Arion Bank

ANNUAL REPORT 2010

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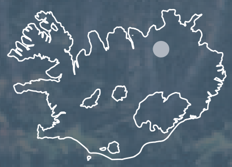
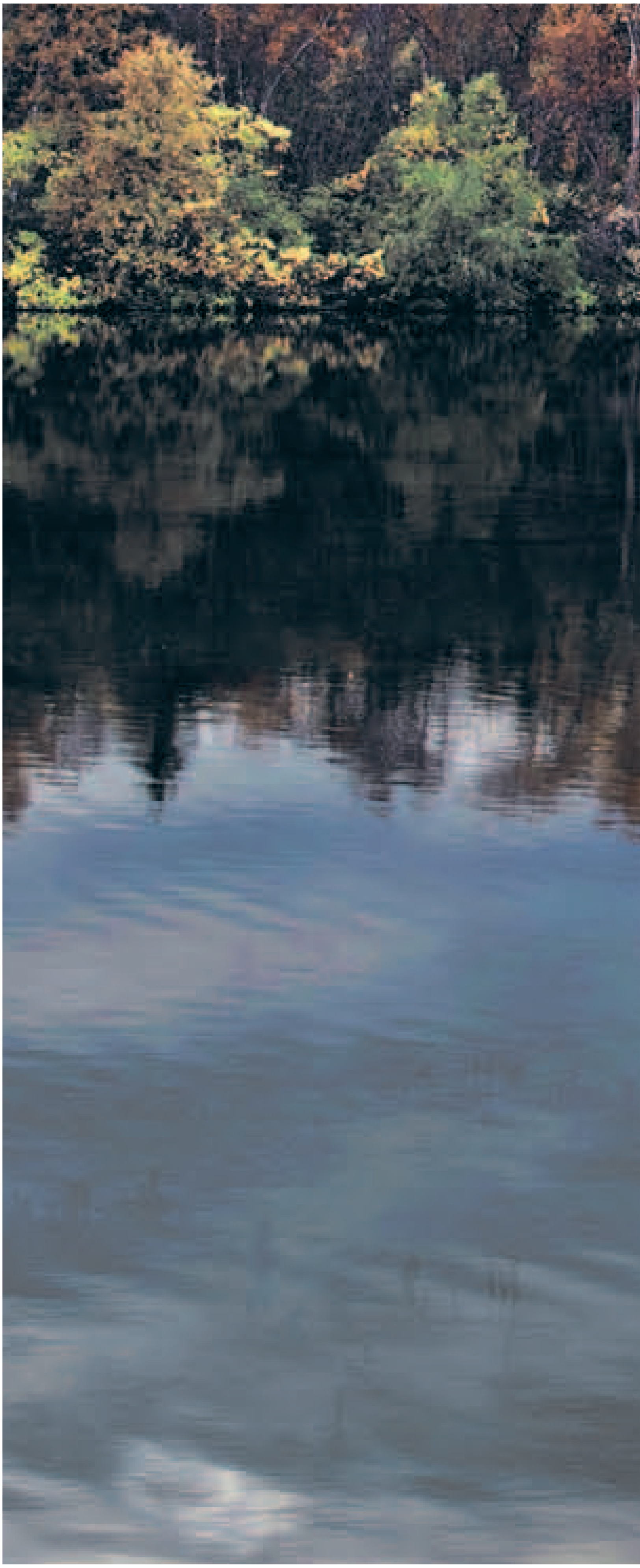
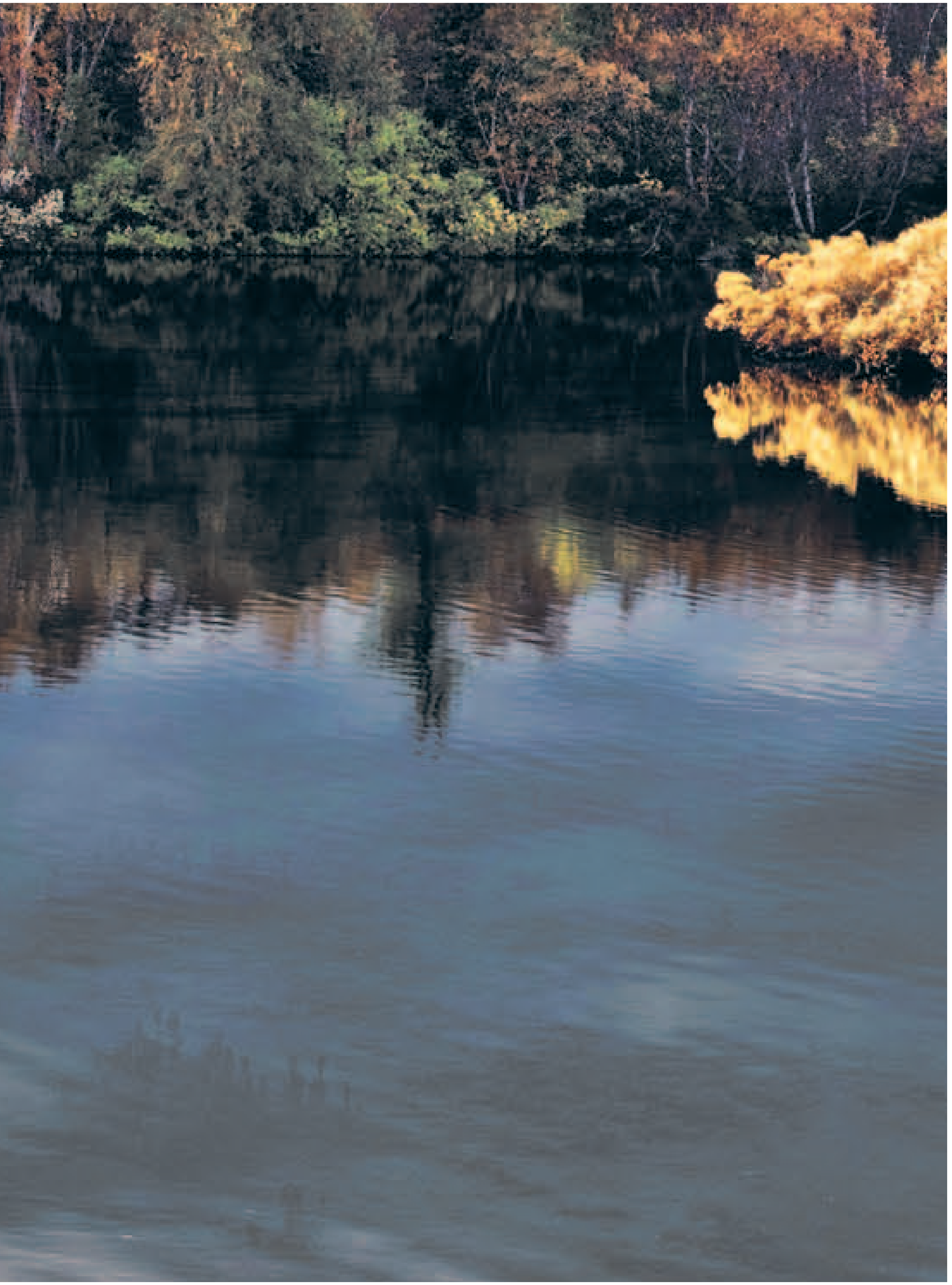


