank's total business has grown in the past three years. The Bank's loans and receivables to credit institutions and to customers amounted to ISK 631 billion, ISK 519 billion and ISK 396 billion as at 31 December 2011, 2010 and 2009 respectively. The Bank's total equity amounted to ISK 115 billion, ISK 110 billion and ISK 90 billion as at 31 December 2011, 2010 and 2009, respectively.

The growth in the Bank's loans and receivables during the period 2009-2011 was primarily the result of the takeover of a mortgage loan fund from Kaupthing. The loan portfolio of the fund is primarily housing loans to individual customers. See further description in Chapter 3 and Chapter 8 "Risk Factors" related to priority claims.

[1] Bloomberg as at 5 February 2013
[2] World economic Outlook, October 2012. IMF, Global Financial Stability Report, October 2012 Bloomberg for CDS spreads , 5yr USD CDS 5 February 2013

Figure 6 – Key data

	2009	2010	2011	9M 2012
Balance sheet (ISK million)[1]				
Total equity	90,034	109,536	114,558	128,432
Total liabilities	667,310	703,079	777,563	747,813
Total assets	757,344	812,615	892,121	876,245
Income statement (ISK million)				
Net interest income	12,188	19,785	23,388	20,134
Impairment on loans and receivables	-9,939	-26,787	-27,424	-7,594
Operating income	31,865	35,623	33,276	34,359
Net earnings	12,871	12,557	11,094	14,537
Balance sheet (EUR million equivalent)[2]				
Total equity	615	712	721	804
Total liabilities	4,557	4,571	4,896	4,681
Total assets	5,172	5,283	5,618	5,485
Income statement (EUR million equivalent)[3]				
Net interest income	71	122	145	126
Impairment on loans and receivables	-58	-165	-170	-47
Operating income	185	219	206	214
Net earnings	75	77	69	91
Profitability				
Return on equity	16.7%	13.4%	10.5%	15.9%
Return on assets	1.8%	1.5%	1.3%	2.2%
Net interest margin on interest bearing assets	1.9%	2.7%	3.4%	3.3%
Net interest margin on total assets	1.7%	2.4%	2.9%	3.0%
Efficiency				
Cost-to-total income[4]	47.7%	54.2%	52.5%	49.8%
Cost-to-total average assets	2.2%	2.2%	2.7%	2.5%
Effective tax rate	15.5%	17.0%	20.1%	19.3%
Capitalisation				
Tier 1 ratio[5]	13.7%	15.2%	16.4%	18.2%
Capital adequacy ratio[6]	13.7%	19.0%	21.2%	23.0%
Leverage ratio[7]	12.5%	12.8%	13.3%	13.9%
Asset quality				
Problem loans[8]	44.4%	53.8%	15.8%	14.7%
Non-performing loans[9]	22.8%	24.7%	10.6%	6.6%
Risk weighted assets / total assets	83.9%	84.7%	74.5%	77.1%
Liquidity				
Loans to deposits ratio	72.2%	98.5%	114.6%	126.0%
Secured liquidity ratio	23.9%	24.8%	34.7%	30.6%
Cash ratio	8.1%	11.2%	15.3%	17.7%
Other				
Loans to individuals as % of loans to customers	15.5%	24.7%	39.7%	41.4%
The Group´s employees at the end of the period	1,124	1,241	1,158	1,177
The Group´s average number of employees	1,141	1,159	1,217	1,160

[1] End of period
[2] Using EUR/ISK for end of period (2009: 146.42, 2010: 153.82, 2011: 158.80, 9M 2012: 159.76)
[3] Using average EUR/ISK for the period (2009: 171.99, 2010: 162.68, 2011: 161.18, 9M 2012: 160.38)
[4] Without net valuation change
[5] The Bank´s official total capital ratio and tier 1 ratio, calculated according to the Act on Financial Undertakings, was 22.5% and 17.7% for 30 September 2012. The official capital ratio is based on reviewed retained earnings at 30 June 2012
[6] The Bank´s official total capital ratio and tier 1 ratio, calculated according to the Act on Financial Undertakings, was 22.5% and 17.7% for 30 September 2012. The official capital ratio is based on reviewed retained earnings at 30 June 2012
[7] Tier 1 capital / adjusted total assets
[8] Over 90 days past due but not impaired loans + individually impaired loans as % of loans to customers
[9] Over 90 days facility default loans as % of loans to customers

3. Bank and business overview

The Bank's business, operates in the following four principal reporting segments:

i. ***Corporate Banking:*** which comprises the Bank's corporate banking and corporate recovery divisions;

ii. ***Retail Banking:*** which comprises the Bank's retail banking division;

iii. ***Asset Management:*** which comprises investment services, private banking and institutional asset management.

iv. ***Investment Banking:*** which principally comprises the Bank's corporate finance division, capital markets and Arion Bank's Research division.

Corporate Banking

The Bank's Corporate Banking divisions provide universal financial services to meet the needs of large corporations, asset management companies, institutional investors and domestic financial institutions. These divisions employed 32 employees at 30 September 2012.

Corporate Banking Division

The Corporate Banking division provides services to corporate clients, from small to medium-sized businesses to large corporations. Corporate Banking comprises a team of account managers specialising in industries, such as food and beverages and real estate, and/or lending, such as project finance and structured finance. The account managers are each responsible for specific clients, thus ensuring personal services and a clear overview of each client's financial requirements. Each account manager also relies on the assistance of staff in a range of support functions, including trade finance and guarantees, legal and documentation, portfolio management and corporate services. Although a significant proportion of the Corporate Banking division's business is the provision of credit, the Bank offers a wide range of products and financial solutions to meet the needs of each customer. Examples of these services include cash management solutions, a range of deposit products, automatic billing and collection services, online payment slips and internet banking.

Corporate Recovery unit

Corporate Banking's loan portfolio has improved dramatically since 2008, cf. FME's loan quality categorization.

The ratio of "non-performing" loans in Corporate Banking was down to just over 13% at the end of 2012. This ratio is expected to continue to decline in 2013 as the Bank's work on recovery cases is drawing to a conclusion and working procedures, loan administration and monitoring have been improved greatly in recent years.

In line with the Bank's strategy, the Corporate Banking division aims to strengthen long-term relationships with current clients as well as attracting new customers to the Bank by continuing to provide outstanding customer service and products. In particular, this divisions' financial focus is on servicing larger corporations in complex working environments through the provision of tailored solutions.

In line with the Bank's strategy, the Corporate Banking division aims to strengthen long-term relationships with current clients as well as attracting new customers to the Bank by continuing to provide outstanding customer service and products. In particular, this divisions' financial focus is on servicing larger corporations in complex working environments through the provision of tailored solutions.

Retail Banking Division

The Retail Banking division provides a range of banking services to individual as well as SMEs. Retail Banking serves its customers through its branch network and other points of contact such as online banking, a call centre and automatic telling machines (ATMs). As at 30 September 2012, the Bank had 25 branches throughout Iceland and over 100,000 retail customers. The branches provide a comprehensive range of financial services, including advice on deposits and loans, payment cards, pension savings, insurance, securities and funds, with a focus on tailored solutions and personalised services to meet customer needs. Retail Banking had 368 employees at 30 September 2012.

Following its establishment in late 2008, the Bank has sought to streamline its retail banking operations by merging a number of its branches. This strategy has resulted in a reduction of the branch network by 15 branches and has created larger and stronger branches which the Bank believes are better able to meet the needs of its customers.

Retail Banking seeks to build long-lasting and profitable relationships with its customers. To maximise operational efficiency the branch network is divided into seven clusters, each cluster has its own business manager. Smaller branches capitalise on the strength of larger units within each cluster. As a result, more executive authority and responsibility is transferred to the branches and therefore closer to the customers. Four of the business managers work in the Greater Reykjavík area and three in other large urban areas.

Retail Banking is in the process of establishing financial consultants within its branches with a view to improving the level of service to its customers. The financial consultants are expected to be knowledgeable in a wide range of fields including banking services, pensions and insurance and other financial instruments.

For the last four years the Bank´s main focus has been on working with distressed customers on financial restructuring. Now the focus has been shifting fast towards a more traditional banking role. This applies both to SME’s and individuals. The Bank has launched new products and expanded its services into new segments. In 2012 the Bank started a leasing division, which has had a very good start and is an important addition to the Bank´s service offering. The Bank has also taken further steps in developing its mortgage products for individuals and has taken a leading role among the banks in this area.

Asset Management Division

The Asset Management division is responsible for managing assets on behalf of the Bank's clients, including institutional investors, corporations, high net worth clients and retail investors. It offers a wide range of services and a broad product mix. In addition to mutual funds, alternative investment vehicles and pension plan schemes, the division offers customised asset allocation strategies and managed accounts designed to meet the diverse needs of investors. The division also offers funds from other leading global fund management companies

Private Banking, a unit within the Asset Management division, seeks to provide first-class financial services tailored to the needs of individual clients with over ISK 10 million in assets under management. Each private banking client has his own account manager who provides personal service and financial advice suited to the client’s needs.

Institutional Asset Management, another unit within the Asset Management division, services pension fund clients, trade unions, insurance companies, government institutions and other institutional investors. The services offered to these clients include portfolio management and advice on devising investment strategies.

The Bank's subsidiary, Stefnir Asset Management Company (Stefnir), operates the fund management business and the Asset Management division is the main fund distributor within the Bank.

As at 30 September 2012, the Bank had consolidated assets under management of ISK 769 billion. Asset Management and subsidiary Stefnir had total 32 employees at 30 September 2012.

The Asset Management division aims to continue satisfying its clients’ needs by offering first-class services and a broad product range with competitive returns on investments as well as safeguarding its clients’ interests. Significant products offered by the division include an asset allocation scheme, Eignaval, offered to private banking customers, the SÍA I Private Equity Fund launched by Stefnir, which is one of only a few post-crisis Icelandic private equity funds, and the Frjalsi Pension Fund, which was voted “The Best Pension Fund in Iceland” by Investment Pension Europe (IPE) Magazine for the third consecutive year in December 2011.

Investment Banking

The Investment Banking division is divided into three units, Corporate Advisory, Capital Markets and Arion Bank’s Research.

Corporate Advisory

Corporate Advisory provides advisory services to corporate clients and investors in relation to merger and acquisition (M&A) and capital markets transactions. Corporate Advisory also advises the Bank's restructuring teams and manages the sales of certain assets acquired by the Bank through corporate insolvencies and restructurings. Corporate Advisory had 13 employees at 30 September 2012.

The collapse of the Icelandic stock market in 2008 and the over-leveraging of a significant proportion of Icelandic companies had a significantly negative impact on M&A activities in Iceland. During 2009 and 2010, Corporate Advisory was involved in a limited number of share listings and delistings as well as the sale of shares in companies which had been acquired by the Bank in settlement of debts owed. Corporate Advisory has also provided valuation reports, managed bond offerings and advised clients on investment opportunities.

During 2009, Corporate Advisory advised the Bank in relation to the valuation of its opening balance sheet and negotiations between the Kaupthing Resolution Committee and the Icelandic Ministry of Finance.

Capital Markets

The Capital Markets unit provides securities brokerage and foreign exchange (FX) sales for institutional investors and corporate clients. It is divided into FX and Fixed Income Sales, Equity Sales and Research units.

FX and Fixed Income Sales offers domestic and foreign brokerage of currency, fixed income and derivatives for institutional investors, corporate clients and smaller domestic financial institutions. Equity Sales is responsible for the brokerage of domestic and foreign equities for institutional investors and corporate clients. Trading on the FX market is significantly restricted in Iceland by the capital controls established in 2008. In the fixed income market, the principal instruments traded are government bonds. On the equities side, the Bank focuses on the United States and Nordic equity markets. The Bank also remains active in the domestic equity market although the market is currently limited.

Arion Bank's Research

The Research unit provides equity, fixed income and macro analysis for its clients. The principal clients of the Research unit are asset management companies, institutional investors and other divisions of the Bank. The Research unit seeks to enhance the services provided to clients of the Bank by providing superior equity, fixed income, real estate and sector analysis. In addition, the Research unit issues regular economic forecasts and updates on key economic developments in Iceland.

Support Divisions

The Bank has five support divisions:

i. ***Corporate Development & Marketing:*** This division assists the Bank in implementing organisational changes, entering new markets, introducing new products, acquiring or divesting assets or divisions and establishing strategic partnerships. The division also develops the Bank's marketing strategy and is responsible for brand management, coordinating marketing initiatives, marketing and tactical plans for products and services and market research, such as statistical analysis, focus groups, interviews and surveys. Finally, the division is responsible for developing the Bank's internet banking solutions, websites, online communication and electronic distribution channels. This division had 32 employees at 31 December 2012.

ii. ***Finance:*** The Finance division includes accounting, analysis, funding and treasury units. The accounting unit is responsible for the Bank's financial reporting, both internally and to external stakeholders, including the FME and the Central Bank. The analysis unit is responsible for short-term and long-term budgeting and for benchmarking the Bank with comparable financial institutions, both local and international. The funding unit is responsible for the Bank's long-term funding in both the domestic and international markets and the treasury unit is responsible for the Bank's liquidity, currency and interest rate management, the internal pricing of interest rates and currency, liaison with other financial institutions, proprietary trading and market making in domestic securities and currencies. The Finance division had 57 employees at 31 December 2012.

iii. ***Risk Management:*** For a description of the activities of the Risk Management division, see "chapter 8.6 – Risk Management". The Risk Management division had 25 employees at 31 December 2012.

iv. ***Legal:*** The Legal division handles collection, appropriated assets and legal representation on behalf of the Bank as well as a range of other legal services for the Bank's other divisions. As at 30 September 2012, the legal division was working on 4,605 collection cases, compared with 5,363 at 31 December 2011. The legal division had 43 employees at 31 December 2012.

v. ***Operations:*** The Operations division comprises information technology (IT), human resources, back office and property management units. The Operations division had 287 employees at 31 December 2012.

3.1 History of the Bank

The Bank was established in October 2008 as the vehicle to receive the transfer of certain assets and liabilities of its predecessor Kaupthing. The Icelandic government assumed control over Kaupthing in October 2008. Kaupthing in turn was the product of a merger in May 2003 of two of Iceland's then leading banks, Kaupthing Bank hf. and Bunadarbanki Islands hf. (Bunadarbanki). Bunadarbanki was established in 1929 by a law passed by the Icelandic parliament, the Althingi. At the beginning of 1998, Bunadarbanki became a limited liability company and was privatised in stages up to the beginning of 2003. Kaupthing hf. was established in Reykjavik in 1982, coinciding with the launch of the free capital market in Iceland. Kaupthing hf. later became an investment bank before its merger with Bunadarbanki in 2003. The merged entity Kaupthing grew to be the largest bank in

Iceland operating both domestically and abroad. Following the onset of the global financial crisis, the Icelandic Government assumed control over Kaupthing in October 2008 and certain assets and liabilities were later transferred to the Bank**.** In July 2009, the Icelandic government and the resolution committee of Kaupthing (the Kaupthing Resolution Committee) reached agreement on the valuation of the assets transferred to the Bank through the issue of a compensation instrument by the Bank to Kaupthing. The compensation instrument was originated due to the difference in the fair value of the transferred assets, liabilities and contingent liabilities from Kaupthing Bank to Arion Bank in accordance with the FME decision in 2008. The compensation instrument was terminated in 2011. In addition, the agreement identified certain ring-fenced assets in respect of which the creditors were accorded a share in certain future increases of value through an escrow and contingent rights agreement (the ECVRA) and the creditors (through the Kaupthing Resolution Committee) were also granted an option to purchase up to 87% of the Bank's equity.

In March 2009, following a ruling from the FME, the Bank acquired all the deposits and card transactions of over 20,000 customers from SPRON Factoring hf. (SPRON). The operations of the six SPRON branches and its online bank were discontinued following the acquisition. In April 2009, the Bank acquired Mýrasýsla Savings Bank (SPM) in Borgarnes and merged it with its branch in Borgarnes, increasing its customer base by a further 2,000 clients. In December 2009, the Kaupthing Resolution Committee acting through Kaupskil ehf. (Kaupskil), a wholly owned subsidiary of Kaupthing, exercised its option to acquire shares in the Bank and, following a capital injection in January 2010, Kaupthing is currently the owner of 87% of the Bank. The Icelandic government owns the remaining 13%. In March 2010 a new board of directors (the Board) was appointed at the Bank's annual general meeting and, on 1 June 2010, the Board appointed a new chief executive officer (CEO). On 30 June 2011, the Bank and Kaupthing executed a settlement agreement under which the compensation instrument and the ECVRA were both discharged.

In January 2012 the Bank and Kaupthing Resolution Committee reached an agreement according to which the Bank acquired a mortgage portfolio which had been managed in a special fund owned by the bankruptcy estate of Kaupthing as well as all the unit shares in the Fund. The agreement also specified that the deal would be funded by the substitution of Kaupthing by the Bank as debtor to certain covered bonds issued by Kaupthing secured by that mortgage portfolio. Hence the Bank assumed the rights and duties of the Issuer under that bond programme. The mortgage portfolio valued at ISK 120 billion, made Arion Bank a strong participant in the mortgage portfolio market in Iceland.

In June 2012 the Financial Supervisory Authority (FSA) approved the merger of Verdis, custody services and former subsidiary of Arion Bank, with Arion Bank.

In September .2012 Ólafsfjördur Savings Bank (SPÓL) merged into Arion Bank With the merger the number of branches went up to 25.

3.2 Selected financial information

When numbers are converted from ISK to EUR the Bank uses an exchange rate which is used in all transactions within the Bank, day-end Reuters. For Balance the exchange rate at period end is used. For income statements the average exchange rate for the period is used. The numbers used for each period are as follows:

Figure 7 – Exchange rates

	Period end	Average
2009	146.42	171.99
2010	153.82	162.68
2011	158.8	161.18
9M 2011	-	161.79
9M 2012	159.76	160.38

Figure 8 – Income statements for the periods 2009-9 months ended 2012

ISK million	2009	2010	2011	9M 2011	9M 2012
Interest income	66,905	52,369	46,433	34,672	43,463
Interest expense	-54,717	-32,584	-23,045	-17,836	-23,329
Net interest income	**12,188**	**19,785**	**23,388**	**16,836**	**20,134**
Increase in value of loans and receivables	20,199	40,269	38,368	29,795	8,073
Impairment on loans and receivables	-9,939	-26,787	-27,424	-6,443	-7,594
Changes in compensation instrument	-10,556	-11,604	-19,593	-19,593	0
Net interest income less valuation changes on loans and receivables	**11,892**	**21,663**	**14,739**	**20,595**	**20,613**
Fee and commission income	8,291	10,373	16,862	12,300	12,089
Fee and commission expense	-2,429	-3,507	-6,177	-4,726	-4,036
Net fee and commission income	**5,862**	**6,866**	**10,685**	**7,574**	**8,053**
Net financial income	1,638	402	511	348	491
Fair value change to Drómi bond	0	-3,500	0	0	0
Net foreign exchange gain	8,715	4,459	1,836	1,979	559
Share of profit or loss of associates	369	556	8	-1	13
Other operating income	3,389	5,177	5,497	3,478	4,630
Operating income	**31,865**	**35,623**	**33,276**	**33,973**	**34,359**
Salaries and related expense	-8,073	-9,272	-11,254	-8,221	-8,813
Administration expense	-5,260	-7,154	-7,810	-5,400	-6,055
Depositors' and investors' guarantee fund	-683	-324	-1,200	-875	-683
Depreciation and amortisation	-759	-819	-956	-655	-714
Other operating expense	-571	-723	-796	-624	-609
Earnings before tax	**16,519**	**17,331**	**11,260**	**18,198**	**17,485**
Income tax expense	-2,568	-3,481	-1,912	-3,079	-3,375
Bank levy	0	-290	-1,046	-684	-771
Net earnings from continuing operations	**13,951**	**13,560**	**8,302**	**14,435**	**13,339**
Net gain (loss) from discontinued operations net of tax	-1,080	-1,003	2,792	-787	1,198
Net earnings	**12,871**	**12,557**	**11,094**	**13,648**	**14,537**

EUR million equivalent[1]	2009	2010	2011	9M 2011	9M 2012
Interest income	389	322	288	214	271
Interest expense	-318	-200	-143	-110	-145
Net interest income	**71**	**122**	**145**	**104**	**126**
Increase in value of loans and receivables	117	248	238	184	50
Impairment on loans and receivables	-58	-165	-170	-40	-47
Changes in compensation instrument	-61	-71	-122	-121	0
Net interest income less valuation changes on loans and receivables	**69**	**133**	**91**	**127**	**129**
Fee and commission income	48	64	105	76	75
Fee and commission expense	-14	-22	-38	-29	-25
Net fee and commission income	**34**	**42**	**66**	**47**	**50**
Net financial income	10	2	3	2	3
Fair value change to Drómi bond	0	-22	0	0	0
Net foreign exchange gain	51	27	11	12	3
Share of profit or loss of associates	2	3	0	0	0
Other operating income	20	32	34	21	29
Operating income	**185**	**219**	**206**	**210**	**214**
Salaries and related expense	-47	-57	-70	-51	-55
Administration expense	-31	-44	-48	-33	-38
Depositors' and investors' guarantee fund	-4	-2	-7	-5	-4
Depreciation and amortisation	-4	-5	-6	-4	-4
Other operating expense	-3	-4	-5	-4	-4
Earnings before tax	**96**	**107**	**70**	**112**	**109**
Income tax expense	-15	-21	-12	-19	-21
Bank Levy	0	-2	-6	-4	-5
Net earnings from continuing operations	**81**	**83**	**52**	**89**	**83**
Net gain (loss) from discontinued operations net of tax	-6	-6	17	-5	7
Net earnings	**75**	**77**	**69**	**84**	**91**

Figure 9 – Financial position as at 30 September 2012 and 31 December 2011, 2010, 2009

Please also see the description of the balance sheet impact of of the Issuer's secured funding In chapter 3.3 "Funding - Secured funding" and the related risk in chapter 8 – "Risk factors – Priority claims".

ISK million	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Cash and balances with Central Bank	41,906	30,628	29,200	16,026
Loans and receivables to credit institutions	38,470	67,846	69,103	88,007
Loans and receivables to customers	357,734	451,219	561,550	572,484
Bonds and debt instruments	173,482	120,112	140,568	119,697
Shares and equity instruments with variable income	7,078	10,316	14,045	15,860
Derivatives	6	1,126	674	969
Securities used for hedging	2,236	3,213	2,372	1,398
Compensation instrument	34,371	24,188	0	0
Investment property	22,947	27,642	27,100	28,171
Investments in associates	5,985	2,713	2,987	3,024
Property and equipment	10,700	7,365	6,271	6,147
Intangible assets	3,512	4,352	4,765	5,102
Tax assets	1,415	295	724	475
Non-current assets and disposal groups held for sale	41,527	44,464	23,886	13,711
Other assets	15,975	17,136	8,876	5,174
Total assets	**757,344**	**812,615**	**892,121**	**876,245**

[1] Using average EUR/ISK for the period (2009: 171.99, 2010: 162.68, 2011: 161.18, 9M 2011: 161.79, 9M 2012: 160.38)

ISK million	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Due to credit institutions and Central Bank	113,647	95,646	16,160	16,459
Deposits from customers	495,465	457,881	489,995	454,405
Financial liabilities at fair value	88	999	4,907	11,122
Tax liabilities	2,841	4,454	3,421	3,220
Non-current liabilities and disposal groups held for sale	19,230	13,514	4,950	2,683
Other liabilities	24,997	39,050	38,822	35,010
Borrowings	11,042	65,278	187,203	192,412
Subordinated liabilities	0	26,257	32,105	32,502
Total liabilities	**667,310**	**703,079**	**777,563**	**747,813**

ISK million	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Share capital	12,646	2,000	2,000	2,000
Share premium	59,354	73,861	73,861	73,861
Other reserves	1,729	1,525	1,637	1,637
Retained earnings	16,150	28,531	32,950	47,126
Total shareholders' equity	**89,879**	**105,917**	**110,448**	**124,624**
Non-controlling interest	155	3,619	4,110	3,808
Total equity	**90,034**	**109,536**	**114,558**	**128,432**
Total liabilities and equity	**757,344**	**812,615**	**892,121**	**876,245**

EUR million equivalent[1]	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Cash and balances with Central Bank	286	199	184	100
Loans and receivables to credit institutions	263	441	435	551
Loans and receivables to customers	2,443	2,933	3,536	3,583
Bonds and debt instruments	1,185	781	885	749
Shares and equity instruments with variable income	48	67	88	99
Derivatives	0	7	4	6
Securities used for hedging	15	21	15	9
Compensation instrument	235	157	0	0
Investment property	157	180	171	176
Investments in associates	41	18	19	19
Property and equipment	73	48	39	38
Intangible assets	24	28	30	32
Tax assets	10	2	5	3
Non-current assets and disposal groups held for sale	284	289	150	86
Other assets	109	111	56	32
Total assets	**5,172**	**5,283**	**5,618**	**5,485**

EUR million equivalent[2]	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Due to credit institutions and Central Bank	776	622	102	103
Deposits from customers	3,384	2,977	3,086	2,844
Financial liabilities at fair value	1	6	31	70
Tax liabilities	19	29	22	20
Non-current liabilities and disposal groups held for sale	131	88	31	17
Other liabilities	171	254	244	219
Borrowings	75	424	1,179	1,204
Subordinated liabilities	0	171	202	203
Total liabilities	**4,557**	**4,571**	**4,896**	**4,681**

EUR million equivalent[3]	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Share capital	86	13	13	13
Share premium	405	480	465	462
Other reserves	12	10	10	10
Retained earnings	110	185	207	295
Total shareholders' equity	**614**	**689**	**696**	**780**
Non-controlling interest	1	24	26	24
Total equity	**615**	**712**	**721**	**804**
Total liabilities and equity	**5,172**	**5,283**	**5,618**	**5,485**

[1] Using EUR/ISK for end of period (2009: 146.42, 2010: 153.82, 2011: 158.80, 9M 2012: 159.76)
[2] Using EUR/ISK for end of period (2009: 146.42, 2010: 153.82, 2011: 158.80, 9M 2012: 159.76)
[3] Using EUR/ISK for end of period (2009: 146.42, 2010: 153.82, 2011: 158.80, 9M 2012: 159.76)

Figure 10 – Cash flow for the nine months ended 30 September 2012 and 2011 and full year 2011, 2010 and 2009

ISK million	2009	2010	2011	9M 2011	9M 2012
Earnings before income tax	16,519	17,331	11,260	18,198	17,485
Adjustments to reconcile earnings before income tax to net cash from (used in) operating activities:					
Non-cash items included in net earnings before income tax and other adjustments	-15,879	-6,386	-1,623	-1,377	-26
Changes in operating assets and liabilities	-36,474	-7,991	-13,443	-15,893	-31,859
Income taxes paid	-585	-748	-3,232	-544	-3,326
Net cash from (used in) operating activities	**-36,419**	**2,206**	**-7,038**	**384**	**-17,726**
Cash flows from (used in) investing activities:	**2009**	**2010**	**2011**	**9M 2011**	**9M 2012**
Purchase of investment property	-2,865	-1,120	-2,160	n.a.	n.a.
Investment in associated companies	-612	-66	-177	n.a.	n.a.
Proceeds from sale of investment property	0	1,705	5,999	n.a.	n.a.
Proceeds from sale of associated companies	193	54	0	n.a.	n.a.
Purchase of intangible assets	-152	-121	-518	n.a.	n.a.
Purchase of property and equipment	-208	-381	-667	n.a.	n.a.
Proceeds from sale of property and equipment	138	110	158	n.a.	n.a.
Proceeds from sale of legal entities acquired exclusively with view to resale	0	706	0	n.a.	n.a.
Proceeds from the sale of individual properties included in discontinued operations	0	1,870	11,028	n.a.	n.a.
Net cash from (used in) investing activities	**-3,506**	**2,757**	**13,663**	**4,792**	**15,104**
Net increase (decrease) in cash and cash equivalents	-39,925	4,963	6,625	5,176	-2,622
Cash and cash equivalents at beginning of the year	92,910	56,094	72,797	72,797	82,815
Cash and cash equivalents acquired through business combinations	804	18,110	11	5	0
Effect of exchange rate changes on cash and cash equivalents	2,305	-6,370	3,382	1,234	2,322
Cash and cash equivalents at the end of the year	**56,094**	**72,797**	**82,815**	**79,212**	**82,515**

EUR million equivalent[1]	2009	2010	2011	9M 2011	9M 2012
Earnings before income tax	96	107	70	112	109
Adjustments to reconcile earnings before income tax to net cash from (used in) operating activities:					
Non-cash items included in net earnings before income tax and other adjustments	-92	-39	-10	-9	0
Changes in operating assets and liabilities	-212	-49	-83	-98	-199
Income taxes paid	-3	-5	-20	-3	-21
Net cash from (used in) operating activities	**-212**	**14**	**-44**	**2**	**-111**
Cash flows from (used in) investing activities:	**2009**	**2010**	**2011**	**9M 2011**	**9M 2012**
Purchase of investment property	-17	-7	-13	n.a.	n.a.
Investment in associated companies	-4	0	-1	n.a.	n.a.
Proceeds from sale of investment property	0	10	37	n.a.	n.a.
Proceeds from sale of associated companies	1	0	0	n.a.	n.a.
Purchase of intangible assets	-1	-1	-3	n.a.	n.a.
Purchase of property and equipment	-1	-2	-4	n.a.	n.a.
Proceeds from sale of property and equipment	1	1	1	n.a.	n.a.
Proceeds from sale of legal entities acquired exclusively with view to resale	0	4	0	n.a.	n.a.
Proceeds from the sale of individual properties included in discontinued operations	0	11	68	n.a.	n.a.
Net cash from (used in) investing activities	**-20**	**17**	**85**	**30**	**94**
Net increase (decrease) in cash and cash equivalents	-232	31	41	32	-16
Cash and cash equivalents at beginning of the year	540	345	452	450	516
Cash and cash equivalents acquired through business combinations	5	111	0	0	0
Effect of exchange rate changes on cash and cash equivalents	13	-39	21	8	14
Cash and cash equivalents at the end of the year	**326**	**447**	**514**	**490**	**514**

[1] Using average EUR/ISK for the period (2009: 171.99, 2010: 162.68, 2011: 161.18, 9M 2012: 160.38)

Figure 11 – Key ratios

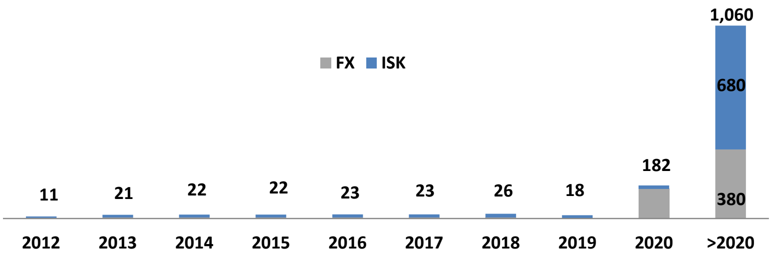
	2009	2010	2011	9M 2012
Return on equity	16.7%	13.4%	10.5%	15.9%
Return on assets	1.8%	1.5%	1.3%	2.2%
Net interest margin on interest bearing assets	1.9%	2.7%	3.4%	3.3%
Net interest margin on total assets	1.7%	2.4%	2.9%	3.0%
Cost-to-total income[1]	47.7%	54.2%	52.5%	49.8%
Cost-to-total average assets	2.2%	2.2%	2.7%	2.5%
Effective tax rate	15.5%	17.0%	20.1%	19.3%
Tier 1 ratio[2]	13.7%	15.2%	16.4%	18.2%
Capital adequacy ratio[3]	13.7%	19.0%	21.2%	23.0%
Leverage ratio[4]	12.5%	12.8%	13.3%	13.9%
Problem loans[5]	44.4%	53.8%	15.8%	14.7%
Non-performing loans[6]	22.8%	24.7%	10.6%	6.6%
Risk weighted assets / total assets	83.9%	84.7%	74.5%	77.1%
Loans to deposits ratio	72.2%	98.5%	114.6%	126.0%
Secured liquidity ratio	23.9%	24.8%	34.7%	30.6%
Cash ratio	8.1%	11.2%	15.3%	17.7%
Loans to individuals as % of loans to customers	15.5%	24.7%	39.7%	41.4%
The Group´s employees at the end of the period	1,124	1,241	1,158	1,177
The Group´s average number of employees	1,141	1,159	1,217	1,160

3.3 Funding

General

Arion Bank has currently a strong wholesale funding position with no significant redemption until 2020. The Bank will continue to strengthen and diversify its funding base.

Figure 12 – Maturity of long-term funding as at 30 September 2012 (EUR million)



The Bank is successful in tilting its deposit base towards term deposits from the more unpredictable on demand deposits. This has been achieved by actively engaging in offering term deposits products to its clients.

[1] Without net valuation change
[2] The Bank´s official total capital ratio and tier 1 ratio, calculated according to the Act on Financial Undertakings, was 22.5% and 17.7% for 30 September 2012. The official capital ratio is based on reviewed retained earnings at 30 June 2012
[3] The Bank´s official total capital ratio and tier 1 ratio, calculated according to the Act on Financial Undertakings, was 22.5% and 17.7% for 30 September 2012. The official capital ratio is based on reviewed retained earnings at 30 June 2012
[4] Tier 1 capital / adjusted total assets
[5] Over 90 days past due but not impaired loans + individually impaired loans as % of loans to customers
[6] Over 90 days facility default loans as % of loans to customers

Figure 13 – Short-term funding (total deposits)

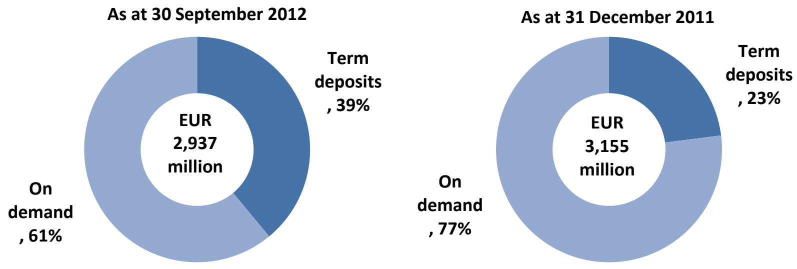
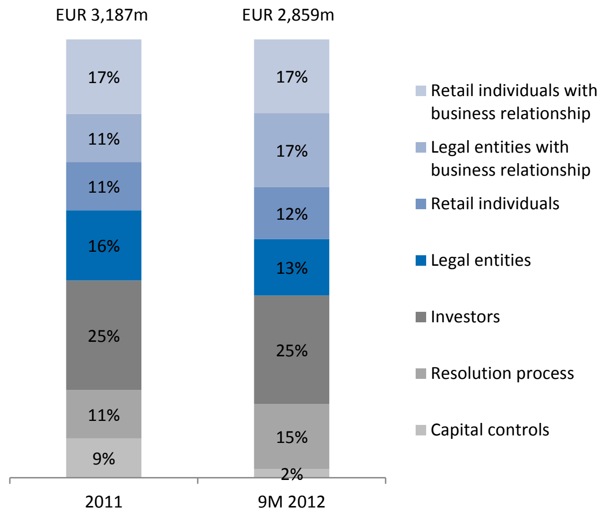


Figure 14 – Deposits from customers by stickiness rating (EUR million)



Secured funding

At the end of 2011 Arion Bank took over the issuance of covered bonds which had originally been issued by Kaupthing hf. in 2006 to 2008. The bonds in question are covered bonds amounting to approximately ISK 130.7 billion, net outstanding, with security in mortgages and bank deposits in an institutional investment fund, Arion Bank Mortgages Institutional Investor Fund (AMIIF). It is a four-series issue, with two 25-year series and two 40-year series maturing in 2031, 2033, 2045 and 2048. The bonds are inflation-indexed with fixed 3.75% to 4.00% interest. Current repayment of principal is currently approximately ISK 1.5 billion a year and currently total annual payment including repayment of principal, indexation and interest is ISK 7.4 billion. This covered bonds programme also allows further bond issues up to an aggregate principal amount of ISK 200 billion, although in the ruling circumstances such an increase is not anticipated (please see chapter 8 "Risk Factors - AMIIF").

These covered bonds are secured with a first priority security interest over the assets of AMIIF, with a current book value of approximately ISK 160 billion. In order to meet the security coverage requirement under the programme, or if further bonds are issued under the programme, further security may need to be provided (please see chapter 8 - "Risk factors – Priority claims").

In February 2012 Arion Bank issued covered bonds from a new EUR 1.0 billion covered bond programme. The bond issue is nominated in Icelandic króna, the amount issued was ISK 2.5 billion. The covered bond issue matures in February 2034 and is inflation indexed with a fixed 3.60% interest.

In May 2012 Arion Bank completed its first non-indexed fixed rate covered bond offering under the EUR 1.0 billion programme, issuing ISK 1.32 billion worth of bonds in the Series Arion CB15. In June 2012 Arion Bank completed its second offering, issuing ISK 1.2 billion worth of bonds in the same series. The series was admitted for trading on NASDAQ OMX Iceland on 21 May 2012. The bonds bear 6.50% interest and mature in 2015.

The covered bonds issued by Arion Bank under the EUR 1 billion programme are secured with a first priority security interest over mortgage loans and related receivables held by Arion Bank, with a current book value of approximately ISK 6.5 billion. The current license allows for further issues up to an aggregate amount of ISK 10 billion.In order to meet the security coverage requirement under the programme, or if further bonds are issued under the programme, further security may need to be provided (please see chapter 8 - "Risk factors – Priority claims").

In January 2010 the Central Bank of Iceland, in connection with the establishment of the Bank, granted a loan to the Issuer secured with certain assets which were transferred to the bank from Kaupthing, mainly mortgage loans to individuals, loans to municipalities and loans to state related entities. The loan has a maturity date in 2016, which can be extended up to 2022 with the same terms. Currently approximately ISK 58.7 billion is outstanding under this loan. The loan is secured with a first priority security interest over assets held by Arion Bank, with a current book value of approximately ISK 75.7 billion.

The liabilities under the covered bonds issued and the loan from the central bank are all included in the "liabilities" of the Issuer as presented in the accounting material in this Information Memorandum. Further, all the assets provided as security for the covered bonds and central bank loan are also included in the accounting material as "assets" and the assets of the AMIIF (over which security is granted for the covered bonds) are consolidated into the numbers for the Issuer.

The table below show the book value of the assets serving as security for the covered bonds, the AMIIF covered bonds and the loan from the Icelandic Central Bank and the Issuer's liabilities under the same, together with the security coverage ratio.

Figure 15 – Asset serving as security for the covered bonds

30 Sep 2012	Assets	Borrowings	Rate
AMIIF	159,551	130,658	122.1%
Covered bonds	6,451	5,116	126.1%
Central Bank loan	75,696	58,690	129.0%
Total	**241,698**	**194,464**	**124.3%**

All in all, the aggregate effect of the covered bonds programme and the loan from the Icelandic Central bank, on the Issuer's balance is ISK 194.464 million in liabilities, and the assets granted as security for these liabilities make up ISK 241.698 million of the assets on the Issuer's balance to date.

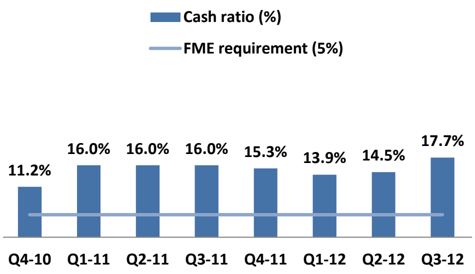
Out of the aggregate liabilities, ISK 11,793 million of bonds are held by the Issuer, hence reducing the net outstanding amount to ISK 182,671 million.

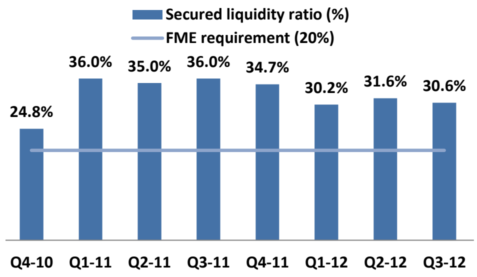
When evaluating the effect of outstanding secured liabilities on the balance sheet of the bank it should be noted that deposits from customers constitute priority claims under Icelandic law – (See Chapter 8 - "Risk Factors - Legal and regulatory risk"). Deposits amounted to ISK 454,405 at the end of the 9 month 2012 reporting period. Both secured liabilities and deposits would enjoy priority over unsecured debt in an insolvency situation under the current law in force. Please see further information under chapter 8 – "Risk factors – Priority claims".

3.4 Liquidity

Arion Bank is acting under robust liquidity rules set up by the Icelandic Financial Services Authority (“FME”). The FME has established guidelines for a minimum secured liquidity ratio and a minimum cash ratio. The guidelines requires that the Bank should have adequate liquidity reserves to weather an immediate deposit outflow of 20% (Secured liquidity ratio), and that cash and cash equivalents shall amount to at least 5% (Cash ratio) of on-demand deposits. The high liquidity reserve required by the FME reflects that a large part of the Bank's liabilities are primarily short term or on-demand deposits while the contractual maturity of the assets is higher. The Bank actively monitors its liquidity reserves by building an understanding and modelling the behaviour of its deposit base

Figure 16 – Deposit coverage ratios





3.5 Capitalisation

The capital base at 30 September 2012 amounted to ISK 155,357 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings, was 22.5%, well above the the requirements set by FME, see further description in Chapter 7 “Legal and regulatory matters”. Arion calculates risk weighted assets based on Basel II standardised approach. Hence mortgages have a minimum risk weight of 35%. Please also see the description of the balance sheet impact of of the Issuer's secured funding In chapter 3.3 "Funding - Secured funding" and the related risk in chapter 8 – "Risk factors – Priority claims".

Figure 17 – Capital position

Capital base	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
ISK million				
Share capital	12,646	2,000	2,000	2,000
Share premium	59,354	73,861	73,861	73,861
Statutory reserve	1,729	1,525	1,637	1,637
Retained earnings	16,150	28,531	32,950	47,126
Non-controlling interests	155	3,619	4,110	3,808
Total equity	**90,034**	**109,536**	**114,558**	**128,432**
Deduction from Tier 1 capital	-2,843	4,647	-5,489	-5,577
Total Tier 1 capital	87,191	104,889	109,069	122,855
Tier 2 capital	0	26,257	32,105	32,502
Total capital base	**87,191**	**131,146**	**141,174**	**155,357**
EUR million equivalent[1]				
Share capital	86	13	13	13
Share premium	405	480	465	462
Statutory reserve	12	10	10	10
Retained earnings	110	185	207	295
Non-controlling interests	1	24	26	24
Total equity	**615**	**712**	**721**	**804**
Deduction from Tier 1 capital	-19	30	-35	-35
Total Tier 1 capital	595	682	687	769
Tier 2 capital	0	171	202	203
Total capital base	**595**	**853**	**889**	**972**

Risk weighted assets	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
ISK million				
Credit risk	480,374	513,328	543,233	557,607
Market risk FX	89,233	97,657	31,990	29,980
Market risk other	14,849	20,394	30,757	29,455
Operational risk	51,055	57,267	58,976	58,976
Total risk weighted assets	635,511	688,649	664,956	676,018
EUR million equivalent[2]				
Credit risk	3,281	3,337	3,421	3,490
Market risk FX	609	635	201	188
Market risk other	101	133	194	184
Operational risk	349	372	371	369
Total risk weighted assets	4,340	4,477	4,187	4,231
RWA / total assets	83.9%	84.7%	74.5%	77.1%
Tier 1 ratio[3]	13.7%	15.2%	16.4%	18.2%
Capital adequacy ratio[1]	13.7%	19.0%	21.2%	23.0%

[1] Using EUR/ISK for end of period (2009: 146.42, 2010: 153.82, 2011: 158.80, 9M 2012: 159.76)
[2] Using EUR/ISK for end of period (2009: 146.42, 2010: 153.82, 2011: 158.80, 9M 2012: 159.76)
[3] The Bank´s official total capital ratio and tier 1 ratio, calculated according to the Act on Financial Undertakings, was 22.5% and 17.7% for 30 September 2012. The official capital ratio is based on reviewed retained earnings at 30 June 2012

Figure 18 – Total capital base (EUR million)

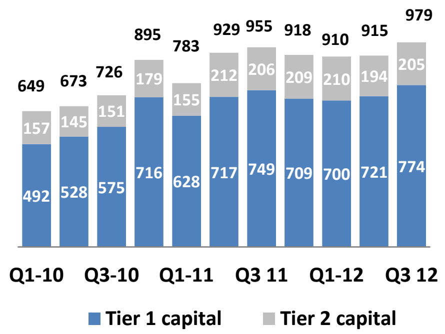
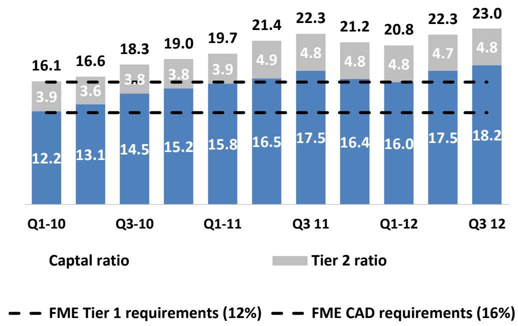


Figure 19 – Total capital ratio (%)



3.6 Asset quality

The Bank has been working actively with its loan portfolio and has been successful in diversifying and improving the asset quality.

Figure 20 – Problem loans (% of loans to customers)[2]

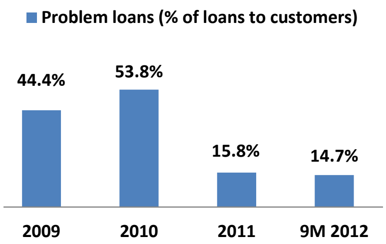


Figure 21 – Non-performing loans (% of loans to customers)[3]

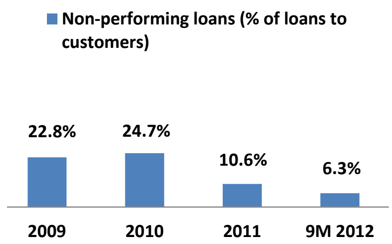
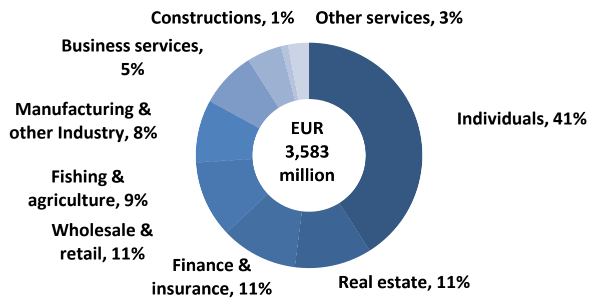


Figure 22 – Loans to Customers by sector as of 30 September 2012



3.7 Strategy

Following his appointment in June 2010, the new CEO sought to establish a new strategic plan for the Bank which was finalised in October 2010. The key elements of the strategy are:

i. positioning the Bank as a universal bank in Iceland, providing a wide range of services and focusing on tailored and personalised solutions for its customers, with special emphasis being placed on the Bank's ability to meet the financial needs of those customers, both retail and corporate, which require comprehensive and diverse financial services; and

ii. improving the Bank's competitiveness by focusing on its product offering, efficiency and profitability in its operations. In particular, the Bank has reduced its branch network from 39 branches at the end of

[1] See footnote above
[2] >90 days past due but not impaired + individually impaired loans
[3] >90 days facility default

2008 to 25 branches at 31 December 2012 and has also sought to reduce back office costs and streamline its organisational structure.

From its creation at the end of 2008, the immediate and ongoing areas of focus for the Bank have been the restructuring of its loan portfolio, expansion of its sources of funding and the need to rebuild trust with its customers, Icelandic society as a whole and international financial institutions and investors. In addition, the Bank inherited certain significant risks in terms of loan and funding concentrations and currency mismatches which it has sought to reduce whilst focusing on maintaining high levels of liquidity and capital.

3.8 Market position and competition

The Bank currently faces competition from the two other large commercial banks in Iceland as well as a few smaller financial institutions. In recent years the banks have been focusing on restructuring their loan portfolios and improving their asset and liability matching, which entails that competition in the market has been somewhat limited. As Iceland's economy recovers and demands for new lending and other banking products increases, the Bank expects to face increased competition from both the other large Icelandic banks and smaller specialised institutions.

The Bank expects to compete on the basis of a number of factors, including transaction execution, its products and services, its ability to innovate, reputation and price.

Figure 23 – Return on equity (%)[1]

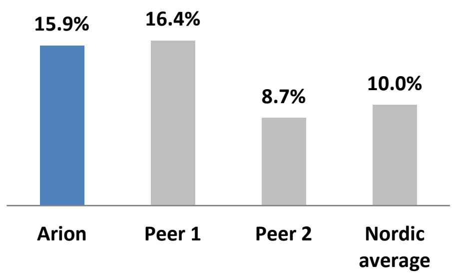


Figure 24 – Asset quality (%)[2, 3]

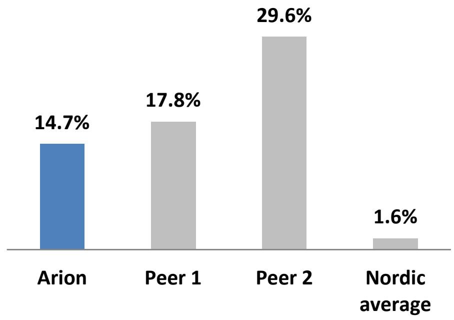


Figure 25 – CAD ratio (%)[4, 5]

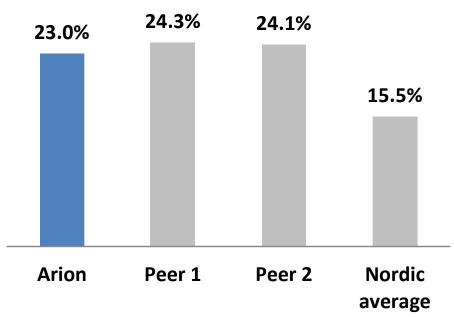
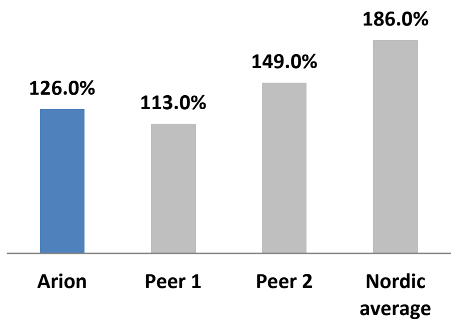


Figure 26 – Loans-to-deposit ratio (%)[6]



[1] Nordic average based on Handelsbanken, SEB, Nordea, DNB and Danske Bank
[2] Nordic average based on Handelsbanken, SEB, Nordea, DNB and Danske Bank
[3] Problem loans (past due but not impaired loans over 90 days + individually impaired loans) as % of loans to customers
[4] Nordic average based on Handelsbanken, SEB, Nordea, DNB and Danske Bank
[5] The Bank's official total capital ratio, calculated according to the Act on Financial Undertakings, was 22.5% - the official CAD ratio is based on reviewed earnings at 30 June 2012
[6] Nordic average based on Handelsbanken, SEB, Nordea, DNB and Danske Bank

4. The Icelandic economy and banking sector

Towards the end of 2008, Iceland suffered a currency and banking crisis. The government of Iceland was forced to step in and take control of the three major Icelandic banks, Kaupthing Bank hf., Landsbanki Íslands hf. and Glitnir Bank hf., which had been very active in the international financial market, to shore up confidence in the financial sector, protect domestic deposits and maintain the orderly function of the payment system. Following this, certain assets and liabilities were transferred from the banks into three new entities, including the Bank, which have operated as commercial banks from that time.