Trout – Mývatn

65° 34′ 37.67″N, 16° 57′ 2.33″W

Trout is a vital resource in the area around Mývatn, one of the best trout lakes in Iceland. It spawns in the period from October to January. The locals cut the fish along the spine, flatten it and pickle in salt for 24 hours and then smoke it over smouldering sheep's dung for a few days. They call the product "saltreyd".





Chairwoman's Address

Iceland is emerging from one of the greatest economic storms any western economy has ever experienced. With the collapse of the currency and the financial sector the challenges facing the people of Iceland over two years ago were enormous: to restore the economy and create a new financial sector. And the people of Iceland are indeed rising to the challenge. Impressive progress is being made and there is every reason to be optimistic about Iceland's future. Arion Bank, as one of Iceland's largest financial institutions, is playing an important role in the regeneration that is currently taking place.

The grave events at the end of 2008 were not restricted to Iceland. They were one of the most drastic consequences of globalization we have ever seen. What was unique about Iceland was the fact that the debt of the financial sector had grown to around 10 times the GDP of the Icelandic economy. As a result the Central Bank of Iceland did not have the resources to come to its rescue. The Icelandic banks were simply bound to fail with the global financial crisis gaining momentum. In fact, financial institutions and sovereigns all over the world found themselves in deep financial difficulties. Some did not survive and others are still dealing with the repercussions.

The events in Iceland leading up to the financial crisis are being investigated on several fronts in order to find out what mistakes were made and to ensure that such mistakes are not repeated.

The all important economic rebuilding process began immediately following the financial collapse of 2008. The economy is showing promising signs of recovery as the fiscal deficit is being addressed and the debt burden of households and corporations is being tackled head on. There are positive signs of economic growth, unemployment is falling, and Iceland has undergone the fourth review of its IMF program, a program scheduled for completion in August 2011. These factors, combined with a lower level of debt in the economy as a whole, have resulted in the narrowing of Iceland's CDS spread.

Of course there is still some way to go for the Icelandic economy. Currency restrictions remain in place, the Icesave dispute lingers and foreign investment in Iceland is still too low, but good progress is being made that allows for optimism. Iceland is further along the path of economic recovery than many other nations which are still dealing with troubled financial sectors, fiscal deficits and unemployment. In fact, Iceland now has a banking system with no pressing external funding needs and a cleansed asset side.

However, one of the most important things the Icelandic financial sector lost in the crisis was trust; this can only be regained with time and effort. This also holds true about the Icelandic economy as a whole. Along with Arion Bank and other Icelandic financial institutions, the Icelandic government and governmental bodies play a crucial role in rebuilding trust on an international level. The integrity of the legal and regulatory environment needs to be unquestioned and political stability ensured for normality in international relations to be regained and for foreign investment in Iceland to increase.