4.1 Country overview

Figure 27 – Country overview[1]

Area in square kilometres	103,000	NOKISK[2]	23.1
Population (2011)	319,000	USDISK[3]	126.5
Urban population (2012)	93.8%	GDP 2011	1,626 billion
Life expectancy (2012)	81	GDP 2011 (current EUR)[4]	9.5 billion
Official language	Icelandic	GDP real growth rate 2011	2.6%
Capital / population (2009)	Reykjavik / 198,093	GDP per capita, PPP EUR (2011)[5]	26,248
OECD income level	High income	Inflation, consumer prices (2011)	4.0%
Currency code	ISK	Public debt to GDP(2011)	128.6%

4.2 Sovereign rating and bonds

Iceland is rated Baa3, BBB- and BBB by Moody, Standard & Poor's and Fitch respectively. On 14 February 2013, Fitch Ratings upgraded the foreign currency rating for Iceland to BBB from BBB-. Iceland is considered investment grade by all three major rating agencies.

Figure 28 – Sovereign ratings[6]

	Moody's	Standard and Poor's	Fitch Ratings
Long-term rating			
Foreign currency	Baa3	BBB-	BBB
Local currency	Baa3	BBB-	BBB+
Short-term rating			
Foreign currency	P-3	A-3	F3
Local currency	n.a.	A-3	n.a.
Outlook	Stable	Stable	Stable
Latest rating action	11 Nov 2009	24 Nov 2008	14 Feb 2013

In June 2011, The Icelandic State issued a 5-year USD 1,000 million bond with a coupon of 4.875%. This was the first international sovereign bond issued post the 2008-2009 crisis. The bond, maturing in June 2016, was quoted at a yield of 2.9% as at 5 February 2013. In May 2012, The Icelandic State issued a 10-year USD 1,000 million bond with a coupon of 5.875%. The bond, maturing in May 2022, was quoted at a yield of 4.3% as at 5 February 2013.

Figure 29 – Icelandic and other sovereign bonds[7]

Issue date	Maturity	USD million	Coupon	Current yield	Moody's	Standard and Poor's	Fitch Ratings
Jun-2011	Jun-2016	1,000	4.875%	2.910%	Baa3	BBB-	BBB
May-2012	May-2022	1,000	5.875%	4.260%	Baa3	BBB-	BBB

[1] World Bank, CIA Factbook
[2] Bloomberg as at 5 February 2013
[3] Bloomberg as at 5 February 2013
[4] EURISK: 171.85, Bloomberg as at 5 February 2013
[5] Based on World Bank's GDP per capita, PPP USD (2011) of 36,485 converted into EUR using the average USDEUR for 2011 at 1.39, Bloomberg
[6] Bloomberg as at 5 February 2013
[7] Bloomberg as at 5 February 2013

Figure 30 –5-year Credit default swap (basis points), Iceland versus other sovereigns[1]

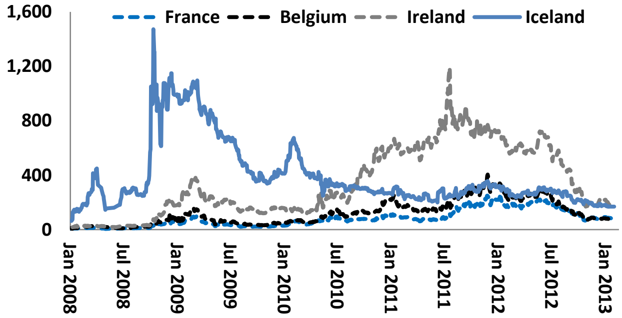
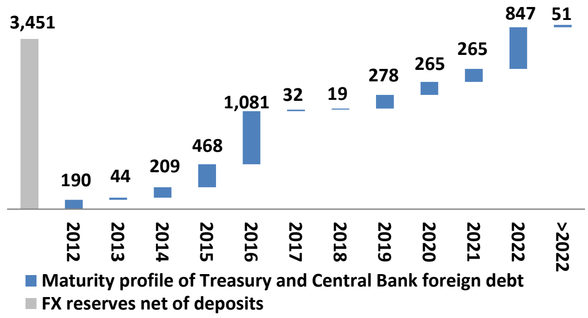


Figure 31 – Maturity of foreign debt and Central Bank FX Reserves (EUR million)[2]



4.3 Reforms are driving the economic and fiscal development

The financial crisis and the ensuing economic downturn significantly altered the government's financial position. It was therefore necessary to undertake broad based fiscal consolidation measures to ensure the long term sustainability of general government finances. To restore confidence and stabilise the economy, a joint economic programme was developed in November 2008 (the Joint Economic Programme) by the Icelandic government, the Central Bank and the International Monetary Fund (the IMF) under a two year Stand By Arrangement that was subsequently extended until 31 August 2011. The Stand By Arrangement included a loan of approximately USD 2.1 billion and was accompanied by bilateral loan commitments from European neighbours and other loan commitments and standing facilities aggregating approximately USD 3 billion. The Joint Economic Programme was a condition of the Stand By Arrangement and its objectives are threefold: (1) to establish exchange rate stability, (2) to achieve fiscal consolidation from 2010 onwards and (3) to restructure the banking system.

Exchange rate stability was a key objective of the Joint Economic Programme. Tighter monetary policy and temporary capital account restrictions were applied to support the Icelandic currency and prevent disorderly capital outflows which could undermine the ISK. The Icelandic authorities intend to lift the capital account restrictions in stages. The first step towards lifting capital controls was taken in October 2009, with the abolition of restrictions on capital inflows. On 25 March 2011, the Central Bank announced a new strategy for the gradual removal of remaining capital controls in phases, each of which is subject to conditions. While the new strategy does not set a timetable for removing of capital controls, the Central Bank stated that conditions are favourable for starting to relax some parts of the controls, but that it would seek authority to extend capital controls, if necessary.

As part of the programme, the government has announced a long term consolidation plan aimed at curtailing the growth of fiscal debt and gradually reducing it over time. The plan envisages that the fiscal deficits will be turned into surplus over several years primarily through large expenditure cuts and increases in direct and indirect taxes. In October 2011, the Ministry of Finance introduced the government's fiscal plan for the years 2012 to 2015 according to which a surplus in the overall balance is envisaged by 2014, with the gross general government debt ratio gradually declining to an estimated 90%. of GDP in 2014 and continuing to fall thereafter. A surplus in the primary balance was confirmed in 2011. The last objective of the Joint Economic Programme centred on rebuilding and restructuring the domestic financial system. The restructuring aimed to improve corporate governance within Iceland's financial institutions, capitalise the new commercial banks, protect the banks' asset portfolios, strengthen financial supervision, create transparency for depositors and other creditors so as to facilitate normal international relations and access to global financial markets and to curtail the impact of private sector losses on the government. As of 26 August 2011, the Executive Board of the IMF completed the sixth and final review of Iceland's economic performance under the Joint Economic Programme, and the programme has been successfully completed.

Iceland has shown positive growth since 2011 and is expected to continue to show a positive development onwards.[3] Public finances have recovered as a function of budget cuts and tax increases. The budget deficit has been funded domestically whilst foreign loans are used to increase FX reserves.

[1] Bloomberg as at 5 February 2013
[2] Central Bank of Iceland press release 18 June 2012
[3] See presentation of November 2012 available at www.ministryoffinance.is

Figure 32 – Iceland compares strongly with other economies[1]

Selected economies forecast for 2013 (IMF)
Annual % change unless noted otherwise

	Real GDP	Consumer prices	Current account balance	Unemployment	5yr CDS (bps)	Net government debt (2012 % of GDP)	Rating (Moody's/S&P/Fitch)
Iceland	2.6	4.4	-2.1	5.7	165.0	67.0	Baa3/BBB-/BBB
Euro area	0.2	1.6	1.3	11.5	n.a	73.0	n.a.
Emerging Europe	2.6	4.4	-4.9	n.a.	n.a	n.a	n.a.
United Kingdom	1.1	1.9	-2.7	8.1	52.2	84.0	Aaa/AAA/AAA
Sweden	2.2	2.0	7.8	7.7	19.7	-17.0	Aaa/AAA/AAA
Denmark	1.2	2.0	4.6	5.3	31.9	4.0	Aaa/AAA/AAA
Ireland	1.4	1.0	2.7	14.4	203.9	103.0	Ba1/BBB+/BBB+
Spain	-1.3	2.4	-0.1	25.1	290.9	79.0	Baa3/BBB-/BBB
Portugal	-1.0	0.7	-1.7	16.0	410.4	113.0	Ba3/BB/WD
United States	2.1	1.8	-0.3	8.1	42.7	84.0	Aaa/AA+/AAA

Figure 33 – Real GDP growth (year-over-year)[2]

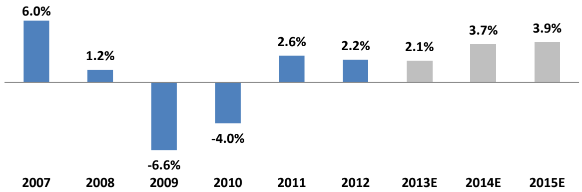


Figure 34 – Inflation (year-over-year)[3]

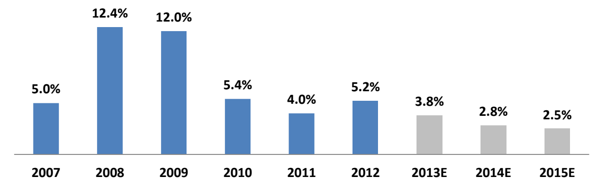


Figure 35 – Government surplus/deficit (% of GDP)[4]

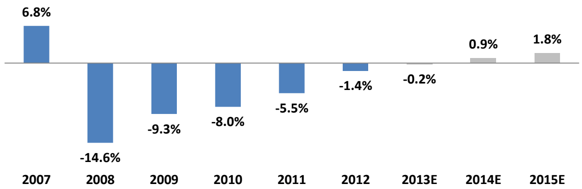
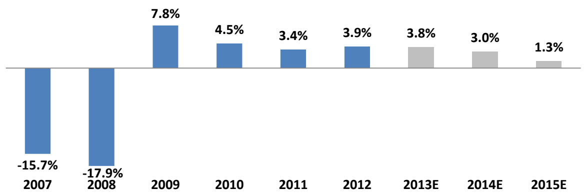
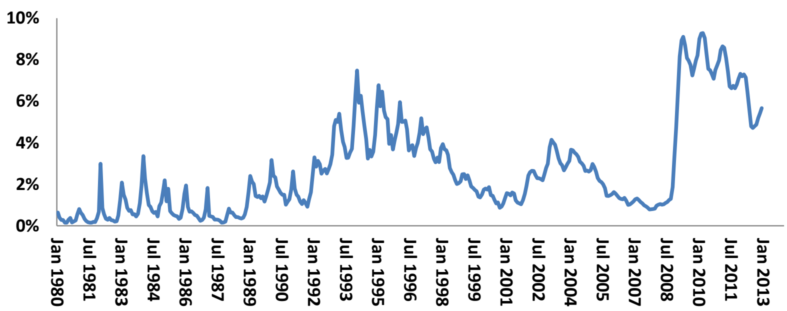


Figure 36 – Fundamental current account balance (% GDP)[5]



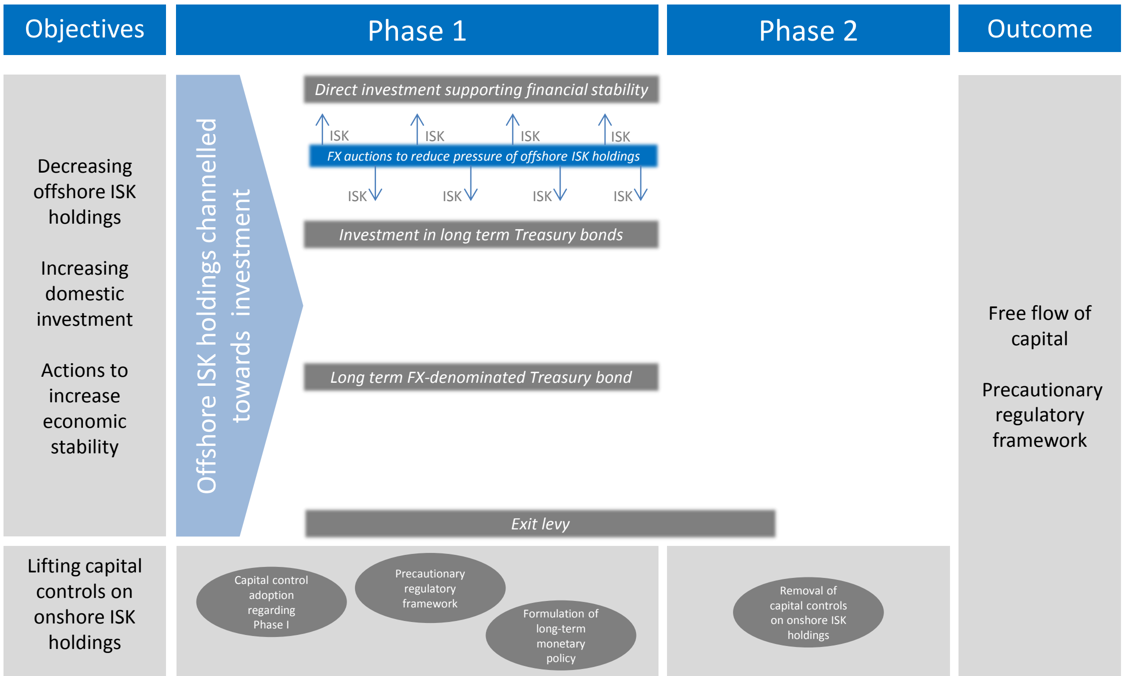
Capital controls are in place since the end of 2008, placing restrictions on both domestic as well as foreign parties. This has put limits for domestic parties on foreign security purchases, derivative transactions and other financial transactions. Foreign parties with Icelandic krona assets are, on the other hand, prohibited from exchanging krona for foreign currencies.

Figure 37 – Unemployment rate[6]



[1]:World economic Outlook, October 2012. IMF, Global Financial Stability Report, October 2012 Bloomberg for CDS spreads , 5yr USD CDS 5 February 2013
[2] Central Bank of Iceland
[3] Central Bank of Iceland
[4] Statistics Iceland, Central Bank of Iceland, Government accounts and budget
[5] Statistics Iceland, Central Bank of Iceland, Government accounts and budget. Without accrued interest due to banks in winding up proceedings, and without net factor income of Actavis
[6] Director of Labour, Iceland

Figure 38 – Stabilisation of the Icelandic krona [1]



4.4 Banking sector overview

General

After the government took control of Kaupthing Bank hf., Glitnir Bank hf. and Landsbanki Íslands hf. in October 2008, certain assets and liabilities were transferred from the banks into new entities, which have now become the Bank, Íslandsbanki hf. and Landsbankinn hf. Following an agreement between the Icelandic government and the Kaupthing Resolution Committee in July 2009, the Kaupthing Resolution Committee announced that it intended to exercise its option to purchase 87% of the Issuer's equity, and subsequent capital injection took place on 8 January 2010. Kaupthing Bank, through its subsidiary Kaupskil ehf., now holds an 87% stake in the Bank and the Ministry of Finance and Economic Affairs holds the remaining 13%. A similar agreement was reached between the government and Íslandsbanki hf. Íslandsbanki Resolution Committee, through ISB Holding, now holds 95% of the shares in Íslandsbanki and the Ministry of Finance holds the remaining 5%. Landsbankinn hf. remains fully state-owned.

On 28 December 2012 the Icelandic Parliament passed the Act No. 155/2012 on the sale of shares in Financial Undertakings. According to Article 1 of the Act the Government of Iceland may sell all or part of, inter alia, its holdings in Arion Bank hf., upon authorization in the Fiscal Budget and having received a proposal from the Icelandic State Financial Investments, under point i and point j of Article 4 of the Act No. 88/2009 on the Icelandic State Financial Investments. The Icelandic State Financial Investments is the Icelandic state’s holding company in the financial market, as the vehicle to hold the state’s shares in financial institutions while the reconstruction and restoration of the financial system is still in progress.

The Icelandic financial sector before 2008

Prior to the collapse of the banking system in Iceland, the financial sector and the legislative environment in Iceland had undergone much transition. Various regulations and directives of the European Union in the field of financial services have been incorporated into the EEA Agreement. Iceland as a Contracting Party to that Agreement has therefore implemented that legislation into Icelandic law, bringing the legal environment of financial services in Iceland in line with the EU/EEA regime. Before 2000, the Icelandic banking system mostly consisted of three investment banks, four commercial banks and 26 savings banks. By 2008, however, the financial market mainly consisted of three major international banks (Kaupthing Bank hf., Glitnir Bank hf. and Landsbanki Íslands hf.), while the number of savings banks had been reduced to 21. The total assets of the Icelandic banking system amounted to around ISK 9,739 billion at the end of December 2007.

[1] Director of Labour, Iceland

Other relevant institutions

The Housing Financing Fund (www.ils.is) was established at the beginning of 1999 by legislation, approved by the Althingi in June 1998. This was aimed at rationalising the state housing fund system. The Housing Financing Fund is by far the largest provider of financing for residential housing in Iceland but with the competition from the three major Banks prior to 2008, its market share shrunk significantly. However, after the collapse of the banking system, the importance of the Housing Financing Fund grew in the shorter term. In turn, after 2011 the Fund's market share started to decline again after the introduction of non-indexed mortgages with flexible interest rates by the banks. The Fund has been and is currently subject to an investigation by the EFTA Surveillance Authority under the EEA State aid rules.

Furthermore, several domestic securities houses are currently operating in Iceland. However, the operations of these securities houses have been greatly limited since the banking collapse, but before 2008, many of them operated mutual funds of various kinds. It is also worth noting that there are several insurance companies licensed to operate in Iceland. Insurance companies have been active in the financial market through their investment activities especially before 2008. Additionally, pension funds receive payments from employers and employees and are an important source of long term finance in the country. Membership in a pension fund is obligatory for wage earners and self-employed people, in accordance with Act No. 129/1997, on Mandatory Pension Insurance and on the Activities of Pension Funds. The pension funds are independent non-government entities. They invest mainly in domestic bond issues, equity capital and foreign securities.

The Financial Supervisory Authority, the Central Bank of Iceland and the Icelandic Stock Exchange

At the beginning of 1999, the Bank Inspectorate of the Central Bank of Iceland and the Insurance Supervisory Authority were merged into a new independent entity, the Financial Supervisory Authority (the FME) (www.fme.is). The field of supervision covered by the new entity is the whole range of financial institutions as well as insurance companies and pension funds. The activities of FME are primarily governed by Act No. 87/1998, on the Official Supervision of Financial Operations, and Act No. 98/1999, on the Payment of Cost Due to the Official Supervision of Financial Activities.

The Central Bank (www.sedlabanki.is) is responsible for implementing monetary policy consistent with the goal of maintaining price stability. The activities of the Central Bank are primarily governed by Act No. 36/2001, on The Central Bank of Iceland. The Central Bank imposes a reserve requirement on all the commercial banks and savings banks. The purpose of this limitation is to ensure that credit institutions have sufficient margin on the reserve requirement account to meet fluctuations in their liquidity positions. Foreign exchange transactions have been subject to capital controls since the banking system collapsed in 2008. The Central Bank oversees surveillance of the Rules on foreign exchange.

The Iceland Stock Exchange (NASDAQ OMX Iceland) (http://www.nasdaqomxnordic.com/nordic/Nordic.aspx) operates under Act No. 110/2007, on Stock Exchanges. In the autumn of 2000, the Iceland Stock Exchange joined NOREX, a joint project of the Nordic stock exchanges. One of the main benefits from the NOREX Alliance was the SAXESS trading system, which is used by all NOREX participants. In September 2006, the Iceland Stock Exchange joined the OMX Nordic Exchange which later merged with NASDAQ.

5. Supervisory and Management board and key employees

The Banks'ʻs management comprises various levels and sub-levels, each of which is responsible for different aspects of the Bank'ʻs activities. The highest level of the Bank'ʻs management and the ultimate decision-making body is the general shareholders meeting. This is followed by the Board of Directors, which is responsible for the general management of the Bank, including strategy coordination and general supervision. The Board of Directors elects the Management Board (which is the collective executive body of the Bank) and the Chairman of the Management Board (who is the sole executive body of the Bank) who are jointly responsible for the day-to-day management of the Bank'ʻs activities.

5.1 Board of directors

The Board of Directors is responsible for general management matters, with the exception of those matters that are designated by law and by the Banks'ʻs charter as being the exclusive responsibility of the general shareholders meeting. The Banks'ʻs Board of Directors meets as necessary, but not less than once a quarter, and makes its decisions, generally, by simple majority of those present provided that a quorum of at least half of the elected members of the Board of Directors is present. Members of the Board of Directors are elected for terms until the next annual general shareholders meeting and may be re-elected an unlimited number of times. The Bank´s Board of Directors currently has six members. The Board of Directors of the Bank are set out below.

Figure 39 – Board of directors

Name	Title	Born	Member of the board of directors since
Monica Caneman	Chairman	1954	2010
Gudrún Johnsen	Vice Chairman	1973	2010
Agnar Kofoed-Hansen	Director	1956	2011
Freyr Thórdarson	Director	1973	2012
Jón G. Briem	Director	1948	2011
Måns Höglund	Director	1951	2011

Monica Caneman, Chairman

Monica was born in 1954. She is Swedish and lives in Sweden. She was first elected as a Director at a shareholders' meeting on 18 March 2010. She is not a shareholder in Arion Bank hf.

Monica graduated as an economist from the Stockholm School of Economics in 1976. She worked at Skandinaviska Enskilda Banken (now SEB) from 1977 to 2001. Monica held various positions at SEB in retail banking. She became a member of the Group Executive Committee and Group Management in 1995 and became deputy CEO in 1997. She became a deputy member of the board of directors at the same time. Monica left SEB in 2001. Since then she has built a career around board assignments. She currently serves on the board of a number of companies and non-profit organizations and is the chairman of several of them.

Gudrún Johnsen, Vice Chairman

Gudrún was born in 1973 and lives in Iceland. She was first elected as a Director at a shareholders' meeting on 18 March 2010. She is not a shareholder in Arion Bank hf.

Gudrún completed a BA in economics at the University of Iceland in 1999. In 2002 she graduated with an MA in applied economics at the University of Michigan in the United States and with an MA in statistics from the same university the following year. Gudrún worked as a securities broker at the Icelandic Investment Bank (FBA) between 1999 and 2001, and as a teaching and research assistant at the University of Michigan in 2002-2003. Between 2004 and 2006 she worked as a specialist in the Monetary and Financial Systems Department of the International Monetary Fund (IMF) in Washington, DC. Gudrún has been an assistant professor at Reykjavík University School of Business since 2006. She has served on the board of a fund management company of MP Bank, is the current chairman of a research and analysis company formed by a group of academics. In 2009 and 2010 Gudrún worked as a senior researcher for the Parliamentary Special Investigation Commission looking into the causes and events leading up to the fall of the Icelandic banking sector in 2008.

Agnar Kofoed-Hansen, Director

Agnar was born in 1956 and lives in Iceland. He was first elected as an Alternate Director at a shareholders' meeting on 18 March 2010. He was elected as a Director at Arion Bank's Annual General Meeting on 24 March 2011. He is not a shareholder in Arion Bank hf.

Agnar received a B.Sc. in mechanical and industrial engineering from the University of Iceland in 1981. He completed a master's in Management Engineering from the Technical University of Denmark in 1983. He did a master's program at MIT Sloan School of Business in the United States, focusing on decision support systems, accounting, marketing and financial analysis. Agnar became an authorized securities dealer in 1991 and in addition he has completed numerous training courses in the field of management, operations and coaching. From 1983 to 1987 he worked for Thróun hf. as manager of sales and marketing. He worked for the Industrial Bank of Iceland hf. as head of the credit department from 1987 to 1989. Between 1989 and 2000 he served as manager of capital markets at Kaupthing hf., managing director of Credit Information Iceland ehf. and was later a board member, owner and director of the credit reporting department at Creditinfo Lánstraust hf. He worked as managing director at SPRON from 2000 to 2007. Today Agnar works as chief financial officer of HRV Engineering ehf.

Freyr Thórdarson, Director

Freyr was born in 1973 and he lives in Iceland. He was elected on to the Board of Directors at the Bank's shareholders' meeting on 22 March 2012. He is not a shareholder in Arion Bank hf.

Freyr completed a Bachelor's degree in business administration at Reykjavík University (RU) in 2003 and earned an MBA degree from the RU School of Business in 2010. Before that he studied at Universität Salzburg in Austria and completed a Vor-diplom in Communication Science in 1999. Freyr has worked in banking and finance since 2001, both in Iceland and abroad, at Straumur Investment Bank, Gnúpur investment company, and Íslandsbanki/Glitnir. In 1999 to 2001, prior to his financial career, Freyr worked at a bottling company called IcelandSpring on plant development and management.

Since 2009 Freyr has managed restructuring and asset recovery projects in Kaupthing HF's Scandinavian portfolio as a Senior Director. He currently sits on the board of Norvestia Oyj, which is listed on the NASDAQ OMX Helsinki and also sits on the boards of two unlisted industrial companies in Scandinavia on behalf of Kaupthing.

Jón G. Briem, Director

Jón was born in 1948 and lives in Iceland. He was first elected as an Alternate Director at Arion Bank's Annual General Meeting on 20 May 2010. He was elected as a Director at Arion Bank's Annual General Meeting on 24 March 2011. He is not a shareholder in Arion Bank hf.

Jón gained a degree in law from the University of Iceland in 1974. He qualified as a district court attorney in 1977 and as a supreme court attorney in 1990. In 1976 to 1990 he was a partner at the law firm Lögfraedistofa Sudurnesja sf. From 1991 to 1999 he was head of the legal division of Íslandsbanki hf. and from 2000 to 2001 he was branch manager at the same bank. He completed a certificate in business and administration from the University of Iceland´s Continuing Education Institute in 1999. In 2002 he opened a law firm in Reykjavík, where he still works. Jón has been a member of the boards of a numerous companies and associations.

Måns Höglund, Director

Måns was born in 1951. He is Swedish and lives in Portugal. He was first elected as a Director at Arion Bank's Annual General Meeting on 24 March 2011. He is not a shareholder in Arion Bank hf.

Måns graduated from Stockholm School of Economics in 1975 where he became a lecturer and researcher after completing his studies. Måns served in various posts at Hambros Bank in London between 1977 and 1984 and was regional director for Denmark and Iceland for two years. In 1984 he started working for Götabanken in London and was transferred to the bank's Stockholm operation in 1989 where he was head of the international finance division until 1991. From 1991 to 1999 he worked for Swedbank, where his roles included director and head of the bank's large corporate business. In 1999 to 2002 he worked for both Unibank (as head of Sweden) and Nordea (as Head of Private Banking, Sweden). From 2002 to 2011 Måns worked for Swedish Export Credit Corporation (SEK) as executive director and head of corporate and structured finance. He was also a member of SEK's Executive Committee.

5.2 Management board

The Management Board is the Bank's collective executive body and is elected by the Board of Directors. Members of the Management Board may be re-elected an unlimited number of times. The Management Board meets as necessary and makes its decisions by simple majority provided that a quorum of at least half of the elected members of the Management Board is present. The Management Board is responsible for the Bank's day-to-day management and administration. The Bank's Management Board currently has ten members. The Management Board of the Bank is set out below.

Figure 40 – Management board

Name	Title	Member of the executive committee since
Höskuldur H. Ólafsson	Chief Executive Officer	2006
Björk Thórarinsdóttir	Managing Director of Corporate Banking	2009
Gísli S. Óttarsson	Chief Risk Officer	2009
Halldór Bjarkar Lúdvígsson	Managing Director of Investment Banking	2011
Helgi Bjarnason	Managing Director of Retail Banking	2011
Jónína S. Lárusdóttir	Managing Director of Legal Division	2010
Margrét Sveinsdóttir	Managing Director of Asset Management	2009
Rakel Óttarsdóttir	Managing Director of Corporate Development & Marketing	2011
Sigurjón Pálsson	Managing Director of Operations	2011
Stefán Pétursson	Chief Financial Officer	2010

Höskuldur H. Ólafsson, Chief Executive Officer

Höskuldur was appointed CEO of Arion Bank in June 2010.

Höskuldur joined Arion Bank from Valitor hf - VISA Iceland, where he had been CEO since 2006. Prior to that he worked at the Icelandic transportation company Eimskip for 17 years and held a range of management positions, including that of deputy CEO. Höskuldur is a board member of the Icelandic Chamber of Commerce, is chairman of the Icelandic Financial Services Association and is a board member of the European Banking Federation. He has also served on the boards of directors of numerous companies and organizations in Iceland and abroad.

Höskuldur graduated with a cand. oecon. degree in business administration from the University of Iceland.

Björk Thórarinsdóttir, Managing Director of Corporate Banking

Björk joined the corporate banking division of Búnadarbanki Íslands (later Kaupthing Bank) in 2001. In 2009 she was appointed managing director of Corporate Banking at Arion Bank.

Björk was previously a specialist and financial director at Baxter International in the United States and later in Germany from 1991 to 1996. In 1997 to 1998 she was financial director of Philips Consumer Communications in France, before moving to Silfurtún in Iceland and Silverton in Norway in 1998 to 2000 as financial director. She was elected as chairman of the board of directors of Valitor hf. in January 2010.

Björk graduated with a cand. oecon. degree in business administration from the University of Iceland in 1990.

Gísli S. Óttarsson, Chief Risk Officer

Gísli joined Kaupthing Bank's risk management division as head of research and development in January 2006. In April 2009 Gísli became the chief risk officer of Arion Bank.

From 1994 to 2001 Gísli worked for Mechanical Dynamics Inc. (Ann Arbor, MI, USA) as a software architect and development manager for the multibody dynamics and motion analysis software ADAMS. From 2001 to 2006 he was a software designer and adviser for the engineering software company MSC.Software (Santa Ana, CA. USA). Gísli received an MSc in applied mechanics in 1989 and a PhD in mechanical engineering in 1994, both from the University of Michigan. In 1988, Gísli received a BSc in civl engineering from the University of Iceland.

Halldór Bjarkar Lúdvígsson, Managing Director of Investment Banking

Halldór was appointed managing director of Corporate Finance at Arion Bank in December 2009. He became managing director of Investment Banking in September 2011.

Between 1992 and 2005 Halldór held a number of management positions, including the position of CEO at Maritech A/S, an international company which sells technical solutions for the fishing industry. In 2005 he joined the corporate banking division of Kaupthing Bank where he supervised lending activities in Scandinavia. Halldór joined Kaupthing's Resolution Committee in 2008 as managing director of the bank's Nordic asset portfolio. Halldór has served on the boards of a number of companies.

Halldór graduated with a degree in mechanical engineering from the University of Iceland in 1991 and a BSc in computer studies in 1992 from the same university.

Helgi Bjarnason, Managing Director of Retail Banking

Helgi joined Arion Bank as managing director of operations in October 2010. He was appointed managing director of Retail Banking in October 2011.

From 1997 to 2006 Helgi worked as an actuary at Okkar Life Insurance. In 2006, Helgi started work at Sjóvá Almennar Insurance and served as managing director of the life insurance company in addition to being vice-president of the damage insurance company. Helgi has served on various boards of directors, such as the Association of Icelandic Actuaries, the Confederation of Employers, the Icelandic Financial Services Association, and he is currently the chairman of the board of directors of Okkar Life Insurance.

Helgi graduated from the faculty of mathematics at the University of Iceland in 1992 and completed a cand. act. degree in actuarial mathematics from the University of Copenhagen in 1997.

Jónína S. Lárusdóttir, Managing Director of Legal Division

Jónína was appointed managing director of the Legal division in November 2010.

In 1996, Jónína started working for the A&P law firm, but moved to the Ministry of Commerce in 2000 where she was a specialist in the financial markets department. She was appointed director of the general office of the Ministry of Industry and Commerce in 2004. In 2007 she became permanent secretary of the Ministry of Commerce, now the Ministry of Economic Affairs, where she worked until she joined Arion Bank. Jónína has served on and chaired numerous committees and has worked as a lecturer in several institutions, including the faculty of law of the University of Iceland. She was chairman of the Depositors' and Investors' Guarantee Fund in 2003 and 2004.

Jónína graduated from the faculty of law at the University of Iceland in 1996 and qualified as a district court attorney the following year. In 2000 Jónína completed a Master's from the London School of Economics and Political Science.

Margrét Sveinsdóttir, Managing Director of Asset Management

Margrét has been managing director of Asset Management at Arion Bank since February 2009.

Margrét has more than 20 years' experience in the financial sector, having worked in credit analysis, customer relationship management and asset management. She started her career in the corporate banking division of the Industrial Bank of Iceland in 1985. Margrét then moved on to Íslandsbanki Securities Ltd, later the asset management division of Glitnir, where she was head of securities brokerage and advisory. In 2007 she became head of financial institutions client relations at Glitnir. Margrét has served on a number of boards of directors, including: The Depositors' and Investors' Guarantee Fund on behalf of SFF, Okkar Life Insurance and several funds in Luxembourg. She has also contributed to several books and magazines on asset management services, investments and financial planning.

Margrét graduated with an MBA from Babson College in Massachusetts in 1990. She also has a cand. oecon. degree in business administration from the University of Iceland and is a certified stockbroker.

Rakel Óttarsdóttir, Managing Director of Corporate Development & Marketing

Rakel joined the Kaupthing Bank in 2005 as an account manager in IT. In 2010 she became head ofArion Bank's Project Office. In December 2011, Rakel was appointed managing director of Corporate Development & Marketing at Arion Bank. Rakel previously worked as a software designer and later ashead of development at TM Software – Libra, a financial services software company.

Rakel graduated with an MBA from Duke University in North Carolina in 2002 and a BSc. in computer science from the University of Iceland in 1997.

Sigurjón Pálsson, Managing Director of Operations

Sigurjón joined Kaupthing´s investment banking division in 2005. He became the head of the Recovery team at Arion Bank in 2009. Sigurjón was appointed the managing director of Operations in October 2011.

Prior to 2004 Sigurjón p held various management positions with the Icelandic contractor Ístak, including the management of infrastructure projects and the construction of industrial buildings. He was also the head of IT while managing these projects.

Sigurjón has served on the boards of directors of various companies in Iceland and abroad. Sigurjón graduated with a master's degree in logistics and supply chain management from MIT in 2005. He completed a master's degree in 1998 in construction management from KTH in Stockholm, Sweden, and in 1996 graduated as a civil engineer from the University of Iceland.

Stefán Pétursson, Chief Financial Officer

Stefán was appointed chief financial officer at Arion Bank in August 2010.

In 1986 to 1989 Stefán worked as head of administration at the Icelandic Fisheries Laboratories Institute. After completing his studies in the US, Stefán joined Landsvirkjun. He began as head of funding but later took over as treasurer and finally CFO, a position he held from 2002. Stefán was on leave from Landsvirkjun in 2008 while serving as the CEO of the investment company HydroKraft Invest hf. Stefán has held a number of directorship positions and other positions of responsibility in recent years. He is currently a member of the board of Landfestar hf. and the Depositors' and Investors' Guarantee Fund on behalf of SFF.

Stefán graduated with an MBA from Babson College in Massachusetts in 1991 and a cand. oecon. degree from the faculty of business of the University of Iceland in 1986.

5.3 Internal audit

The Internal Auditor is appointed by the Board and reports directly to the Board. The Board sets the Internal Auditor a charter which lays out the responsibilities associated with the position and the scope of work. Internal Audit is required to provide independent and objective assurance and consulting services 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 the Bank.

The internal audit is governed by the audit charter, an FME directive on the internal audit function in financial institutions and international standards on internal auditing. All internal audit work is completed by issuing an audit report with deadlines for the implementation of audit findings. Implementations are followed up by Internal Audit every quarter. Internal Audit had 11 employees at 31 December 2012.

5.4 Employees

The Bank had 976 employees as at 31 December 2012.

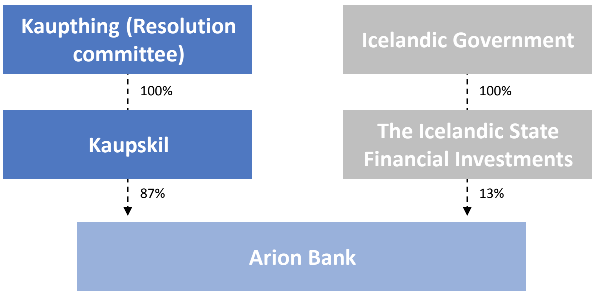
5.5 Shareholders and ownership structure

On behalf of its creditors Kaupthing, through its subsidiary Kaupskil, assumed ownership of Arion Bank on 8 January 2010. Today Kaupskil holds an ownership stake of 87%. The Icelandic State Financial Investments (ISFI) which represent the Government of Iceland's holdings in financial institutions owns 13% of shares.

Kaupskil appoints five out of six board members of Arion Bank, the government appoints the sixth´. Kaupskil has a call option on the government's stake at a later point. The call option can be viewed as two options. First, an option call to buy 3% additionally, or up to 90% stake for tax purposes. Second, there is a call option for 10% or up to 100% shareholding. Should the latter call option be excersised, the subordinated loan from the Government of Iceland, afforded in 2010 as a part of the recapitalisation of the bank,needs to be repaid or refinanced.

Various restrictions were and have been placed on Kaupthing by the FME, including with regard to the sale of shares of the Issuer until September 2012. Kaupthing is required to notify the FME in advance of a proposed transfer of ownership of shares in the Issuer or Kaupskil. Upon receipt of such a notification, the FME will carry out a new eligibility assessment of the prospective owners if the change of ownership affects the board of directors of the Issuer. Further conditions relate to the financial strength of Kaupskil, the ownership of the Issuer, supervisory interest and the owners' objectives in line with the general requirements by law relating to eligibility assessment of shareholders in financial institutions.

Figure 41 – Structural overview of all legal entities within the Group



6. Financial Information

6.1 Material factors influencing the Bank's financials

Overall growth of the Bank

The Bank's total business has grown in the past three years. The Bank's loans and receivables to credit institutions and to customers amounted to ISK 631 billion, ISK 519 billion and ISK 396 billion as at 31 December 2011, 2010 and 2009 respectively. The Bank's total equity amounted to ISK 115 billion, ISK 110 billion and ISK 90 billion as at 31 December 2011, 2010 and 2009, respectively.

The growth in the Bank's loans and receivables during the period 2009-2011 was primarily the result of the takeover of a mortgage loan fund from Kaupthing, as further described under chapter 2.3 – "Key financials". The loan portfolio of the fund is primarily housing loans to individual customers.

Fluctuations in exchange rates

The Bank maintains open currency positions and so fluctuations in exchange rates impact the Bank's financial condition and results of operations. The Bank's exposure to exchange rate risk depends on numerous factors beyond its control, such as overall market trading activity, interest rate levels and fluctuations, fluctuations in exchange rates, government actions and general market volatility. There has been a material fluctuation in the Icelandic Krona since 2008. The Icelandic Krona fell 46.3% and 5.5% in 2008 and 2009 against the Euro, the Krona appreciated against the Euro by 17.0% in 2010, but then depreciated against the Euro by 3.2% and 6.5% in 2011 and 2012 respectively.

The ability of the Icelandic government and the Icelandic central bank to limit any volatility of the ISK will depend on a number of political and economic factors, including the Icelandic central bank's and the Icelandic government's ability to control inflation, the availability of foreign currency reserves and FDI inflows, and any failure to do so or a major depreciation or devaluation of the ISK could adversely affect Iceland's economy and, in turn, the Bank's results of operations.

Critical accounting policies

The Bank's Financial Statements are prepared in accordance with International Financial Reporting Standards.

Management makes judgements that affect the reported amounts of assets and liabilities at the dates of the Bank's statements of financial position and the reported amount of income and expenses during the year ended. Management evaluates its estimates and judgments on an on-going basis. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. The Annual Reports which have been previously published contain explanations of Significant accounting policies which the accounts of the Bank are based on. In the Annual Report for the year 2011 the Policies are explained on pages 81-94.

Impairment of financial assets

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.

An impairment loss is recognised whenever the carrying amount of a financial asset exceeds its recoverable amount. Impairment losses are recognised as described below.

The Group recognises losses for impaired loans when there is objective evidence that impairment of a loan or portfolio of loans has occurred. This is done on a consistent basis in accordance with the Group's guidelines.

There are two basic methods of calculating impairment losses, those calculated on individual loans and those losses assessed on a collective basis. Losses expected as a result of future events, no matter how likely, are not recognised.

Objective evidence of impairment includes observable data about the following loss events:

i. Significant financial difficulty of the borrower;

ii. A breach of contract, such as a default on instalments or on interest or principal payments;

iii. The Group granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a refinancing concession, that the lender would not otherwise consider;

iv. It becomes probable that the borrower will enter bankruptcy or undergo other financial reorganisation;

v. Deterioration in collateral to loan ratio; or

vi. Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of loans since the initial recognition of those assets, even if the decrease cannot yet be identified with the individual financial assets in the group, including:

   a. Adverse changes in the payment status of borrowers in the Group; or

   b. General national or local economic conditions connected with the assets in the Group.

Valuation of financial instruments

Financial instruments that are classified as available-for-sale are stated at fair value. The fair value of such financial instruments is the estimated amount at which the instrument could be exchanged between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value is calculated based on the market price. When valuation parameters are not observable in the market or cannot be derived from observable market prices, the fair value is derived through analysis of other observable market data appropriate for each product and pricing models, which use a mathematical methodology based on accepted financial theories. Pricing models take into account the contract terms of the securities as well as market-based valuation parameters, such as interest rates, volatility, exchange rates and the credit rating of the counterparty. Where market-based valuation parameters are missed, management will make a judgment as to its best estimate of that parameter in order to determine a reasonable reflection of how the market would be expected to price the instrument. In exercising this judgment, a variety of tools are used including proxy observable data, historical data, and extrapolation techniques. The best evidence of fair value of a financial instrument at initial recognition is the transaction price unless the instrument is evidenced by comparison with data from observable markets. Any difference between the transaction price and the value based on a valuation technique is not recognised in the consolidated statement of operations on initial recognition.

Subsequent gains or losses are only recognised to the extent that it arises from a change in a factor that market participants would consider in setting a price.

The Bank considers that the accounting estimate related to valuation of financial instruments where quoted markets prices are not available is a key source of estimation uncertainty because: (i) it is highly susceptible to change from period to period because it requires management to make assumptions about interest rates, volatility, exchange rates, the credit rating of the counterparty, valuation adjustments and specific feature of the transactions; and (ii) the impact that recognising a change in the valuations would have on the assets reported on its statement of financial position as well as its profit/loss could be material. Had management used different assumptions regarding the interest rates, volatility, exchange rates, the credit rating of the counterparty and valuation adjustments, a larger or smaller change in the valuation of financial instruments where quoted market prices are not available would have resulted that could have had a material impact on the Bank's reported net income.

6.2 Income statements for the periods 2009-9 months ended 2012

The following table sets forth the breakdown of the Bank's consolidated net income for the periods indicated:

Figure 42 – Income statements for the periods 2009-9 months ended 2012

ISK million	2009	2010	2011	9M 2011	9M 2012
Interest income	66,905	52,369	46,433	34,672	43,463
Interest expense	-54,717	-32,584	-23,045	-17,836	-23,329
Net interest income	**12,188**	**19,785**	**23,388**	**16,836**	**20,134**
Increase in value of loans and receivables	20,199	40,269	38,368	29,795	8,073
Impairment on loans and receivables	-9,939	-26,787	-27,424	-6,443	-7,594
Changes in compensation instrument	-10,556	-11,604	-19,593	-19,593	0
Net interest income less valuation changes on loans and receivables	**11,892**	**21,663**	**14,739**	**20,595**	**20,613**
Fee and commission income	8,291	10,373	16,862	12,300	12,089
Fee and commission expense	-2,429	-3,507	-6,177	-4,726	-4,036
Net fee and commission income	**5,862**	**6,866**	**10,685**	**7,574**	**8,053**
Net financial income	1,638	402	511	348	491
Fair value change to Drómi bond	0	-3,500	0	0	0
Net foreign exchange gain	8,715	4,459	1,836	1,979	559
Share of profit or loss of associates	369	556	8	-1	13
Other operating income	3,389	5,177	5,497	3,478	4,630
Operating income	**31,865**	**35,623**	**33,276**	**33,973**	**34,359**
Salaries and related expense	-8,073	-9,272	-11,254	-8,221	-8,813
Administration expense	-5,260	-7,154	-7,810	-5,400	-6,055
Depositors' and investors' guarantee fund	-683	-324	-1,200	-875	-683
Depreciation and amortisation	-759	-819	-956	-655	-714
Other operating expense	-571	-723	-796	-624	-609
Earnings before tax	**16,519**	**17,331**	**11,260**	**18,198**	**17,485**
Income tax expense	-2,568	-3,481	-1,912	-3,079	-3,375
Bank Levy	0	-290	-1,046	-684	-771
Net earnings from continuing operations	**13,951**	**13,560**	**8,302**	**14,435**	**13,339**
Net gain (loss) from discontinued operations net of tax	-1,080	-1,003	2,792	-787	1,198
Net earnings	**12,871**	**12,557**	**11,094**	**13,648**	**14,537**

Interest income

The Bank generates interest income from loans to customers, amounts due from credit institutions and securities. The following table sets forth the breakdown of the Bank's interest income, by source, for the periods indicated:

Figure 43 – Interest income

Interest income	2009	2010	2011	9M 2011	9M 2012
Cash and balances with Central Bank	2,793	937	486	381	461
Loans and receivables	45,408	38,004	37,410	28,036	36,121
Securities	10,934	11,320	7,690	5,722	6,530
Compensation instrument	2,411	1,256	322	322	0
Other	5,359	852	525	211	351
Total interest income	**66,905**	**52,369**	**46,433**	**34,672**	**43,463**

Total interest income increased by 25% to ISK 43 billion for the nine months ended 30 September 2012 from ISK 35 billion for the nine months ended 30 September 2011. The increase in the Bank's interest income in 2012, as compared to 2011, was primarily a result of the increase in the amount of loans, receivables and deposits.

The major part of the Bank's interest income is attributable to interest income from loans to customers, which represented 83% and 81% of total interest income for the nine months ended 30 September 2012 and 2011 respectively and 77% on average for the period depicted above. Interest income from loans, receivables and deposits increased by 29% to ISK 36 billion for the nine months ended 30 September 2012 from ISK 28 billion for the nine months ended 30 September 2011. The increase in the Bank's interest income from loans to customers in 2012, as compared to 2011, was primarily due to the housing loans portfolio from the Mortgage fund acquired from Kaupthing.

Interest income from the Bank's securities represented 15% and 17% of total interest income for the nine months ended 30 September 2012 and 2011 respectively. Interest income from securities increased by 14% to ISK 7 billion for the nine months ended 30 September 2012 from ISK 6 billion for the nine months ended 30 September 2011. The increase in interest income from investment securities in 2012, as compared to 2011, primarily reflected higher inflation.

Interest expense

The Bank's interest expense consists primarily of interest expense in respect of loans, receivables and deposits as well as borrowings. The following table sets forth the breakdown of the Bank's interest expense for the periods indicated:

Figure 44 – Interest expense

Interest expense	**2009**	**2010**	**2011**	**9M 2011**	**9M 2012**
Deposits	53,060	28,222	18,338	14,243	12,943
Borrowings	1,564	2,683	2,597	1,966	9,095
Subordinated liabilities	17	1,250	1,830	1,404	1,169
Other	76	429	280	223	122
Total interest expense	**54,717**	**32,584**	**23,045**	**17,836**	**23,329**

Total interest expense increased by 31% to ISK 23 billion for the nine months ended 30 September 2012 from ISK 18 billion for the nine months ended 30 September 2011. The increase in total interest expense in 2012, as compared to 2011, was primarily due to the increase in borrowings and higher inflation.

Interest expense on loans, receivables and deposits represented 55% and 80% of the Bank's total interest expense for the nine months ended 30 September 2012 and 2011 respectively. Interest expense on loans, receivables and deposits decreased by 9% to ISK 13 billion for nine months ended 30 September 2012 from ISK 14 billion for the nine months ended 30 September 2011. The decrease in interest of loans, receivables and deposits in 2012, as compared to 2011, principally reflected lower interest rates.

Interest expense on borrowings represented 39% and 11% of the Bank's total interest expense for the nine months ended 30 September 2012 and 2011, respectively. Interest expense on borrowed funds increased by 360% to ISK 9 billion for the nine months ended 30 September 2012 from ISK 2 billion for the nine months ended 30 September 2011. The increase in total interest expense on borrowed funds in 2012, as compared to 2011, was primarily due to increase in borrowings, where the takeover of the obligations of the Mortgage fund acquired from Kaupthing at year end 2011.

Net interest income

Net interest income is derived from the difference between the interest income generated by the Bank's interest-earning assets and the interest expense incurred on the Bank's interest-bearing liabilities. The following table sets forth the breakdown of the Bank's net interest income for the periods indicated:

Figure 45 – Net interest income

ISK million	**2009**	**2010**	**2011**	**9M 2011**	**9M 2012**
Interest income	66,905	52,369	46,433	34,672	43,463
Interest expense	-54,717	-32,584	-23,045	-17,836	-23,329
Total	**12,188**	**19,785**	**23,388**	**16,836**	**20,134**

Net interest income increased by 20% to ISK 20 billion for the nine months ended 30 September 2012 from ISK 17 billion for the nine months ended 30 September 2011. The increase in the Bank's net interest income in 2012, as compared to 2011, was primarily due to the increase in interest income from loans, receivables and deposits, which reflected the growth of the Bank's loan portfolio.

Non-interest income

The Bank generates non-interest income principally from changes in loans and receivables as well as from net fee and commission income.

Impairment of loans and receivables increased by 18% from the nine months ended 30 September 2011 to the nine months ended 30 September 2012. Main drivers of impairment were court judgements on the legality of FX dominated loans. For more information please refer to chapter 8 "-Risk factors".

In June 2011 an extensive valuation project was finalized in connection with a settlement agreement between the Bank and Kaupthing. This resulted in a considerable increase in the book value of loans and receivables. By the settlement agreement the compensation instrument was terminated. The compensations instrument was originated by the difference in the fair value of assets and liabilities transferred from Kaupthing at the establishment of Arion Bank. According to the instrument, Kaupthing was entitled to 80% of the value increase of defined loans. After the settlement date neither party has any payment obligations towards any other party based on the establishment valuations. For more information please refer to chapter 8 "Risk factors".

Fee and commission income consist primarily of asset management, cards and other fee and commission income. The following table sets forth the breakdown of the Bank's non-interest income for the periods indicated:

Figure 46 – Fee and commission income

ISK million	2009	2010	2011	9M 2011	9M 2012
Asset management	2,968	2,447	2,716	1,921	1,881
Cards	0	3,975	10,031	7,486	6,816
Collection and payment services	0	1,066	1,164	773	762
Derivatives	373	169	179	139	127
Interbank clearing	0	651	682	512	532
Lending and guarantees	622	540	667	535	792
Security trading	285	189	250	192	127
Other fee and commission income	4,043	1,336	1,173	743	1,052
Fee and commission income	**8,291**	**10,373**	**16,862**	**12,300**	**12,089**

The Bank's fee and commission income decreased by 2% to ISK 12 billion for the nine months ended 30 September 2012. The decrease in net fee and commission income for the nine months ended 30 September 2012, as compared to the nine months ended 30 September 2011, was due to decreases in asset management as well as cards.

Other income amounted to ISK 4.6 billion for the nine months ended 30 September 2012, which corresponded to an increase of 33% from ISK 3.5 billion for the nine months ended 30 September 2011. Other operating income comprises primarily of rental income, fair value changes and gain on investment properties.

Non-interest expenses

The Bank's non-interest expenses are comprised of fee and commission expenses, personnel expenses, selling, general and administrative expenses, depreciation, amortisation and impairment, other operating expenses and various tax expenses.

Fee and commission expense consist primarily of cards, interbank clearing and other fee and commission income. The following table sets forth the breakdown of the Bank's non-interest income for the periods indicated:

Figure 47 – Fee and commission expense

Fee and commission expense	2009	2010	2011	9M 2011	9M 2012
Asset management	637	177	105	147	136
Cards	0	2,215	4,892	3,810	2,965
Collection and payment services	0	42	32	21	13
Interbank clearing	0	703	708	531	545
Security trading	170	201	44	31	33
Other fee and commission expense	1,622	169	396	187	344
Total interest income	**2,429**	**3,507**	**6,177**	**4,726**	**4,036**

The Bank's fee and commission expense decreased by 15% to ISK 4.0 billion for the nine months ended 30 September 2012. The decrease in net fee and commission income for the nine months ended 30 September 2012, as compared to the nine months ended 30 September 2011, was primarily due to decreases in card expenses.

Other non-interest expenses are comprised primarily of personnel expenses, selling, general and administrative expenses, depreciation, amortisation and impairment, other operating expenses and various tax expenses. Such expenses in total increased by 7% to ISK 16.9 billion for the nine months ended 30 September 2012 from ISK 15.8 billion for the nine months ended 30 September 2011. The increase in other non-interest expenses for the nine months ended 30 September 2012, as compared to the nine months ended 2011 principally reflected the increases in personnel expenses (salaries and administration expenses). The following table sets forth the breakdown of the Bank's other non-interest income for the periods indicated:

Figure 48 – Other non-interest expenses

ISK million	2009	2010	2011	9M 2011	9M 2012
Salaries and related expense	8,073	9,272	11,254	8,221	8,813
Administration expense	5,260	7,154	7,810	5,400	6,055
Depositors' and investors' guarantee fund	683	324	1,200	875	683
Depreciation and amortisation	759	819	956	655	714
Other operating expense	571	723	796	624	609
Other non-interest expenses	**15,346**	**18,292**	**22,016**	**15,775**	**16,874**

Profit/(loss) before income tax benefit

The Bank generated a profit before income tax of ISK 17.5 billion for the nine months ended 30 September 2012 and a profit before income tax of ISK 18.2 billion for the nine months ended 30 September 2011. The decrease in 2012, as compared to 2011, was a function of an increasing net interest income but also of an adjusted cost base and lower valuations changes. The Bank also benefited from a net gain from discontinued operations stemming from sale of legal entities.

6.3 Analysis of financial position as at 30 September 2012 and 31 December 2011, 2010, 2009

The following table sets forth the breakdown of the Bank's assets as at the periods indicated:

Figure 49 – Total assets

ISK million	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Cash and balances with Central Bank	41,906	30,628	29,200	16,026
Loans and receivables to credit institutions	38,470	67,846	69,103	88,007
Loans and receivables to customers	357,734	451,219	561,550	572,484
Bonds and debt instruments	173,482	120,112	140,568	119,697
Shares and equity instruments with variable income	7,078	10,316	14,045	15,860
Derivatives	6	1,126	674	969
Securities used for hedging	2,236	3,213	2,372	1,398
Compensation instrument	34,371	24,188	0	0
Investment property	22,947	27,642	27,100	28,171
Investments in associates	5,985	2,713	2,987	3,024
Property and equipment	10,700	7,365	6,271	6,147
Intangible assets	3,512	4,352	4,765	5,102
Tax assets	1,415	295	724	475
Non-current assets and disposal groups held for sale	41,527	44,464	23,886	13,711
Other assets	15,975	17,136	8,876	5,174
Total assets	**757,344**	**812,615**	**892,121**	**876,245**

Total assets

The Bank's assets decreased by 2% to ISK 876 billion as at 30 September 2012 from ISK 892 billion as at 31 December 2011. The development in the Bank's assets as at 30 September 2012, as compared to 31 December 2011, was primarily attributable to a 45% decrease in cash and balances with the Central Bank, a 27% increase in loans and receivables to credit institutions, a 2% increase in loans and receivables to customers, a 15% decrease in bonds and debt instruments and a 43% decrease in non-current assets and disposal groups held for sale. The Bank's assets increased by 10% to ISK 892 billion as at 31 December 2011 from ISK 813 billion as at 31 December 2010, primarily driven by a 24% increase in loans and receivables to customers.

ISK 454,405 million of the Bank's liabilities consist of deposits. Depositors' claims are given priority over other claims in an insolvency scenario. Further, ISK 241,698 million of the Bank's assets are granted as security for its covered bonds programmes and a loan from the Icelandic Central Bank. Covered bond holders, the Icelandic Central Bank and depositors therefore currently enjoy a first right of security.,. Please see the description of the balance sheet impact of of the Issuer's secured funding In chapter 3.3 "Funding - Secured funding" and the related risk in chapter 8 – "Risk factors – Priority claims".

The following table sets forth the breakdown of the Bank's liabilities and equity as at the periods indicated:

Figure 50 – Total liabilities and equity

ISK million	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Due to credit institutions and Central Bank	113,647	95,646	16,160	16,459
Deposits from customers	495,465	457,881	489,995	454,405
Financial liabilities at fair value	88	999	4,907	11,122
Tax liabilities	2,841	4,454	3,421	3,220
Non-current liabilities and disposal groups held for sale	19,230	13,514	4,950	2,683
Other liabilities	24,997	39,050	38,822	35,010
Borrowings	11,042	65,278	187,203	192,412
Subordinated liabilities	0	26,257	32,105	32,502
Total liabilities	**667,310**	**703,079**	**777,563**	**747,813**

ISK million	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Share capital	12,646	2,000	2,000	2,000
Share premium	59,354	73,861	73,861	73,861
Other reserves	1,729	1,525	1,637	1,637
Retained earnings	16,150	28,531	32,950	47,126
Total shareholders' equity	**89,879**	**105,917**	**110,448**	**124,624**
Non-controlling interest	155	3,619	4,110	3,808
Total equity	**90,034**	**109,536**	**114,558**	**128,432**
Total liabilities and equity	**757,344**	**812,615**	**892,121**	**876,245**

Total liabilities

The Bank's liabilities decreased by 4% to ISK 748 billion as at 30 September 2012 from ISK 778 billion as at 31 December 2011. The increase in the Bank's liabilities as at 30 September 2012, as compared to 31 December 2011, was primarily attributable to a 7% decrease in deposits, and a 3% increase in borrowings. The Bank's liabilities increased by 11% to ISK 778 billion as at 31 December 2011 from ISK 703 billion as at 31 December 2010.

Total equity

Total equity increased by 12% to ISK 128 billion as at 30 September 2012 from ISK 115 billion as at 31 December 2011. The increase in total equity as at 30 September 2012, as compared to 31 December 2011, was primarily attributable to increase in retained earnings. The Bank's total equity increased by 5% to ISK 115 billion as at 31 December 2011 from ISK 110 billion as at 31 December 2010.

6.4 Cash flow for the nine months ended 30 September 2012 and 2011 and full year 2011, 2010 and 2009

The following table sets forth the breakdown of the Bank's consolidated cash flows for the periods indicated:

Figure 51 – Cash flow statement

ISK million	**2009**	**2010**	**2011**	**9M 2011**	**9M 2012**
Earnings before income tax	16,519	17,331	11,260	18,198	17,485
Adjustments to reconcile earnings before income tax to net cash from (used in) operating activities:					
Non-cash items included in net earnings before income tax and other adjustments	-15,879	-6,386	-1,623	-1,377	-26
Changes in operating assets and liabilities	-36,474	-7,991	-13,443	-15,893	-31,859
Income taxes paid	-585	-748	-3,232	-544	-3,326
Net cash from (used in) operating activities	**-36,419**	**2,206**	**-7,038**	**384**	**-17,726**
Cash flows from (used in) investing activities:	**2009**	**2010**	**2011**	**9M 2011**	**9M 2012**
Purchase of investment property	-2,865	-1,120	-2,160	n.a.	n.a.
Investment in associated companies	-612	-66	-177	n.a.	n.a.
Proceeds from sale of investment property	0	1,705	5,999	n.a.	n.a.
Proceeds from sale of associated companies	193	54	0	n.a.	n.a.
Purchase of intangible assets	-152	-121	-518	n.a.	n.a.
Purchase of property and equipment	-208	-381	-667	n.a.	n.a.
Proceeds from sale of property and equipment	138	110	158	n.a.	n.a.
Proceeds from sale of legal entities acquired exclusively with view to resale	0	706	0	n.a.	n.a.
Proceeds from the sale of individual properties included in discontinued operations	0	1,870	11,028	n.a.	n.a.
Net cash from (used in) investing activities	**-3,506**	**2,757**	**13,663**	**4,792**	**15,104**
Net increase (decrease) in cash and cash equivalents	-39,925	4,963	6,625	5,176	-2,622
Cash and cash equivalents at beginning of the year	92,910	56,094	72,797	72,797	82,815
Cash and cash equivalents acquired through business combinations	804	18,110	11	5	0
Effect of exchange rate changes on cash and cash equivalents	2,305	-6,370	3,382	1,234	2,322
Cash and cash equivalents at the end of the year	**56,094**	**72,797**	**82,815**	**79,212**	**82,515**

Proceeds from investing activities in 2011 and 2012 primarily originate from the sale of legal entities and investment property.

Net cash from (used in)/ operating activities

The Bank's net cash used in operating activities amounted to ISK 17.7 billion for the nine months ended 30 September 2012 and the Bank's net cash from operating activities amounted to ISK 0.4 billion for the nine months ended 30 September 2011. The net cash generated in operating activities in 2012, as compared to net cash generated from operating activities 2011, principally reflected changes in operating assets and liabilities, which amounted to ISK -31.9 billion for the nine months ended 30 September 2012 compared to ISK -15.9 billion for the nine months ended 30 September 2011.

Net cash from investing activities

Net cash from in investing activities increased by 215% to ISK 15.1 billion for the nine months ended 30 September 2012 from ISK 4.8 billion for the nine months ended 30 September 2011. The increase in net cash from in investment activities in 2012, as compared to 2011, was mainly attributable to greater success in the sale of legal entities and investment properties taken over from defaulting customers.

6.5 Commitments and contingencies

The Bank has credit-related commitments and contingent liabilities in respect of, among others, guarantees and letters of credit. These instruments bear a credit risk similar to that of loans granted to customers. The Bank also has commitments and contingent liabilities in respect of operating leases, capital expenditures and tax. The following table sets forth the Bank's commitments and contingencies as at the periods indicated:

Figure 52 – Commitments and contigencies

ISK million	31 Dec 2009	31 Dec 2010	31 Dec 2011	30 Sep 2012
Guaranties	15,318	11,675	8,662	10,628
Unused overdrafts	36,152	40,806	34,258	34,899
Loan commitments	21,859	13,946	17,687	35,262
Operating lease commitments, lessor	967	1,965	1,744	n.a.
Operating lease commitments, lessee	8,859	11,959	10,418	n.a.

For more information about the commitments and contingencies please refer to the latest annual report.

The outstanding contractual amount of any guarantee or letter of credit does not necessarily represent future cash requirements, as many of these commitments may expire or terminate without needing to be funded.

6.6 Auditors

The Bank's consolidated financial statement as at and for the years ended 31 December 2011, 2010 and 2009 have been audited, as applicable, by Ernst & Young hf.

7. Legal and regulatory matters

7.1 Banking law

General information

Act No 161/2002 on Financial Undertakings is the primary source of law regulating the operations of financial institutions in Iceland. As a Contracting Party to the EEA Agreement, Iceland has in general implemented the relevant EU legislation in the field of financial services bringing the legal environment in Iceland in line with the EU/EEA regime. Thus the Act implements inter alia Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions, Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions, Directive 93/22/EEC on investment services in the securities field, Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions, and Directive 2000/28 amending Directive 2000/12 / EC relating to the taking up and pursuit of the business of credit institutions.

Act No 161/2002 also affords the Minister of Economic Affairs powers to enact regulations to further specify the general conditions laid down in the Act.

Act No 161/2002 is changed or updated regularly to implement new EEA legislation in the field of financial services. The Act has further been amended several times in the last few years to further clarify the national framework for financial services. Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions was implemented with the adoption of Act No. 75/2010, amending the Act No. 161/2002 on Financial Undertakings.

Changes made to legislation

On November 13th the Icelandic Parliament (Althingi) passed Act No. 129/2008 amending Act on Financial Undertakings, No. 161/2002, This Act somewhat clarified the legal framework regarding the old banks which had been taken over by the Government. The Act provides financial undertakings under the control of FME resolution committees, such as the old Landsbanki, Glitnir and Kaupthing, the possibility of a moratorium of up to 24 months, within which the banks are granted practical immunity from their creditors and are even granted immunity from legal proceedings meaning that legal proceedings shall not be initiated against a financial undertaking while a moratorium of payments is in effect unless explicitly authorised by law or in the case of criminal proceedings in which criminal penalties applicable against a financial undertaking are demanded. The Act further enables the banks to carry on financial activity in order for them to preserve the value of their assets. Certain amendments were made to the Act on Financial Undertakings, No. 161/2002 with the adoption of Act No 78/2011 by Parliament on 10 June 2011. Among the changes is the application to the Winding-up Boards (and to Resolution Committees or provisional Boards of Directors, where appropriate) of the special qualification requirements which apply to the management and board members of financial undertakings, as provided for in paragraph 2, the fourth sentence of paragraph 3 and paragraph 4 of Article 52 of the Act. Rules were also adopted on the supervisory role of the FME regarding financial undertakings in winding-up proceedings, regardless of whether the operating licence of the financial undertaking concerned had been revoked or limited in connection with those proceedings. The authorisation of the Winding-up Board to make payment towards finally recognised claims was limited to priority claims and provisions on payment to an escrow account, in cases of disputed claims, were clarified. Furthermore, it was stipulated that Winding-up Boards (and Resolution Committees/provisional Boards of Directors, as appropriate) are to disclose information on all significant measures taken concerning the sale or disposition of assets of the estate. The intention is to have such disclosure generally take place prior to the action, unless this could be detrimental to the interests of the estate.

Act No. 44/2009 amending Act No 161/2002 provided that as of 1 January 2012, all the tasks of Resolution Committees would be incumbent upon the Winding-up Boards of the financial undertakings concerned.

Licensing

The Issuer, as a Commercial Bank, operates under the conditions provided for in its operating license. The Financial Supervisory Authority (FME) grants the licence subject to the provisions of Act No 161/2002 on financial undertakings. A licence holder has to meet the general requirements set out in Chapter II of the Act No 161/2002 and any further requirements specified in the licence. The FME keeps a register of financial undertakings and their branches, including all the principal information on the undertakings concerned. Act No 161/2002 further entails provisions on all the permitted operations of a Commercial Bank and defines the fields of operation, including other services than those directly deriving from banking.

The principal provisions concerning the regulatory functions of the FME are laid down in Act No. 87/1998 on the official supervision of financial operations, mainly in Chapter III of the Act. In addition, there are provisions on the supervisory posers of the FME in various acts of law and rules on financial activities, although the main provisions can be found in the two Acts mentioned above.

Mandatory financial ratios

Act nr. 161/2002 on Financial Undertakings includes the rules on mandatory financial ratios, or capital requirements. According to Article 84 of the Act the capital base of a financial undertaking shall at any time correspond to a minimum of 8% of the risk base. The risk base is the aggregate of weighted risk factors, such as credit risk, equality risk, interest rate risk, currency risk, commodity risk and operating risk, entailed in the business activities of financial undertakings. The FME supervises the compliance with capital requirements and may require a financial undertaking, which does not meet the minimum requirement of this Act and rules based on it, to take corrective action as further stipulated in the Article 84 of the Act.

The FME issues detailed rules on the capital requirements and on the risk factors, risk weightings and the calculation of risk base. The rules implement the requirements of Council Directive 202/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in financial conglomerate as incorporated into the EEA Agreement. The current rules are issued under the title Rules on the Capital Requirements and Risk Weighted Assets of Financial Undertakings, No 215/2007. These rules are amended regularly and the latest version was issued in March of 2012.

Rules 215/2007 require financial undertakings to send solvency ratio reports to the FME on a quarterly basis. Chapter III of the Rules lays down the requirements, in particular Article 4 which entails the requirements for credit risk and dilution risk in respect of all business activities, for trading-book business, for position risk, settlement and counterparty risk, for foreign exchange risk and for commodities risk, both on-balance sheet and off-balance sheet items, and for operational risk. Certain requirements and restrictions are in place with regard to individual clients and related parties that exceed 25% of the financial undertaking's total own funds (large exposures).

The FME is permitted to increase the financial ratios requirements for financial undertakings under Article 84 Act No 161/2002. FME has used this authorization and in some cases it has required for a limited period of the Commercial Banks a 12% of base risk of Core Tier 1 Capital, as defined in paragraph 5 of Article 84. And for Tier 2 Capital 16% of base risk.

Liquidity requirements

The FME has issued guidelines on best practice for managing liquidity in financial undertaking No 1/2008. The guidelines entail principles for the developing of a structure for managing liquidity, measuring and monitoring net funding requirements, market access, contingency planning, foreign currency liquidity management and internal controls for liquidity risk management. The FME and the Central Bank monitor the liquidity of financial institutions by collecting monthly reports. The FME Guidelines entail a minimum secured liquidity ratio and a minimum cash ratio. According to the guidelines the commercial banks should have adequate liquidity reserves to withstand an instantaneous deposit outflow of 20% (Secured liquidity ratio), and cash and cash equivalents shall amount to at least 5% (Cash ratio) of on-demand deposits. The high liquidity reserve required by the FME reflects the uncertainty of the deposit's stickiness of the Icelandic banks and the fact that a large part of the banks' liabilities are primarily short term or on-demand deposits while the contractual maturity of the assets is much higher.

Large Exposures

Rules on large exposures No 216/2007 are intended to implement Directive 2006/48/EC, as incorporated in the EEA Agreement. Directive 2009/48/EC amending Directive 2006/48/EC is yet to be implemented in such rules. According to Directives 2006/48/EC and 2009/48/EC, Member States may fully or partially exempt exposures incurred by a credit institution to its own subsidiaries in so far as those undertakings are covered by supervision on a consolidated basis to which the credit institution itself is subject. In implementing directive 2009/48/EC, the Icelandic regulator may elect to withdraw such exemptions which would have an impact on the calculation of large exposures and financial ratios.

Emergency Bank Act

The Icelandic parliament passed on October 6th 2008 Act No 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances (The Emergency Act), allowing the FME to take over the operations of the banks in unusual and extraordinary circumstances in order to limit damage or the risk of damage in the financial markets. The Emergency Bank Act further entailed the classification of deposits as a priority claim on the bank's estates. This was done in order to secure the interests of depositors in the foreign branches. Ideally, a bank's assets will be worth enough to cover all or most outstanding deposits.

These unusual and extraordinary circumstances are stipulated further in Paragraph 2 of Article 1 of the Act. This list of circumstances is however not exhaustive; the FME can thus, in other circumstances, apply its powers under the law subject only to the approval of the board of the FME. The Central bank, which monitors liquidity status of financial institutions, appoints one member of the FME board. The Central bank therefore has first-hand information about the status of financial institutions and probable FSA actions in that regard.

The FME assumed the control of the biggest commercial banks in accordance with the powers afforded by the Act as described in Chapter 3. The procedure has been as follows:

i. The boards of Directors were dismissed

ii. Special Resolution Committees were appointed to take over board activities and management

iii. New companies were founded to assume the old banks domestic operations

iv. The FME decides on disposal of assets and liabilities of the old banks to the new companies

v. The Government, the Resolution Committees and the new banks came to an agreement on capitalization of the new banks and compensation to creditors of the old banks.

vi. The Resolution Committee of Glitnir, on behalf of its creditors, decided to acquire 95% of the new bank, Islandsbanki.

vii. The Resolution Committee of Kaupthing, on behalf of its creditors, decided to acquire 87% of the new bank, Arion Bank (previously known as New Kaupthing). The government will hold a 13% share in Arion bank.

viii. NBI bank, built on the domestic operations of Landsbankinn, will be owned by the Government.

ix. In January 2010 the FME authorized Kaupskil ehf., on behalf of the creditors of Kaupthing, to acquire a qualifying holding in Arion Bank hf. Similarly the FSA authorized ISB Holding ehf. on behalf of the creditors of Glitnir, to own a qualifying holding in Íslandsbanki.

x. The FME has not made use of the powers afforded to it in the Emergency Act since 2010 when the FME assumed the control of two savings banks; Byr and SpKef.

Insolvency regime

As described above, the Emergency Bank Act was enacted in October 2008. It included changes to the Act on Financial Undertakings no. 161/2002 and the general insolvency regime in Iceland.

The FME was afforded extensive powers, inter alia, when it deems necessary, to assume the powers of a shareholder´s meeting in a financial undertaking, dismiss the Board of Directors and appoint a Resolution Committee in its stead, and or/take over the operations of any financial undertaking either in part or whole, or decide on measures regarding the future of the company, or dispose of such an undertaking, including the merger of the undertaking with another entity in accordance with article 100 a of Act No 161/2002 as amended by Act No 125/2008. The Resolution Committees take decisions they deem appropriate in order to maximize the worth of the institutions´ assets, in order to reimburse the creditors as well as possible. The creditors´ claims continue to exist, but are less likely to be reimbursed. The Resolution Committees have effectively taken over all authority of the Board of Directors of the old banks in accordance with Icelandic company law as laid out in the relevant acts, e.g. Act No 2/1995 on Public Limited Companies and Act No 161/2002 on Financial Undertakings. Therefore, the Resolution Committees have the complete authority and capacity to commit the old banks in any way a Board of Directors normally could commit its company according to Icelandic law.

Each Resolution Committee is selected by the FME, and they are all currently formed by 5 individuals with expertise in Icelandic business, legal and accounting fields.

In November 2008, each Resolution Committee applied for moratorium (cessation of payments) according to the Bankruptcy Act No 21/1991. That was done primarily to ensure that all creditors were treated fairly and appropriately, and to protect the assets of the banks and maximize their value.

According to the Bankruptcy Act, when a company is under moratorium, it is protected from certain actions by creditors, and restrictions are also placed on the company regarding its authorisation to dispose of assets, to discharge liabilities and to assume new liabilities. Each company under moratorium must appoint a supervisor confirmed by a court, to supervise all actions taken by the company. He must oversee the distribution of the assets of the banks and the payment of claims during the moratorium. He must approve every transaction undertaken by the Resolution Committee and ensure that no transactions are in violation of the Bankruptcy Act.

Each moratorium is automatically recognised in EEA member states (EU member states plus Iceland, Norway and Lichtenstein) under article 3 of EU Directive on reorganisation and winding-up of credit institutions (2001/24/EC) which has been incorporated in the EEA Agreement.

The moratorium provides each bank with appropriate global protection from legal action taken, or anticipated to be taken by its creditors. The moratorium is needed to ensure fair treatment of all creditors under Icelandic law in accordance with established priorities. In addition, its purpose is to give the old banks time to build an effective and suitable asset realisation strategy, thereby maximising total return for the creditors of the old banks.

More specifically, the moratorium restricts the payments of claims, the disposal of assets or the assumption of financial obligations unless the prior approval of the supervisor is obtained and other conditions of the Bankruptcy Act are met. In brief, the disposition of assets is only permitted if it secures day to day operations of the old banks, necessary for the reorganisation of the old banks´ finances or if the disposal of an asset is necessary to protect the value of the asset.

The Emergency Act also included a very important amendment to the Bankruptcy Act regarding priority claims. Claims arising from “deposits” (pursuant to “the Act on Deposit Guarantees and an Investors Compensation Scheme”) are now granted priority over all other claims upon liquidation of the estate of a bankrupt financial undertaking. Some legal scholars have maintained that this provision of the Emergency Act is a clear breach of the general principal of creditors´ equality. However it has to date been upheld by the national courts.

Initially, the Resolution Committees operated in close consultation and cooperation with the FME. But after the banks were granted a moratorium status, the Committees have become virtually independent from any governmental body, although the FME has of course the powers to perform any strategic changes of the Resolution Committee it deems necessary.

Current winding up proceedings for Kaupthing

In October 2008, Kaupthing was taken into a special resolution regime, and the Kaupthing Resolution Committee was appointed by the FME. The relevant provisions which set out the details of this regime are found in the Act on Financial Undertakings no. 161/2002, and subsequent amendments, and the Act on Bankruptcy etc. no.21/1991. The Act on Financial Undertaking in some respects deviates from the Bankruptcy Act, but in other respects applies its general provisions as described above.

Under this regime, Kaupthing does not go bankrupt like other corporate entities or individuals under the Bankruptcy Act. Kaupthing entered into moratorium on 24 November 2008, which ended following a ruling of the Reykjavik District Court, on 22 November 2010 after which it entered into a winding-up process.

Pursuant to the Act of Financial Undertaking, the Kaupthing Resolution Committee is given power by law to represent Kaupthing in all matters and safeguard its interest. The Kaupthing Resolution Committee has a legal obligation to maximise the value of Kaupthing's assets and preserve the interest of the creditors as a whole. In addition the Kaupthing Resolution Committee is responsible for managing daily operations.

Under winding-up proceedings, agreements and obligations of the financial undertaking continue to exist and Kaupthing is protected against petitions for insolvent liquidation. Its assets cannot become subject to an attachment, execution or forced sale. No law suit can be filed against Kaupthing in Iceland while it is in winding-up proceedings, unless in accordance with a provision of law (primarily concerning disputes as to the processing of claims against Kaupthing) or through criminal proceedings. The Winding-up Committee is in full control of Kaupthing during the winding-up proceedings and has full authority to manage its business, in accordance with the Act on Financial Undertakings.

In June 2011, the Icelandic parliament passed an amendment to the Act on Financial Undertakings. Changes put in place through this amendment include that the Kaupthing Resolution Committee was dissolved on 1 January 2012. Consequently, the Winding-up Committee has assumed all responsibility for managing the Kaupthing estate as of 1 January 2012.

The current winding-up process is in essence a temporary period for Kaupthing. According to the Act on Financial Undertakings a company can only be in winding-up proceedings as long as the intention is to achieve a composition with creditors. The Kaupthing Resolution Committee has announced its intention to achieve a composition agreement in 2013. The possibility of such an agreement is however contingent upon the rules on capital controls since it would entail considerable off-shore payments.

7.2 Capital controls

Existing currency restrictions** - **Icelandic rules on foreign exchange

On 28 November 2008, the Icelandic Parliament passed Act no. 134/2008 (the Amending Act), on Amendments to the Act on Foreign Exchange no 87/1992, as amended, (the Foreign Exchange Act) granting the Central Bank powers to intervene in the currency market with the view of stabilising the foreign exchange rate of the Icelandic króna. For this purpose, the Central Bank issued Rules on Foreign Exchange, no 1082, of 28 November 2008 (the Foreign Exchange Rules). With Act No 127/2011 amending the Foreign Exchange Act, the rules where amended and adopted into the Act on Foreign Exchange. The general restrictions regime is now stipulated in Article 13 of the Act. It was at the time intended to only be valid for a certain time period, i.e. lifted in April 2014. However this expiration date of the capital controls is uncertain today in particular in light of the position adopted by a bi-partisan committee appointed by the Minister of Finance. The committee as called for a change in the capital controls regime, whereby the lifting of the restrictions regime would be conditional upon certain economic factors rather than a specific date.

In March 2012, further restrictions on the outflow of foreign currency were enacted by the passing of Act No. 17/2012.Act No 17/2012 entailed two amendments to the capital controls regime, inter alia, in response to a perceived increase in circumvention of the currency restrictions. Before these amendments, an investor could change amortization and the indexation share of a CPI indexed annuity bond into foreign currency and transfer out of the economy – even though a principle payment on a non-CPI indexed bond could not be converted into foreign currency. The legislation removed the previous exemption provided for the amortization and indexation share of bond payments which are now subject to the general capital controls regime. Furthermore, the wide exemptions for payments of the winding-up boards of the failed Icelandic banks to creditors were removed, and such payments are now subject to an application for exemption to the Central Bank. Thus the rules on currency restrictions have at least in the shorter term been tightened.

The Foreign Exchange Rules effectively prohibit the outflow of foreign currency from Iceland unless it is a payment for goods or services. Therefore all financial transactions leading to currency outflow are prohibited unless explicitly exempted in the Act. More specifically, the Act and related Foreign Exchange Rules include provisions prohibiting certain transactions including lending and borrowing between resident and non-resident parties as well as currency derivatives of any kind, the acquisition by domestic parties of financial instruments nominated in foreign currency. Furthermore the Foreign Exchange Rules make it compulsory for Icelandic nationals and companies to “repatriate” all their foreign currency back into the country.

The Commercial banks are provided a general exemption from some of the provisions of the Act on Foreign Exchange, and thus the capital controls. The general exemption, set in paragraph 6 of Article 13 m, is in regards to Articles 13.g, 13.h and 13.l. They exempt commercial banks, savings banks and credit corporations operating under a licence awarded by the FME from restrictions on borrowing and lending between national and foreign parties, the restriction on joining or assuming liability for payments between national and foreign parties, and the requirement to return all foreign currency that nationals may possess or acquire to a licenced commercial bank.

The Act provides for the possibility of specific exemptions from the restrictions of the legislation. Such exemption has to be applied for to the Central Bank of Iceland, cf. Article 7. The process of such application takes the estimated time of 6-8 weeks. The exemption is sent in writing to the Central Bank with relevant documentation supporting the request of exemption. The Act sets out criteria the Central Bank has to consider when processing the applications. These criteria include the effects of the restriction on the applicant, what are the intended goals with the restrictions and the effect an exemption would have on the stability of currency- and monetary policy.

The Central Bank of Iceland presented a “Report on capital account liberalisation strategy” on 25 March 2011. In that report various conditions for lifting the capital controls are described in two main phases and are outlined in some detail. According to the report the restrictions will be lifted in steps, the first one being to allow the inflow off off-shore krona to Iceland. Steps in this phase are foreign exchange auctions held by the CBI, which have been held the past few months. The CBI usually offers three different auctions at each time. It offers to purchase euros in exchange for Icelandic krona for long-term investment in the Icelandic economy, or in exchange for payment in Treasury bond series. Furthermore, it advertises for bids on the sale of Icelandic krona for cash payment in foreign currency.

Following the adoption of Act No. 17/2012, only interest payments of ISK denominated bonds may be converted into foreign currency and transferred to non-resident parties outside of Iceland. Previously, Bondholders not resident in Iceland were able to convert interest, indexed and principal payments of bonds into foreign currency and transfer such amounts out of Iceland.

The currency restrictions constitute protective measures under Article 44 of the EEA Agreement and have as such been notified to the EFTA Standing Committee under the procedures provided for in Protocol 18 to the Agreement in conjunction with Protocol 2 to the Surveillance and Court Agreement. Following a referral by the District Court of Reykjavik, the EFTA Court issued an advisory opinion on 14 December 2011, whereby the Court ruled that it had competence under the EEA Agreement and the Surveillance and Court Agreement to review the rules on currency restrictions inter alia in light of the general principle of proportionality. The Court further declared that at the time in question the rules in question where proportionate. Thus the rules on currency restrictions may at any time be subject to the scrutiny of the EEA Institutions.

Taxation

More detailed discussion on taxation can be found in Chapter 9 here below and here the taxation applicable in Iceland, regarding Icelandic and non-Icelandic tax residents will be mentioned. The taxation requirement for non-Icelandic residents is in regards to withholding tax on interest payments and for Icelandic residents in regards to income tax on interest payments.

Interest and Price Indexation

In accordance with Act No 38/2001 on interest and price indexation, savings and loans may be indexed if the basis of the price indexation is the consumer price index as calculated by Statistics Iceland in accordance with legislation applicable to the index and published monthly in the Legal Gazette. The Central Bank may, subject to the approval of the Minister of Economic Affairs, decide on a minimum maturity for indexed deposits and loans. The Bank may also, subject to the approval of the Minister, decide that the interest rates on indexed deposits and loans should be fixed during the period of the loan. The Central Bank has adopted further rules on the indexation of savings and loans in Regulation 492/2001.

7.3 Other regulations

Anti-Money Laundering legislation

Iceland has adopted EEA rules on anti-money laundering in Act No 64/2009 on measures against money laundering and terrorist financing. According to Icelandic law, financial institutions are required to establish a compliance function and must ensure that it is effective and independent of other aspects of the institution's operations. The compliance function is required to:

i. monitor and regularly assess the adequacy and effectiveness of policies and procedures designed to detect any risk of failure by an institution and to put in place procedures to minimise that risk;

ii. monitor and assess the actions taken to address any deficiencies in the institution's compliance with its obligations; and

iii. provide the employees of the institution responsible for carrying out the execution of securities transactions with the necessary training, advice and assistance to enable them to discharge the institution's obligations under applicable Icelandic law.

Deposit insurance

In act in Iceland is the Act No 98/1999 on Deposit Guarantees and Investor. This act was adopted into legislation in 1999 but has been amended since, especially after the collapse of the financial sector and the consequences of the claims of the deposit owners in regards to their deposits in the banks. The main changes have been made with Act No 55/2011 and Act No 79/2012. The former added preliminary provisions dividing the guarantee fund into the new and the old fund, where the new fund guarantees all new deposits post 2008. The old fund is kept idle, without additional payments, in light of the uncertain situation regarding the deposits in off-shore branches of the old banks. The Act further introduced new methods of calculating the premium and a new definition of deposit. The latter stipulated the formal adoption of these preliminary provisions into the Act itself. Iceland has not fully implemented changes made to Directive 94/19/EC of the European Parliament and the Council on deposit-guarantee schemes, with the relevant increase in guarantees. The matter is still being discussed in the Parliament. In December 2011, The EFTA Surveillance Authority lodged a formal application with the EFTA Court, having issued a reasoned opinion finding Iceland to be in breach of the Deposit Guarantee Directive inter alia with regard to the ring-fencing of domestic deposits. In a judgment on the 28th of January 2013, the EFTA Court dismissed the application, finding there to be no obligation of result attached to the Directive and that the measures in question could not be considered discriminatory as the fell outside the scope of that Directive.

In October 2008 the government of Iceland issued a declaration of a blanket guarantee regarding all deposits in the Icelandic banks. The guarantee has not been further stipulated in law. However, it will be assumed to be valid until it has been officially revoked by the government. The EFTA Surveillance Authority has in a number of State aid decisions referred to the blanket guarantee as justification for the assumption of control of failing banks and thus not formally raised doubts as to the compatibility with the State aid rules. However, the EFTA Surveillance Authority has indicated that the necessity of the blanket guarantee remains under its review under the State aid rules.

As described above, deposits were granted priority status in the event of insolvency by the Emergency Act. The term deposit in the Emergency Act is not, however, synonymous with the term deposit under the Deposit Guarantee Directive. The EFTA Court has in an advisory opinion to the District Court of Reykjavík stated that there is a difference between the term deposit in the functional sense, i.e. a deposit qualifying for protection under a deposit guarantee scheme, and the technical classification of a transaction as a deposit which does not entail such protection. The Icelandic Courts have thus held that the classification of certain money market loans as technical deposits does not entail their classification as priority claims under the Emergency Act.

Competition law

The Competition Act No 44/2005 provides the general principles on the competition regime in Iceland which is in line with the obligations entailed in the EEA Agreement. In 2011 an amendment to the Competition Act was approved by Parliament, giving the Competition Authority extended powers to intervene in the market regardless of an actual breach of the prohibition rules of the Act. The Act further entails extensive powers of the Competition Authority with regard to merger control. In the aftermath of 2008 and in relation to the financial restructuring of companies the new banks have assumed control over a large number of companies. The Competition Authority has classified these changes in ownership or control as mergers which have to be notified to the Competition Authority. The mergers have generally been approved with extensive commitments regarding inter alia management, transparency and disposing of assets. A company in violation of the prohibition provisions of the Competition Act or commitments undertaken in relation to mergers may be fined in an amount up to 10% of annual turnover.

8. Risk factors

8.1 Economic and other country specific risk factors

The Icelandic economy

Iceland's economy is vulnerable to a range of risks affecting the banking system as well as risks relating to high levels of public debt resulting from the banking system and economic collapse.

In addition, if the ISK does not strengthen over the long term and confidence in Iceland's currency does not increase, it may be less likely that Iceland's economy will emerge fully from recession. Essential elements to such recovery include significant debt reduction by Icelandic households and businesses, in particular in respect of their foreign currency and indexed borrowings, which will be challenging in light of the currently lower exchange rate for the ISK than at the time most of the loans were incurred and a scarcity of foreign currency; revived investment and revived but contained growth in consumer demand, which may be constrained by the continued high indebtedness of Icelandic consumers and businesses; controlled inflation that remains within targets set by the Central Bank; continued demand for Iceland's exports; appreciation of the ISK to levels that sustain a favourable balance of trade and current account; renewed access to foreign financial markets; and sufficient, stable foreign currency reserves.

As described above, Iceland introduced a capital controls regime in 2008. Initially, that regime entailed a sunset clause referring to a specific date when the controls should be lifted. The government is currently considering a change in approach whereby the lifting of the capital controls would be contingent upon the fulfilment of certain economic criteria rather than a specific date. Any changes to the capital controls regime may have a material adverse effect on the Icelandic economy. Furthermore, it must be noted that the political parties have divergent views as to the future of the national currency and the capital controls. The result of the upcoming elections in April could therefore have an impact on the capital controls regime.

Finally, Iceland's economy is highly dependent on international trade. This means that Iceland's economy may be vulnerable to external events that disrupt trade flows to and from Iceland. Such events include, but are not limited to: natural events, changes in the exchange rate of the ISK against other currencies; economic conditions of major trading partners; Iceland's relationship with trading partners; tariffs and other trade barriers; and international hostilities. If Iceland experiences a significant and prolonged disruption in its international trade as a result of any one or more of the factors mentioned above or for any other reason, Iceland's economy could be materially adversely affected.

Should Iceland's economy continue to be adversely affected by external shocks or otherwise fail to recover, whether as a result of any of the above factors or for other reasons, this could adversely affect the ability of the Bank's customers to repay their loans (many of which have already been restructured) which in turn could have a material adverse effect on the Bank's business.

The Banking sector

Following the collapse of Glitnir, Landsbanki and Kaupthing, the FME transferred certain of their assets and liabilities (including the domestic deposits) into the new banks, as described above. The Icelandic banking sector is dominated by the new banks but also includes other commercial banks and savings banks. The new banks currently have limited access to the international financial markets and have so far engaged in only limited lending, primarily domestic lending in ISK. The vast majority of the new banks' funding comes from deposits by customers. As described in Chapter 7 –"Legal and regulatory matters", the government has from October 2008 maintained a policy that deposits in banks domiciled in Iceland are guaranteed by the State. A withdrawal of the guarantee could therefore affect the banking sector. Moreover, should current capital controls be lifted, funding of Icelandic banks could be adversely affected by the removal of deposits by customers who are currently unable to do so due to such capital controls. The government has stated its intention to manage the exchange controls with a view to mitigating the risk of capital flight from such customers, although no assurance is given that this will prove to be the case.

Iceland's new banking system is small and the new banks have limited opportunities for growth in the near term. Given the existing leverage of Icelandic households and businesses and continuing lack of economic growth, the new banks are not expected to grow significantly through domestic lending in the near term. It is also not likely that the new banks will grow through international operations in the near future. Further, the growth of foreign currency transactions by Icelandic banks is expected to be limited by continued capital controls. Even though a large amount of Icelandic banks' assets are denominated in foreign currencies, the banks do not have access to foreign funding or exchange rate hedging to the same degree as before.

Uncertainty about the quality of the loan assets held by the new banks is a major risk to the success of Icelandic banks. Iceland's new banks are capitalised with pre crisis domestic loans extended by the failed banks, many of which are being restructured and many of which may be unrecoverable. During the period from 2003 through 2007, the old banks maintained liberal lending policies, and Icelandic households and businesses took on a large amount of debt, of which a large proportion was denominated in, or indexed to the value of, a foreign currency. Prior to October 2008, Iceland's banks lent extensively in foreign currency. As a result, a large portion of the assets of the new banks consist of foreign currency loans to businesses and individuals in Iceland that were made before the financial crisis. Uncertainty about the quality of the loan book also reflects legal risk regarding loans linked to foreign currencies, especially with respect to commercial loans indexed to a foreign currency. As a result, loan recovery is unusually uncertain, in terms of both the amount recoverable and whether loans will be repaid on time. Determination of loan values and write off needs will depend on general economic developments and on the operating and financial condition of the particular borrowers.

Should an unexpectedly large number of borrowers default on loans transferred to the new banks by the old banks or need to restructure or reschedule these loans, the balance sheets of the new banks could be materially adversely affected. In the event that the quality of assets held by one or more of the new banks is so poor that it is not able to meet applicable capital standards, then additional State assistance may be necessary to rescue it. Any such rescue could be costly for the State and would represent a major setback for the growth and international acceptance of the new Icelandic banking system.

If Iceland's banking system does not increase in size and in the strength of its assets and business, or if some or all of the new banks should collapse, Iceland's economy could be vulnerable to renewed disruptions, cessation or reversal of growth and a deepening recession. The new banks could also be adversely affected if other developments in the Icelandic economy or in world affairs result in further slowing the growth of Iceland's economy or trigger a deepening recession.

The occurrence of any of the factors described above could seriously undermine Iceland's economy and confidence in the banking system in Iceland, and could have a material adverse effect on the Bank's business.

8.2 Business risk

Risk management

The Bank seeks to manage its risks through a process of on-going risk identification, measurement and monitoring, using limits and other controls. This process of risk management and the ability to evaluate, manage and price the risk encountered is critical to the Bank's continuing profitability and its ability to ensure that the Bank's exposure to risk remains within acceptable levels.

The Bank's risk management strategies may fail under certain circumstances, particularly when confronted with risks that have not been identified or anticipated. Risk methodologies and techniques that the Bank adopts to assess credit risk, market risk, liquidity risk and operational risk may be flawed or may not take all risks into account, and it is possible that the methods for assessing these risks are not sound or are based on faulty information, or that they will be misunderstood, not implemented correctly or misapplied by the Bank's personnel. In addition, the Bank's risk management policies are constantly being re-evaluated and there may be a lag in implementation. Furthermore, some of the Bank's qualitative tools and metrics for managing risk are based upon the use of observed historical market behaviour. The Bank may apply statistical and other tools to these observations to arrive at quantifications of risk exposures. These tools and metrics may fail to predict future risk exposures.

The Bank's losses thus could be significantly greater than its risk management measures would indicate. In addition, the Bank's quantified modelling does not take all risks into account. The Bank's more qualitative approach to managing risks takes into account a broader set of risks, but is less precise than quantified modelling and could prove insufficient. Unanticipated or incorrectly quantified risk exposures could have a material adverse effect on the Bank's business and its ability to make payments in respect of the Bonds.

Large exposures

In accordance with applicable Icelandic regulations, a large exposure is defined as an exposure to a group of financially related borrowers which exceeds 10% of the Bank's capital base net of eligible collateral. The legal maximum for individual large exposures is 25% of a Bank's risk capital and the sum of all large exposures cannot exceed 400% of a Bank's risk capital. The Bank's internal limit, after taking account of collateral, is 150%. The Bank had no large exposures in excess of the legal limit of 25% at 30 September 2012. The sum of all of the Bank's large exposures was 108% on 30 September 2012 before taking account of collateral and 63% after taking account of collateral.

The loans which were transferred from Kaupthing to the Bank include loans which have led to high counterparty concentration for the Bank. Should any of the customers to which the Bank has a large exposure default, this would have a material adverse effect on the Bank's business and its ability to make payments in respect of the Bonds. The table below shows all gross exposures exceeding 10%. of the Bank's risk capital as at 30 September 2012, and the equivalent exposures of those loans as at 31 December 2011, together with the net amount of each of those exposures after taking account of collateral.

The table below shows exposures to the Bank's 5 largest borrowers where gross exposure exceeds 10% of capital base to each group of financially related borrowers.

Figure 53 – Large exposures

	31 Dec 2011	31 Dec 2011	30 Sep 2012	30 Sep 2012
no.	**Gross**	**Net**	**Gross**	**Net**
1	49%	0%	45%	0%
2	23%	23%	19%	19%
3	20%	20%	20%	20%
4	19%	19%	13%	13%
5	14%	14%	11%	11%
Sum of exposure gross > 10%	**125%**	**76%**	**108%**	**63%**

Credit risks relating to the Bank's collateral

Given that several of the Bank's loans are granted with mortgages on residential real estate as collateral, the credit risk is driven in part by performance of the real estate and housing market in Iceland. There can be no assurance regarding the future development of the value of this collateral. Should the prices of real property and the housing market substantially decline, this could adversely affect the Bank's results of operations, financial condition and business prospects and its ability to perform its obligations under the Bonds.

There are many circumstances that affect the level of credit loss, including early repayments, withdrawals and final payments of interest and principal amounts, such as changes in the economic climate, both nationally and internationally, changes regarding taxation, interest rate developments, inflation and political changes. Borrowers may default as a result of interest rate increases or as a result in changes in their own personal circumstances. Default in respect of a material amount of the Bank's assets could jeopardise the Bank's ability to make payments in full or on a timely basis on the Bonds.

Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates will cause fluctuations in the value and cash flows of financial instruments. The risk arises from imbalances in the Bank'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 Bank's strategy towards market risk is to seek to limit the risk exposure that arises as a result of imbalances in the Bank's balance sheet (referred to as its banking book) but to accept limited market risk in its trading book. The market risk in the trading book arises from proprietary trading activities whereas market risk in the banking book arises from mismatches in assets and liabilities principally in relation to currencies, maturities and interest rates.

Trading book market risk

In the case of proprietary trading, the CEO determines limits for market risk exposure by asset class and for the total trading book, in each case expressed as maximum overnight exposure. The principal exposures are listed Icelandic treasury notes and Icelandic housing fund bonds and, to a very limited extent, listed equities. Although the Bank uses derivatives, principally interest rate swaps and options and forwards on Icelandic treasury notes and Icelandic housing fund bonds, in its proprietary trading activities, the Bank did not have a material exposure to derivative instruments as at 30 September 2012.

Trading book equity price risk

Equity price risk is the risk that the fair value of equity securities decreases as the result of changes in the level of equity indices and individual stocks. The Bank faces both trading book equity price risk which is managed through the proprietary desk within the Treasury department and banking book equity price risk as a result of the fact that, through the loan restructuring process, it has acquired significant shareholdings in troubled companies. Note 41 to the Interim Financial Statements provide information on assets seized by the Bank and held for sale. Several factors, including the general development of the Icelandic economy and the sectors in which the companies in question operate, and any particular risk factors these companies are exposed to, may adversely impact the value of these shareholdings.

Banking book market risk

The principal banking book market risks faced by the Bank are interest rate risk, inflation risk, currency risk, equity risk and prepayment risk.

Prepayment risk

Prepayment risk is the risk that the Bank will incur a financial loss because its customers and counterparties repay or request repayment earlier or later than expected, such as fixed rate mortgages when interest rates fall. The Bank was not materially exposed to prepayment risk at 30 September 2012.

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments. The Bank's operations are subject to interest rate risk associated with mismatches between its interest bearing assets and its interest bearing liabilities. The principal mismatch is the large maturity gap resulting from the fact that the Bank has significant on demand liabilities. Note 56(a) to the Interim Financial Statements provides further information on the Bank's maturity asset and liability gap. The Bank also faces interest rate risk between its interest bearing assets and interest bearing liabilities due to different floating rate calculations in different currencies.

The Bank's strategy for managing the interest rate risk in its banking book is to seek to achieve an interest rate balance between its assets and liabilities by offering deposit incentives and through targeted lending.

Inflation risk

The Bank is exposed to inflation risk when there is a mismatch between its inflation-linked assets and liabilities. As at 30 September 2012, the total amount of the Bank's indexed assets was ISK 267.4 billion and the total amount of its indexed liabilities was ISK 223.6 billion. The Bank also has significant maturity mismatches in its inflation-linked assets and liabilities. See note 56(b) to the Interim Financial Statements.

Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Bank is primarily exposed to currency risk through a currency mismatch between its assets and liabilities. The Bank's liabilities are predominantly denominated in ISK whereas its assets principally comprise foreign currency denominated loans to customers. The Bank's foreign currency imbalances exceeded applicable regulatory limits until the second quarter of 2012, however the Bank was granted a dispensation from complying with the regulatory limits by the Central Bank.

The Bank's strategy for reducing its currency imbalance is first to seek to convert into ISK foreign currency denominated loans to customers who have ISK income and second to hedge its other currency imbalances, principally through agreements with the Central Bank and other counterparties. Until the end of 2010, the Bank was limited in its ability to pursue the first part of its strategy as a result of legal uncertainty relating to the status of foreign currency loans. The status of foreign currency indexed loans has been somewhat clarified by a series of judgments by the Supreme Court in the period of 2010 to 2012, as further described in Chapter 8.2.

Even though no foreign currency indexed ISK loans made by the Bank have been considered by the Icelandic Supreme Court, the Bank has decided and announced that these rulings provide a precedent for the Bank to follow, and that all of the Bank's loans which fall within the conditions established by the Supreme Court in its rulings will be recalculated into ISK denominated loans. The Bank estimates that around 4,000 retail and corporate loans will have to be recalculated.

The precedents set by the Supreme Court resulted in the recalculation of loans previously denominated in foreign currency. As a result, almost all of the Bank's foreign currency indexed ISK loans to individuals have been or will be recalculated into ISK denominated loans. In the case of corporate loans, the Bank was advised in mid-2010 that certain of its foreign currency corporate loans were fully compliant with the applicable law whilst others were more vulnerable, as subsequent rulings of the Supreme Court have confirmed. The Bank remains party to a number of court cases relating to such loans, as further described in Chapter 8.5 –"Litigation".

The Bank's net exposures on a per currency basis are monitored centrally within the Bank. The table below indicates the currencies to which the Bank had significant exposure at 31 December 2011. The analysis calculates the effect of a 10% movement of the currency rate against the ISK (with +10% in the table denoting a depreciation of the ISK) on the Bank's income statement as a result of the change in fair value of currency sensitive non-trading monetary assets and liabilities. A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase.

Figure 54 – The table assumes that all other variables remain constant (ISK million)

	2011	2011
Currency	**-10%**	**+10%**
EUR	-579	579
USD	-828	828
CHF	-103	103
GBP	-279	279
JPY	12	-12
Other	-643	643

Liquidity risk

Liquidity risk is the risk that the Bank will encounter difficulty in repaying its funding or will only be able to secure funding at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

The Bank's primary source of funding is deposits from individuals, corporations and financial institutions. The Bank's liquidity risk stems from the fact that the maturity of its loans exceeds the maturity of its deposits, the majority of which are on demand deposits.

The Bank's strategy is to seek to increase the maturity profile of its liabilities and to strengthen the Bank's liquidity reserve. The Bank has made significant process in converting its on demand deposits to term deposits. As at 31 December 2010, 71.6% of the Bank's deposits were on demand compared to 76.8% at 31 December 2011 and 65.1% at 30 September 2012.

The Bank has classified its deposit base according to its stickiness. The stickiness of the deposit base is determined by the stability of the deposits in the past and their expected stability in the future. Deposits that are determined to have the highest stickiness are the ones that have proven to be the most stable funding source for the Bank in the past and are expected to remain so. The least sticky deposits are the deposits that are expected to be withdrawn under particular circumstances, such as the lifting of capital controls. The Bank’s deposits are classified into seven categories, the first category being the least sticky and the seventh being the most sticky.

As at 31 December 2011, 45% of the Bank’s on demand deposits were classified as falling within the three least sticky categories, being (i) deposits from customers (including foreign financial institutions) that are believed to be waiting to withdraw their deposits when the capital controls are lifted, (ii) deposits from entities that are in the resolution process, including in many cases entities that are insolvent and whose deposits are held as security against other liabilities and (iii) deposits from investors (such as Icelandic pension funds) who may reduce their deposits when other investment opportunities become available or if a competitor bank raises its interest rates on deposits. As at 30 September 2012, the Bank’s 10 largest customer deposits accounted for 31% of its total customer deposits.

The Bank’s strategy is to seek to increase the maturity profile of its liabilities (in part through the conversion of demand deposits to term deposits) and to strengthen the Bank’s liquidity reserve No assurance can be given that the Bank will continue to be successful in converting its demand deposits to term deposits or will otherwise be able to increase the maturity profile of its funding.

The Bank’s non-deposit funding principally comprises a limited number of loans (including two subordinated loans from the Icelandic state and a loan from the Central Bank), certain covered bonds issued and equity funding.

For so long as the Bank is unable to match more closely the maturity profiles of its assets and liabilities, the Bank will continue to be exposed to a material risk that it may be unable to repay its funding or will only be able to do so at excessive cost. The Bank is also exposed to the risk that it experiences a material loss of its least sticky deposits in the future. In either of these cases the Bank’s business and its ability to make payments in respect of the Bonds would be materially adversely affected.

Secured liquidity and cash ratios

The FME has established minimum secured liquidity ratio and minimum cash ratio guidelines. These guidelines stipulate that the Bank should have adequate liquidity reserves to withstand an instantaneous deposit outflow of 20% (the secured liquidity ratio guideline) and that its cash and cash equivalents should amount to at least five % of its on demand deposits (the cash ratio guideline). The Bank calculates its secured liquidity ratio as the sum of (i) cash on hand and cash balances with the Central Bank, (ii) Icelandic treasury notes and housing fund bonds which are held specifically as liquidity reserves and (iii) other eligible assets for repurchase transactions with the Central Bank divided by the Bank's total interest-bearing liabilities. The high liquidity reserve required by the FME reflects uncertainty relating to the stickiness of the deposits made with Icelandic banks and the fact that a large part of these deposits are primarily short term or on demand while the contractual maturity of the assets held by Icelandic banks is much higher.

The Bank's secured liquidity and cash ratios during the nine months ended 30 September 2012 and the year ended 31 December 2011 were as follows:

Figure 55 – Secured liquidity and cash ratios

	31 Dec 2011	30 Sep 2012
Liquidity ratio	33.4%	30.8%
Cash ratio	15.0%	17.8%

The Bank's stress tests are primarily focused on what the effect of lifting capital controls in Iceland would be on the Bank's deposit base and its liquidity buffer.

8.3 Capital adequacy

The Bank's capital policy is to maintain a strong capital base to support business development and to meet regulatory capital requirements, even in times of stress. Long term capital planning for the Bank is currently based on a benchmark minimum core tier 1 capital ratio of 12% and a capital adequacy ratio of at least 16 %. All the risk factors identified in this document could have an adverse effect on capital adequacy ratios.). After a dividends payment in 2011, the bank has not paid dividends to shareholders and such payments are not envisaged in the shorter term.

In January 2010, Kaupskil, which is owned by the creditors of Kaupthing, acquired an 87% shareholding in the Bank from the Icelandic State. At the same time, the Icelandic State provided the Bank with tier 2 capital in the form of a subordinated loan, according to Article 84 of the Act No. 161/2002 on Financial Undertakings. As part of the agreement, the Bank was required to pay to the Icelandic State a special dividend amounting to ISK 6.5 billion out of retained earnings if, following the publication of the 2010 Financial Statements, the Bank's core tier 1 ratio was at least 12% after excluding ISK 6.5 billion of retained earnings. This dividend was paid in ISK in June 2011 and, at the same time, the Bank received a subordinated foreign currency loan from the Icelandic State which qualifies as Tier II capital.

Capital requirements according to Pillar 1 are based on the sum of risk weighted assets (RWA) for credit risk, market risk and operational risk, computed using formulas from the EU's Capital Requirements Directive (the CRD). The CRD offers different approaches for calculating RWA for these risk types.

The Bank uses the following approaches for its capital requirement calculations:

i. The standardised approach is used to calculate the capital requirements for credit risk;

ii. The standardised method is used to calculate the capital requirements for market risk; and

iii. The basic indicator approach is used for operational risk.

Banking operations are categorised as either trading book or banking book and the calculation of RWA is conducted differently for the assets in different books. Banking book RWA are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account eligible collateral or guarantees. Banking book off balance sheet items giving rise to credit, foreign exchange or interest rate risk are assigned risk weights appropriate to the category of the counterparty, taking into account eligible collateral or guarantees. Trading book RWA are determined by taking into account market related risks such as foreign exchange, interest rate and equity position risks, and counterparty risk.

The Bank's ICAAP is an ongoing process intended to ensure that the Bank has in place sufficient risk management processes and systems to identify, manage and measure the Bank's total risk exposure. The ICAAP is aimed at identifying and measuring the Bank's risk across all risk types and ensuring that the Bank has sufficient capital in accordance to its risk profile.

To measure the Pillar 2 capital requirement the Bank uses an internal economic capital model. Pillar 2 is based on Pillar 1 calculations, using internal models for credit risk calculations, and takes into consideration risks that are not covered under Pillar 1, including concentration risk, residual risk, country risk, settlement risk, foreign exchange risk, liquidity risk, interest rate risk in the banking book, reputational risk, legal and compliance risk, business risk and strategic risk.

In relation to its Pillar 2 calculations, the Bank has currently implemented methods to calculate concentration risk for single name concentration and sector concentration and includes valuation risk, interest rate risk in the banking book, legal risk and business risk. The Bank expects to develop methods for evaluating other Pillar 2 risks in due course.

Although the Bank uses credit rating models for credit risk monitoring, these models are not used for capital adequacy calculations. The Bank intends to recalibrate those models for use in its ICAAP. The Bank has implemented methods and tools for operational risk management based on the minimum requirements for the standardised approach. The Bank expects to continue refining these tools and methods as part of its internal management of operational risk and is using them within its ICAAP.

Stress tests are an important part of the ICAAP and show how the Bank's capital could be affected by sharp macroeconomic changes, downturns in the Bank's core business or other major events.

The Bank's capital base at 30 September 2012 amounted to ISK 155,537 million. The Bank's capital adequacy ratio, calculated in accordance with Icelandic requirements, was 22.5%, exceeding the minimum legal requirement of 8% and exceeding the FME's enhanced capital adequacy requirement of 16%.

Figure 56 – The Group's risk weighted assets calculations

ISK million	**31 Dec 2011**	**30 Sep 2012**
Capital base		
Share capital	2,000	2,000
Share premium	73,861	73,861
Statutory reserve	1,637	1,637
Retained earnings	32,950	47,126
Non-controlling interests	4,110	3,808
Total equity	**114,558**	**128,432**
Deduction from Tier 1 capital	-5,489	-5,577
Total Tier 1 capital	**109,069**	**122,855**
Tier 2 capital	32,105	32,502
Total capital base	**141,174**	**155,357**
Risk weighted assets		
Credit risk	543,233	557,607
Market risk FX	31,990	29,980
Market risk other	30,757	29,455
Operational risk	58,976	58,976
Total risk weighted assets	**664,956**	**676,018**
Tier 1 ratio[1]	16.4%	18.2%
Capital adequacy ratio[2]	21.2%	23.0%

8.4 Relations to Kaupthing

Transfer of assets from Kaupthing

The Bank has a related party relationship with Kaupskil, Kaupthing, the Bank's associates, the Board of the Bank, the key management personnel of the Bank and close family members of individuals referred to above. Transactions with related parties are conducted on an arm's length basis.

Prior to 30 June 2011, the principal related party transaction was the compensation instrument issued by Kaupthing in an amount of ISK 38.3 billion, reflecting the difference between the fair value of the assets, liabilities and contingent liabilities transferred from Kaupthing to the Bank in accordance with the FME decision

[1] The Bank´s official total capital ratio and tier 1 ratio, calculated according to the Act on Financial Undertakings, was 22.5% and 17.7% for 30 September 2012. The official capital ratio is based on reviewed retained earnings at 30 June 2012

[2] The Bank´s official total capital ratio and tier 1 ratio, calculated according to the Act on Financial Undertakings, was 22.5% and 17.7% for 30 September 2012. The official capital ratio is based on reviewed retained earnings at 30 June 2012

in 2008. The compensation instrument was denominated 50% in ISK and 50% in euro and was subject to floating rates of interest. The maturity of the compensation instrument was 30 June 2012 and it was a priority claim against Kaupthing.

Related to the compensation instrument was the ECVRA under which Kaupthing was entitled to receive 80% of the appreciation of certain loans transferred to the Bank (the ring-fenced assets). Any increase in value of the ring-fenced assets operated to decrease the value of the compensation instrument. If the compensation instrument is finally settled due to an increase in the aggregate value of the ring-fenced assets (such increase being 125% of the original value of the compensation instrument) then 50% Of any future increase in the value of the ring-fenced assets must be passed on to Kaupthing up to a maximum amount of ISK 5 billion.

The bank entered into a settlement agreement with Kaupthing on 15 July 2011. The settlement agreement includes the termination of previous settlements and agreements between the parties and thus constitutes a final settlement of all claims between them. This includes the termination of the ECVRA and the finalization of all pledge agreements and agreements on division of possible upside. The agreement also entails the final settlement of commitments between the parties, cf. agreement on capitalisation at 3 September 2009. Thus, the agreement constitutes a final settlement of any and all claims of the parties referred to in the agreement which might arise from any fact, transaction or occurrence prior to the date of the agreement.

Purchase of mortgage portfolio

In December 2011, the Bank and the Kaupthing Resolution Committee reached an agreement whereby, subject to the passing of an extraordinary resolution by holders of Kaupthing Covered Bonds (as defined below) to waive various existing events of default, the Bank would acquire the mortgage portfolio managed in a special fund (the Fund) owned by the bankruptcy estate of Kaupthing. The Fund had guaranteed the covered bonds issued from 2006 to 2008 by Kaupthing to finance its mortgage loans (the Kaupthing Covered Bonds) under the structured covered bond programme established by Kaupthing on 30 March 2006 (the Kaupthing Covered Bond Programme).

On 20 January 2012, the holders of the Kaupthing Covered Bonds (as creditors of Kaupthing and the Fund) passed an extraordinary resolution directing the representative appointed under the Kaupthing Covered Bond Programme to act for the benefit of the holders of the Kaupthing Covered Bonds to waive the various events of default under the Kaupthing Covered Bonds on their behalf.

Following this, the Bank:

i. acquired all of the units in the Fund from Kaupthing, pursuant to a unit transfer agreement between Kaupthing and the Bank; and

ii. was substituted for, and assumed all liabilities and obligations (past, present and future, other than Kaupthing's liabilities and obligations relating to withholding tax payments) of, Kaupthing in respect of each of the six series of outstanding Kaupthing Covered Bonds.

The Kaupthing Covered Bonds are inflation linked with final maturities between 2033 and 2048, and have an aggregate face value of approximately ISK 92.5 billion.

In addition, the Bank paid an agreed cash consideration to the Kaupthing Resolution Committee in connection with the acquisition. The mortgage portfolio which the Bank now holds following the acquisition of all of the units in the Fund is valued at ISK 122.6 billion. The name of the fund was subsequently changed to AMIIF.

The programme documents include an Asset Monitor Agreement which entails an Asset Coverage Test to be carried out by the appointed Asset Monitor. The Asset Coverage Test is met if the Adjusted Aggregate Loan Amount is equal to or exceeds the ISK Equivalent of the aggregate Principal Amount Outstanding under the Covered Bonds from time to time as further defined in the Agreement. Pursuant to the terms of the Fund Deed, the Issuer will agree to use all reasonable endeavours to transfer Loans and their Related Security or Substitution Assets to the Fund in order to ensure that the Portfolio is in compliance with the Asset Coverage Test. In consideration thereof, the Issuer will receive a combination of: (a) a cash payment made by the Fund; and/or (b) being treated as having made an Equity Contribution to the Fund (in an amount up to the difference between the Outstanding Principal Balance of the Loans sold by the Issuer to the Fund as at the relevant Assignment Date and the cash payment (if any) made by the Fund for such Loans). The Agreement and other programme documents are available at the bank's website; www.arionbanki.is.

This acquisition increased the Bank's loan portfolio and is a significant addition to the Bank's balance sheet. The acquisition does, however, expose the Bank to risks if the acquired mortgage portfolio does not generate profits as anticipated. In such a case, the Bank may achieve lower than expected cost savings or otherwise incur losses in relation to the mortgage portfolio. In addition, the Bank's results of operations and financial position could be materially adversely affected if the mortgages acquired do not generate sufficient revenue to service the associated covered bonds.

It should also be noted that the mortgages are pledged as security for the covered bonds issued under the Programme as described above, hence the covered bonds creditors will have a priority claim to these assets.

Winding-up proceedings of Kaupthing

Since the claims against Kaupthing exceed its assets, the Winding-up Committee is currently seeking composition with Kaupthing's creditors and working to prepare a draft proposal to that effect. In the event that such efforts prove unsuccessful and a proposal is not approved by the creditors or there is no basis for seeking a composition, the Winding-up Committee is likely to submit a request to the District Court to place Kaupthing in bankruptcy proceedings. Were Kaupthing to be declared bankrupt, the general rules on bankruptcy proceedings would apply, which may result in the forced sale of assets and other similar procedures. However, all actions taken during the winding-up proceeding concerning claims against Kaupthing, including the notice to creditors and the processing of claims submitted, shall remain valid.

8.5 Legal and regulatory risk

The Bank's business operations are governed by law and regulations and are subject to the supervision of the FME. Any changes to the current legislation might affect the Bank's business operations and its operating results. In particular, changes to the capital controls regime could have an impact on the bank's business.

Priority claims

In accordance with the amendments made to the Bankruptcy Act in 2008, deposits constitute priority claims in insolvency proceedings of financial institutions, meaning that the depositors will enjoy priority over, inter alia, unsecured creditors with the full amount of any deposits.

Further, as described in Chapter 3.3. - "Funding - Secured funding" the Issuer has granted security over its assets, including cash and property mortgages, with a book value of ISK 241,698 million, to secure its liabilities under its covered bond programmes and its loan from the Icelandic Central Bank.

As the covered bonds programmes require a certain loan/security ratio to be maintained, the Issuer may be required to provide further assets as security for the covered bonds programmes if the value of the security assets (as calculated pursuant to the terms of the covered bonds programmes agreements) would fall or if the Issuer would choose to issue further bonds under the programme.

Under the AMIIF programme, currently ISK 130,658 million in covered bonds have been issued out of a maximum limit of ISK 200 billion.

Under the EUR 1 billion covered bonds programme currently ISK 5,116 million have been issued out of a maximum limit of ISK 10 billion under the current licence.

Further utilisation of the covered bonds programmes would potentially require additional assets being granted as security (pursuant to valuation principles under the covered bonds programmes). The granting of additional security under the covered bonds programmes would undermine the security position of unsecured creditors in an enforcement scenario. It should also be noted that any further issues under the AMIIF programme may lead to a risk of the asset holding fund being classified by the FME as an out of group entity. This could entail the classification of the intercompany loan agreement between the bank and the Fund as a large exposure which in turn could have an effect on the capital adequacy requirements. Please see chapter 8 "Risk factors – AMIIF" below.

The security granted in favour of the covered bonds and the loan from the Icelandic Central Bank reduces the amount of assets that may be available to the unsecured creditors in an enforcement scenario. Further, priority status of deposits under the laws of Iceland introduces a further right of recovery ranking prior to the unsecured creditors. The current book value of assets granted as security in favour of covered bondholders and the Icelandic Central Bank amount to ISK 241,698 million and deposits from customers amount to ISK 454,405 at the end of the 9 month 2012 reporting period, see further description in Chapter 3.3. "secured funding".

Furthermore, pursuant to Icelandic insolvency law, certain other claims will also enjoy a priority status, including employees claims for outstanding salary claims etc.

Hence, based on the Bank's balance as of 30 September 2012 recording total assets at ISK 876,242 and taking into account the current legal regime, the Issuer's unsecured creditors may have access only to a limited amount of assets in which they may seek recovery in an insolvency scenario.

Foreign currency indexed loans

The legitimacy of loans to corporates and individuals denominated in foreign currency remains somewhat unclear in Iceland. By a series of judgments in 2011, the Icelandic Supreme Court held that certain types of foreign currency loans and lease agreements with SMEs were in fact loans in ISK and indexed to a foreign currency exchange rate. As a result, these loans were held to be in breach of applicable Icelandic legislation relating to interest and price indexation which restricts indexation to a consumer or construction index.

It must however be noted that the EFTA Surveillance Authority has in a letter of formal notice to the Icelandic Government dated 19 April 2012 raised doubt as to the general prohibition on foreign currency indexation of loans, finding it provisionally to be in breach of Article 40 of the EEA Agreement on the free movement of capital. It therefore remains uncertain whether the general illegality of such loans is in breach of Iceland's duties under the EEA Agreement.

Even though no foreign currency indexed ISK loans made by the Bank have been considered by the Icelandic Supreme Court, during 2011 the Bank determined that these rulings provided a precedent for the Bank to follow and, as a result, all of the Bank's approximately 2,000 loans which fell within the conditions established by the Supreme Court in its rulings were recalculated into ISK denominated loans by the end of 2011. As a result of this recalculation and the recalculation of foreign currency indexed ISK mortgage loans which was implemented in 2011, almost all of the Bank's foreign currency indexed ISK loans to individuals have been recalculated into ISK denominated loans.

In the case of corporate loans, the Bank was advised in mid 2010 that certain of its foreign currency corporate loans were fully compliant with applicable regulations whilst others were more vulnerable, as the recent rulings of the Supreme Court have confirmed.

The Government responded to the rulings of the Supreme Court by enacting legislation laying down the principles of how foreign currency indexed loans should be converted into loans denominated in ISK and the applicable interest rates. In February 2012 the Icelandic Supreme Court held that the legislation in question was unconstitutional in cases where the recalculated interest rates amounted to a higher amount than that actually paid by the borrower. This ruling therefore appeared to restrict the Bank's ability to recover recalculated interest. In October 2012, the Supreme Court confirmed that this principle also applied to loans awarded to municipalities and companies. Although the impact of these rulings is not yet certain, the Bank currently estimates that the loss to its foreign loan portfolio could be in the region of ISK 13.8 billion and impairment in this amount has been recognised by the Bank in its 2011 financial statements. During 2012 the bank gained more clarity regarding foreign currency impairments. The bank will remain within Capital Ratio requirements set by the FME even if the worst possible outcome will realise. Further disclosure on foreign currency impairments will be disclosed in the Bank‘s Consolidated Financial Statements for 2012.

Further issues are to be resolved in regards to the foreign currency loans calling for an evaluation on a case by case basis in some instances.

The Bank remains exposed to significant uncertainty regarding its foreign currency loans in two respects. First, in relation to the February 2012 Supreme Court judgment referred to above, uncertainty exists with respect to the loans that will require recalculation and as to the method of recalculation which could result in a loss significantly greater than the currently estimated ISK 13.8 billion. Second, legal uncertainty remains as to the outcome of future court decisions or legislative changes that could require recalculation of other categories of foreign currency loans not currently considered by the bank to be vulnerable.

Litigation

There are a number of cases concerning the legality of foreign currency loans owed to the Bank which could have an impact on the Bank's loan portfolio and results of operations.

The largest dispute case regarding the re-calculation of foreign currency loans is the case of Hagar hf. against Arion bank. Hagar hf. has sued the Bank based on a claim regarding repayment on the grounds of overpayment maintaining that the loan in question was foreign currency indexed in breach of law and should have been re-calculated in line with Supreme Court precedents. The aggregate amount involved is approximately ISK 824 million. The case has been filed with the courts but a Court date has not yet been set.

In June 2011, Stefnir Asset Management Company (Stefnir), formerly Rekstrarfélag Kaupþings banka hf., a subsidiary of the Bank, received two demands for the rescission of contracts from the winding up committee of Landsbanki. The aggregate amounts involved are approximately ISK 450 million plus interest. Stefnir intends to defend the claims.

One further significant court case is a case between Drómi and the Bank. By means of a decision issued by the FME on 21 March 2009, the Bank acquired the deposits of SPRON. According to the decision the resolution committee of SPRON was required to establish a specific limited liability company owned by SPRON (and later Drómi), to receive all the assets of the savings banks and all security interests, including all liens, guarantees and other comparable interests linked to SPRON's claims. The subsidiary was then supposed to take over all SPRON's obligations to the Bank relating to the acquisition of SPRON's deposit obligations and issue a bond to the Bank as compensation for the deposit obligations. The relevant documentation provided that the interest rate on the debt principal would be determined by the FME at any given time. The FME decided that the debt should bear an annual interest rate plus an interest premium until repayment of the debt originally in full. It was also specified that the FME was permitted to review the decision upon request by the parties every six months.

In a letter dated 2 December 2009, Drómi requested that the FME review its former interest rate decision. On 4 February 2011, the FME confirmed that the debt should bear the originally specified annual interest rate and premium from the takeover date until 30 June 2010, but that thereafter the premium should not be payable. The Bank has brought a legal action against the FME and Drómi in an attempt to annul the FME's decision of 4 February 2011. On 4 May 2011, Drómi brought a legal action against the FME and the Bank. Drómi's action seeks the annulment of all decisions by the FME on interest rates and the determination of a revised interest rate from the outset. The District Court of Reykjavík dismissed the case in April 2012. That decision was, however, overruled by the Supreme Court which reverted the matter back to the District court for a ruling on substance. The case resulted in an acquittal and the Bank has appealed that ruling to the Supreme Court. However, the possible impairment related to the outcome of the case has been fully accounted for in the financial statements of the bank referred to in this Information Memorandum.

The Bank has made agreements with clients of Private Banking to buy their approved claims against the estate of Kaupthing hf. The claims relate to claims for damages by clients made against the estate of Kaupthing hf. These claims were initially rejected but Kaupthing hf. has since offered these parties a settlement. The claims involved are general claims against the Kaupthing hf. estate and as a compromise to the clients, the Bank has acquired the claims at 30% of the claim value and paid them immediately instead of making the clients wait until the estate has been wound up. ISK 240 million of claims have already been acquired and one claim has not been settled. There is still uncertainty over the recovery of these claims from Kaupthing hf. when the company is wound up or makes composition with creditors

Investigation by the Icelandic Competition Authority

The Icelandic Competition Authority (ICA) has opened a formal investigation into the alleged abuse of an alleged collective dominant position by the new banks. The investigation was initiated by separate complaints from BYR bank and MP bank. The ICA received a similar complaint from an insurance company regarding the new banks' abuse of an alleged collective dominant position. The complaints from BYR bank and MP bank concern the terms of the new banks' mortgage arrangements, which, according to the complaint, deter individuals from moving their business to other banks and thereby restrict competition. The insurance company's complaint concerns the new banks' alleged tying of banking services and insurances. The ICA has also opened a formal investigation into alleged abuse of a dominant position and collusion between all card issuers in Iceland, including the Bank, following a complaint by Kortathjonustan, a credit card payment acquirer, in 2009. The Bank has made objections to all of the complaints. The extent of the investigations and outcome of the cases is still uncertain as well as any effect on the Bank.

The Bank has entered into commitments in relation to mergers decisions of the Competition Authority, related to arms' length principles, management and the disposure of assets within a stipulated time frame.

Two formal investigations involving the Bank were launched by the EFTA Surveillance Authority (ESA) in 2010, which have now both been concluded.

Investigations by the EFTA Surveillance Authority

The first investigation, commenced in September 2010, relates to whether or not the purchases by each of the new banks, i.e. the Group, Íslandsbanki hf. and Landsbankinn hf., of assets of money market funds in the autumn of 2008 should be considered to be state aid under the Agreement on the European Economic Area (EEA Agreement). The Group, which was state-owned at the time, acquired assets worth ISK 7.7 billion from the funds of Rekstrarfélag Kaupþings banka hf. (now Stefnir hf.) on 30 October 2008. On 11 July 2012, ESA concluded that the Icelandic authorities had granted state aid with the acquisition by each of the new banks of the assets in the above funds. However, ESA found the aid to be compatible with the EEA Agreement ESA considered that the Government had to implement extraordinary measures in an attempt to stabilize the economy and that the the measures at issue were necessary in order to try to restore faith in the financial sector. In this respect it was necessary and appropriate to protect the investors from even greater losses on their savings.

The second investigation was launched in December 2010 and relates to the state aid granted in the restoration of certain operations of Kaupthing and the establishment and capitalisation of the Group. Similar investigations were launched in relation to the restoration and capitalisation of Íslandsbanki hf. and Landsbankinn hf. In its investigation, the ESA considered the appropriateness of the capitalisation measures taken by the Icelandic authorities, which were not notified to the ESA in advance of their implementation. On 11 July 2012, the ESA concluded that the aid measures taken constitute state aid compatible with the EEA Agreement. In connection with this decision, Arion has undertaken certain commitments to prevent distortion of competition. Arion will provide information on its website how customers can move their business to another bank. Arion has also undertaken not acquire other financial companies until the 1st of December 2014, except if it obtains the Surveillance Authority´s approval beforehand. In the Authority's decision it is stated that this means that further concentration of the Icelandic financial market through acquisitions by Arion can be prevented, unless further mergers would be necessitated by financial stability considerations. Arion commits to sell, as soon as possible, shareholdings in operating companies, which have been taken over due to restructuring in line with Article 22 of the Act on Financial Undertakings No. 161/2002. The bank commits to follow the procedure and time-limits, which are set out in this provision and as interpreted by the FME. This commitment is a legal obligation already present. Arion furthermore committed to maintain up-to-date information on its website or of a subsidiary on subsidiaries and shareholding that are held for sale.

Regulatory issues

According to a statement issued by the bank on 31 January 2013, all filings of reports with the FME under the Act No 161/2002 and related regulations are regular and there have been no significant comments or objections raised by the Authority affecting the bank's operations.

License to issue covered bonds

The Bank has been issued a license by the FME to issue Covered Bonds. This license was issued in November 2011 under Act No 11/2008 on covered bonds and rules No. 528/2008. The license is issued with certain conditions which must be fulfilled, inter alia that the issue is limited to ISK and cannot exceed 10 billion ISK. The licence further stipulates conditions related to the performance of a stress test and present value calculations of the cover pool as well as disclosure to investors requirements.

AMIIF

As described above, the bank purchased all unit shares in the AMIIF fund and thus assumed its mortgage loan portfolio as well the obligations as issuer of the bonds issued under the AMIIF programme. The purchase further entails an Intercompany Loan Agreement between Arion and the Fund. After the purchase the bank entered into correspondence with the FME on the proper classification of the Fund in the Arion Group. The FME accepted to consider the Fund as a subsidiary of the bank for reporting purposes. The Fund is therefore exempted from the rules of large exposures cf. Article 3, Paragraph 4 of the rules on large exposures no. 216/2007. However, this position was contingent upon possible amendments to the rules and no further issue of bonds under the programme. Should the Bank decide to issue further covered bonds under the Programme such a decision could have the effect that the Fund would no longer be considered to be a subsidiary for the purposes of the rules on large exposures no 216/2007, which in turn could have an effect on the capital adequacy requirements.

Capital requirements

As mentioned in chapter 7, the FME has in accordance with its powers und Act No 161/2002 required an increase in the financial ratio requirements stipulated by the Act for a limited period. Thus, in August 2009 the FME required all the new banks to meet the requirement of 16% of base risk in the Core Tier 2 Capital. On 13 December 2012 the FME stated in a letter to the bank that that special obligation would be lifted whilst at the same time confirming that the Bank meets its mandatory financial ratios.

8.6 Risk management

The Board is ultimately responsible for the Arion Group's risk management framework and ensuring that satisfactory risk management processes and policies for controlling the Arion Group's risk exposure are in place. The Board defines the overall risk appetite of the Bank which is translated into exposure limits and targets that are monitored by the Bank's Risk Management division, which reports its findings regularly to the Bank's CEO and its Board. Risk is measured, monitored and reported according to internal policies, principles and processes that are reviewed and approved by the Board at least annually. The Board is also responsible for the Bank's internal capital adequacy assessment process (ICAAP). The Board has determined that management of risks encountered within subsidiaries should principally be carried out within each subsidiary.

The CEO is responsible for sustaining an effective risk management framework, policies and control as well as maintaining a high level of risk awareness among the Bank's employees.

The Bank operates the following committees to manage risk:

i. Board Audit and Risk Committee (the BARC). This committee is responsible for supervising the Bank's risk management framework, risk appetite and ICAAP. The BARC regularly reviews reports on the Bank's risk exposures.

ii. Asset and Liability Committee (the ALCO). This committee is chaired by the CEO and is responsible for managing any asset-liability mismatches, liquidity risk, market risk, interest rate risk and capital management.

iii. Credit Committees. The Bank operates a number of credit committees. The committee with the highest authority is the Board Credit Committee which decides on all major credit risk exposures. The next highest credit granting authority is the Bank Credit Committee which operates within limits specified as a fraction of the Bank's capital. The Bank Credit Committee is chaired by the CEO. The third highest credit granting authority is the Corporate Credit Committee, which is a joint credit committee for the Corporate Banking, Capital Markets and Retail Banking divisions. There are also seven Retail Credit Committees, one for each branch cluster which have tighter limits than the Corporate Credit Committee. The Bank also has two temporary recovery committees that are focused on recovery cases, one for corporate customers and the other for retail customers. The recovery committees have authority to approve credit and write-offs, within their limits, in connection with recovery proposals. The Bank expects that the recovery committees will be combined with the existing Corporate and Retail credit committees, respectively, once the corporate and retail restructuring processes have been substantially completed.

The Bank's internal audit division conducts independent reviews of the Bank's operations, risk management framework, processes, policies and measurements. Internal audits examine both the adequacy and completeness of the Bank's control environment and processes as well as the Bank's compliance with its procedures, internal rules and external regulations. Internal audit results are discussed with the Bank's management and reported to the BARC.

The Bank's risk management division is divided into five units: Credit Control, which monitors credit exposures on a customer-by-customer basis; Credit Analysis, which supports and monitors the credit granting process; Portfolio Risk, which monitors liquidity risk and risks in the Bank's assets and liabilities at the portfolio level; Economic Capital, which is responsible for the Bank's ICAAP and for monitoring portfolio credit risk; and Operational Risk, which monitors risks associated with the daily operations of the Bank.

Credit risk

The Bank manages and controls credit risk by setting limits on the amount of risk it is willing to accept for individual counterparties and groups of connected clients, by monitoring exposures in relation to those limits and by taking collateral where appropriate. The Bank is principally exposed to credit risk through loans granted, through commitments to extend credit to the extent that they can't be cancelled, through guarantees given by the Bank and through derivatives which have positive fair values where the Bank is exposed to the ability of the counterparty to make any payments due. Note 55(a) to the Bank's consolidated interim financial statements as at and for the nine months ended 30 September 2012 (the Interim Financial Statements) shows the Bank's maximum exposure to credit risk related to on-balance sheet assets. As at 30 September 2012 and 31 December 2011, the Bank's total on and off balance sheet credit risk exposure totalled ISK 882,816 billion and ISK 871,628 billion respectively, of which the major industry exposures at 31 December 2011 were (i) individuals (28% of the total exposure), (ii) financial and insurance activities (27% of the total exposure) and (iii) services such as business services, public administration, defence, education, health and social work (14% of the total exposure).

Credit approval process

The Bank's credit approval process begins when a loan application is made, through an account manager (in the case of a corporate client), using the Bank's standard application forms together with appropriate supporting material such as financial statements and budgets (for corporate customers) and proof of identity and income (for retail clients). In addition, information relating to any collateral to be provided must also be supplied.

A credit analyst will screen the application and confirm the customer rating. The application is then submitted to the appropriate credit committee for consideration and is either approved, rejected or further information is required. Once a loan has been approved at credit committee, appropriate legal documentation is prepared and the loan is disbursed once all documentation is signed and conditions precedent to lending have been satisfied.

The amount and type of collateral required by the Bank in relation to a new loan depends on the Bank's assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained by the Bank are:

i. For retail lending, mortgages over residential properties;

ii. For corporate lending, charges over real estate, fixed and current assets, inventory and trade receivables; and

iii. For derivative exposures, cash or treasury bills.

The loan to value ratios (LTV) permitted by the Bank differ depending on the type of asset to be used as collateral. In the case of fixed assets such as commercial or residential properties and fishing vessels with an allocated fishing quota, the accepted LTV is 75%. For commercial and residential properties, the Bank bases its valuation on (a) the selling price of a property on the day the transaction is made, or (b) an independent appraisal conducted by a licensed estate agent, or (c) an acquisition offer, signed on behalf of both the seller and the buyer, or (d) the rateable value of the property, made by The Icelandic Property Registry. For fishing vessels and quotas, the Bank bases the valuation on the market prices of the quotas concerned. When valuing fishing vessels, the Bank relies on the valuation from the borrower's insurance company or a ship brokerage company valuation.

The value of any collateral given is monitored by the credit control unit in the Risk Management department and additional collateral may be requested in accordance with the underlying agreement. The value of any collateral given is taken into account when determining the adequacy of the allowance for impairment losses made in relation to each loan.

Credit monitoring

The valuation of assets that were transferred to the Bank from Kaupthing attempted to account for all realised and foreseen losses. Whilst this has significantly reduced the credit risk that would otherwise have been present in the Bank's loan portfolio the Bank is still exposed to credit-type risks through the loan portfolio relating to the accuracy of the transfer valuation, the performance of the loans and the success of the Bank in restructuring non-performing loans. The Bank also has credit concentrations to a few significant customers and to certain business sectors, such as the financial and insurance sector, the agriculture, forestry and fishing sector and the real estate sector.

The Bank uses an internal rating system to rate its loans to companies and individuals. The rating model for larger companies bases its rating both on qualitative factors (such as the quality of their management and strategy and their current market position) and quantitative factors (such as their equity and liquidity ratios). The rating model for SMEs and individuals are purely quantitative models.

Credit recovery process

The Bank has developed a number of solutions to assist customers that are experiencing payment difficulties. The credit recovery process is intended to be transparent and non-discriminatory and is subject to review by an independent committee appointed by the parliament.

The recovery strategy is based on identifying clusters of similar customers and implementing standardised solutions for those customers based, where applicable, on the provisions of Icelandic law implementing an agreement between the Icelandic Government and financial institutions on the restructuring of loans to individuals and SMEs. In the case of larger companies, the solutions are tailored to the circumstances of each company.

Solutions for individuals

i. Temporary payment relief, such as payment holidays, payment of a fixed amount of ISK 5,000 per ISK 1 million borrowed and amending loans which are linked to a consumer price index or currency exchange rate so that they are linked to a national salary index instead.

ii. Writing down mortgage loans to 110% of the market value of the underlying property, up to a limit of ISK 4 million per individual. If interest and instalment payments exceed 20% of the customer's total income, the write-off amount can be up to ISK 15 million per individual.

iii. Special debt adjustments for those with serious financial difficulties and a negative equity position. Payments are adjusted to the customer's ability to pay. The loan can be written down to 70% of the market value of the customer's assets/the underlying security for the loan and the difference between 129 70% and 100% of the value of the assets/security is restructured into a three year loan with no interest. Debt exceeding 100% of the customer's assets/security is written off.

Solutions for companies

The corporate recovery portfolio is separated into two main clusters, corporate recovery for large companies and retail recovery for smaller companies. The solutions for each cluster are:

i. ***Corporate Recovery:*** An independent business review of each company is undertaken with a range of possible outcomes including debt restructuring, full or partial debt for equity swap, acquiring control of the company and/or its assets and liquidation of the company. All seized assets are transferred to one of the Bank's specialised subsidiaries with the aim of divesting them as soon as is practical and economically viable.

ii. ***Retail Recovery:*** A standardised solution is applied. Indexed investment loans and business loans are offered up to the amount which maximises the operational capacity of the company concerned to service its debt. These loans are at standard market terms with a standard payment schedule. A subordinated loan is taken in an amount equal to the difference between the amount of investment and business loans and 100% of the asset value of the company. The subordinated loan bears below market interest and the payment schedule varies depending on the company's business sector and the availability of collateral. No equity position is taken in the company and any debts to the Bank exceeding the asset value of the company are written off.

Loan provisioning

The Bank's loan portfolio consists of loans which were acquired from Kaupthing at a fair value, that is taking into account the likelihood of the loan being repaid. However, the Bank continues to maintain its loan portfolio on a face value basis. Accordingly, an allowance for credit losses is established if there is objective evidence that the Bank will be unable to collect all amounts due according to the original contractual terms.

When considering loans at face value, allowances for credit losses are evaluated at a counterparty specific level and on a collective basis, based on the principles described below.

Individually assessed allowances

A loan is considered impaired when there is objective evidence that it is probable that the Bank will not be able to collect all amounts due according to the original contractual terms or the equivalent value. Individual loan exposures are evaluated based upon the borrower's character, overall financial condition, resources and payment record; the prospects for support from any financially responsible guarantors and, where applicable, the realisable value of any collateral.

The estimated recoverable amount is the present value, using the loan's original effective interest rate, of expected future cash flows, which may result from restructuring or liquidation. Impairment is measured and an allowance for credit losses is established for the difference between the carrying amount and the estimated recoverable amount of the loan.

Upon impairment, the accrual of interest income based on the original terms of the loan is discontinued, but the increase of the present value of impaired claims due to the passage of time is reported as interest income.

Impaired claims are reviewed and analysed at least every three months. Any subsequent changes to the amounts and timing of the expected future cash flows compared to the prior estimates will result in a change in the allowances for credit losses and be charged or credited through impairment on loans.

An allowance for impairment is reversed only when the credit quality has improved such that there is reasonable assurance of improved collection of principal and interest.

A write-off is made when all or part of a claim is deemed uncollectible or forgiven. Write-offs are charged against previously established allowances for credit losses or directly to credit loss expense and reduce the principal amount of a claim.

Collectively assessed allowances

All loans for which no impairment is identified on a counterparty specific level are grouped into economically homogeneous portfolios to collectively assess whether impairment exists within a portfolio. Allowances from collective assessment of impairment are recognised as credit loss expense and result in an offset to the loan position. As the allowance cannot be allocated to individual loans, interest is accrued on all loans according to their contractual terms.

Special provisioning for currency exchange rate impairment

The loan book transferred from Kaupthing contained certain loans which required special consideration. These are loans in ISK made to Icelandic companies and individuals whose income is primarily in ISK but where the principal amount repayable varies depending on the exchange rate between the ISK and a specified foreign currency (typically euro). When the ISK depreciates against the foreign currency, the ISK value of the loan increases. However, since the borrower's ability to pay does not increase, the increase in loan value is considered unrecoverable. Provisions are made for this unrecoverable value increase. Conversely, when the ISK appreciates (as occurred in 2010, for example) and the ISK value of the loan decreases, there is a reversal of loan impairment due to the borrower's increased ability to repay.

Loan provisioning

As described above, a portfolio of assets and liabilities was transferred to the Bank following its establishment at the end of 2008. These assets and liabilities resulted in significant foreign exchange, interest rate and liquidity mismatches. In addition, the serious recession in Iceland in 2009 and 2010 resulted in a significant increase in non-performing loans and poor asset quality.

The valuation of assets that were transferred to the Bank from Kaupthing attempted to account for all realised and foreseen losses and this has significantly reduced the credit risk that would otherwise have been present in the Bank's loan portfolio. However, the Bank is still exposed to credit type risks through the loan portfolio relating to the accuracy of the transfer valuation, the performance of the loans and the success of the Bank in restructuring non-performing loans. The Bank also has credit concentrations to a few significant customers and to certain business sectors.

At 31 December 2011, 56% of the Bank's customer loans and receivables (the customer loan portfolio) was classified as performing with the remaining loans being classified as watch (18%), sub performing (13%) or non performing (13%). As at the same date, the Bank's provisions on its customer loan portfolio amounted to 9% of the total amount of the portfolio.

As at 31 December 2011, the aggregate amount of the Bank's 10 largest customer loans and receivables equalled 22% of its total gross customer loans and receivables at that date. The Bank's loan portfolio is also highly concentrated on Icelandic borrowers.

The Bank has developed a number of solutions to assist customers that are experiencing payment difficulties. The recovery strategy is based on identifying clusters of similar customers, such as small to medium sized enterprises (SMEs) and individuals, and implementing standardised solutions for those customers. In the case of larger companies, the solutions are tailored to the circumstances of each company. Although significant progress has been made restructuring the debts of the Bank's largest corporate customers, considerable work remains in relation to restructuring the debts of SMEs and individuals. The goal of the corporate restructuring process is to create companies with a healthy capital structure, no covenant breaches, satisfactory operating results and motivated management teams and owners although no assurance can be given as to the extent to which this can be achieved or that the Bank will not be forced to put a significant number of corporate customers into liquidation, thereby experiencing material losses.

Should a customer to which the Bank has a large exposure default or if the outcome of the restructuring process is that a greater number of loans prove to be non-recoverable in whole or in part than originally anticipated, the Bank's business and its ability to make payments in respect of the Bonds would be materially adversely affected.

Derivatives

The Bank offers financial derivatives instruments to professional investors, including interest rate swaps and options and forwards on Icelandic treasury notes and housing financing bonds. The fair value of these derivative instruments varies in response to changes in interest rates and security prices. Credit risk arising from derivative financial instruments is, at any time, limited to those with positive fair values (being those under which the Bank is owed money). The Bank applies limits to its total exposure and on the positive fair value net of collateral to control the Bank's risk in relation to these instruments. These limits are generally client specific and may refer specifically to different categories of derivative contract. Generally, collateral is required to cover potential losses on a derivative contract. The Bank accepts either cash or treasury bills as collateral for margin accounts. Should the net-negative position of a contract fall below a certain level, the Bank's policy is to seek additional collateral. If extra collateral is not supplied within the specified deadline, the contract is typically closed. The Bank also seeks to reduce its exposure to credit losses by entering into master netting agreements with client counterparties that have significant and/or diverse credit related business with the Bank. These agreements reduce the Bank's credit risk since, in the case of default, all amounts owing between the Bank and the counterparty are terminated and settled on a net basis.

9. Tax considerations

9.1 Taxation in Norway

The description below regarding taxation in Norway is based on the laws in force in Norway as of the date of this Information Memorandum. The description is subject to any changes in law or practice occurring the date of this Information Memorandum, which could be made on a retrospective basis. The following summary does not purport to be a comprehensive description of all the tax considerations that may be relevant to a decision to purchase, own or dispose of the Bonds. Investors are advised to consult their own tax advisors concerning the overall tax consequences of their ownership of the Bonds.

i. Non-Norwegian tax residents

Bondholders that are not tax resident in Norway ("Non-resident Bondholders") will not be subject to Norwegian income taxation or Norwegian net wealth taxation in connection with acquisition, holding and disposal of the Bonds, unless the Bonds are held in connection with the conduct of a trade or business in Norway. The issuance of the Bonds with Norsk Tillitsmann ASA as trustee and registration of the Bonds in the Norwegian Central Securities Depository ("VPS") will not as such have any Norwegian income tax or wealth tax consequences for Non-Norwegian Bondholders.

ii. Non-resident Bondholders should consult with and rely upon local tax advisors as regards the tax position in their country of residence.Norwegian tax residents

These will also be subject to Norwegian taxation and should seek separate advice on taxation in Norway.

9.2 Taxation in Iceland

The comments below are of a general nature regarding the current law and practice in Iceland. They should not be construed as providing specific advice as to Icelandic taxation and are subject to changes as to the applicable rules in the future. They relate only to the position of persons who are the absolute beneficial owners of the Bonds. They may not apply to certain classes of persons, such as dealers. Prospective holders of the Bonds who are in any doubt as to their personal tax position or who may be subject to tax in any other jurisdiction should consult their professional advisers.

Taxation on financial undertakings

The taxes payable under laws in Iceland on financial undertakings are mostly the same as for other commercial entities. The Capital gains tax is 20% and the income tax for companies is also 20%. In 2012 a new tax was imposed on financial undertakings and insurance companies, tax on financial activities. The tax is imposed on all remuneration paid to employees at a rate of 6.75%. A temporary tax of 6% on profit over ISK 1 billion of financial institutions was imposed in 2012 and extended for 2013.

i. Non Icelandic tax residents

There are taxes payable under the laws of Iceland in Iceland in respect of the amounts payable on the Bonds paid to a holder who is not a tax resident of Iceland. Article 3(8) of the Income Tax Act No. 90/2003 (ITA) specifically states that any interest received from Iceland (outbound payments), such as e.g. the interests payable according to the bonds, received by any person or entity residing outside of Iceland is taxable income in Iceland unless a double taxation treaty states otherwise. If applicable, the beneficial owner may apply for a tax exemption or a refund of paid taxes, if such payment has taken place. Certain foreign entities are further exempted, primarily foreign states and international institutions. According to Article 70(b) of the ITA, numerical 8, the tax shall be: (a) 10% for individuals, of all income exceeding the annual amount of the ISK 100,000.00; and (b) 10% for legal entities.

The Issuer or the relevant Icelandic custodian will be making the relevant withholding at source in accordance with the provisions of Regulation No 1082/2009, on the taxation and withholding of interest to parties subject to limited tax liability (as based on Article 3(8) of the ITA and Article 41 of the Act No 45/1987 on Withholding of Public Levies at Source). The Issuer will file the appropriate applications for the exemption/lowered tax rate in connection with issues of bonds, in order to implement and make fully practical the use of the provisions of Regulation No 1082/2009 or the relevant bilateral tax agreements as the case may be. In addition, prospective holders of bonds should note that the Issuer has agreed to gross up all interest payments on the bonds so as to hold bondholders harmless in respect of any required deduction or withholding pursuant to conditions of the bond loan agreement.

There are no estate or inheritance taxes, succession duties, gift taxes or capital gains taxes imposed on the holder of the Bonds by Iceland or any authority of, or in, Iceland in respect of the Bonds if, at the time of the death of the holder or the transfer of the Bonds, such holder or transferor and transferee are not tax residents of Iceland.

No Icelandic issue tax or stamp duty will be payable in connection with the issue of the Bonds.

ii. Icelandic tax residents

Beneficial owners of the Bonds that are resident in Iceland for tax purposes are subject to income tax in Iceland on their interest income in accordance with Icelandic tax law. The rate depends on their tax status.

Subject to certain exemptions (which apply, inter alia, to most banks and pension funds), the Issuer or, as the case may be, the Fund is required to withhold a 20% tax on the interests paid to the holders of Bonds who are Icelandic residents. Such withholding is considered a preliminary tax payment but does not necessarily constitute the final tax liability of the holder.

In December 2010, the Icelandic Parliament passed a law (Act no. 155/2010) under which certain types of financial institutions, including the Bank, are required to pay an annual tax calculated at 0.041% of the carrying amount of their liabilities as determined for tax purposes, starting in 2011 based on figures for calendar year 2010. In December 2011, a transitional provision was introduced under which financial institutions, including the Bank, must pay an additional 0.0875% of their tax base in 2012 and 2013. The additional tax will fall due on November 2012 and 2013.

APPENDIX

APPENDIX I:	**Term Sheet**
APPENDIX II:	**Consolidated interim financial information 9M 2012 (unaudited)**
APPENDIX III:	**Consolidated interim financial information 6M 2012 (audited)**
APPENDIX IV:	**Consolidated financial statements 2011 (audited)**