A strong indication of how the system has changed in Iceland in the last couple of years is the great number of requests and inquiries financial institutions receive from different regulatory and supervisory authorities such as the Icelandic Financial Supervisory Authority (FME), the Central Bank of Iceland and the competition authorities. Additionally numerous governmental bodies continue to investigate the collapse of the financial system with the assistance of the financial sector. This is a very positive development. Nevertheless regulators, supervisory agencies and investigators are still finding their balance in this new reality. Increased cooperation and coordination between governmental bodies in this respect would be welcomed by financial institutions as the related costs are rising to proportionally unsustainable levels for a small financial system.

In the two years since Arion Bank was founded the Bank has established itself as one of Iceland's leading financial institutions. The Bank had 26 branches at the end of 2010, around 100,000 customers, assets of around ISK 813 billion and a capital ratio of 19%. The FME has imposed strict conditions to be met by Icelandic financial institutions, including a minimum 16% capital ratio and 20% liquidity ratio. Arion Bank surpasses all statutory requirements and requirements set by the FME by a comfortable margin.

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In 2010 one of the most important tasks facing the Icelandic financial sector was the restructuring of household and corporate debt. This is a complex and sensitive issue with a number of financial, economical and ethical considerations. Arion Bank has played a key role and has in many ways been leading the way. A large number of Arion Bank's customers require debt restructuring and it is important to get them back on track as soon as possible in order to further revitalize the economy.

The year 2010 was a positive and significant year in the history of Arion Bank. The ownership structure of the Bank was finalized and a new board of directors and CEO, Höskuldur H. Ólafsson, took the helm at the Bank. This was the year when the strategic direction for the new Bank was set after a comprehensive groundwork done by the Bank's management team and employees. And most importantly it was the year when the final foundations were secured for the future of the new Bank.

The year 2011 will be a watershed year in Arion Bank's short history. It will be the year when we can shift our focus from past events to efforts towards what we believe we do best: provide first-rate banking services and serve our customers to the best of our abilities.

CEO's Address

Arion Bank reported a net profit of ISK 12.6 billion in 2010, with net operating income increasing to ISK 35.6 billion. The net interest margin increased sharply during the year, primarily as a result of changes to the asset portfolio and falling interest rates. Return on equity was 13.4% during the period.

We are pleased to see that our focus on strengthening the Bank's capital base has yielded clear results in recent months. A strong capital ratio evidently reflects this achievement – in the second half of the year the Bank's capital ratio increased by 2.6 percentage points, from 16.4% to 19% and the Tier 1 ratio rose to 15.2%. The Bank's liquidity position is also solid.

A year of change

Arion Bank is a new bank. We build on a legacy which is both helping us and holding us back.

I believe that Arion Bank will have to undergo four 12-month stages of development before reaching its full strength. In 2009 we fought a tough battle for survival. In 2010 we concentrated our efforts inwards; saw new ownership, new management and the Bank finalized its strategic planning for the future. Furthermore we made good progress with recovery work on our loan portfolio, whilst continuously having to confront new regulatory and legislative realities. In 2011 we will focus on completing the recovery work, clarifying our loan book and implementing the strategies necessary to make Arion Bank a competitive relationship bank – a bank that is well equipped to play a leading role in the regeneration of the Icelandic economy. And finally, in 2012 we expect more traditional banking operations to play a greater role, and we are optimistic that by then the Icelandic economy will have stabilized and will be on a much firmer footing.

We are fortunate to have a loyal customer base and a highly dedicated and ambitious workforce. It is up to us to ensure that our clients feel the benefits of the services we offer by providing swift and effective solutions and by launching attractive innovations.

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One of the greatest challenges we face is the loss of trust – we have to regain that trust. By acting on what we say, taking our responsibilities seriously and not repeating the same mistakes we can achieve the desired results. We have to work harder to restore public confidence in Arion Bank. I am convinced that we can do this but it will take time.

One of my first priorities when I joined the Bank was to devise a new strategic plan for the Bank. It was finalized in October 2010 and is currently being implemented, a process which should largely be completed in 2011. According to the new strategy Arion Bank will remain a universal bank, providing a wide range of services and focusing on tailored and personalized solutions. Special emphasis will be placed on the Bank's ability to meet the needs of those customers, both personal and corporate, who require comprehensive and diverse services. The Bank's competitiveness will be honed by focusing on product offering, efficiency and profitability in operations.

The Bank's organizational structure was modified to better reflect the Bank's new strategy. The changes aim to simplify operations and increase synergies between divisions. Four new managing directors joined the Bank during the year. They are bringing their expertise to a management team already possessing extensive experience from all corners of the business sector.

Arion Bank began streamlining its business in 2009 by reducing the number of branches and this continued into 2010. In March 2011 we will complete the latest phase of our branch restructuring program when we merge three branches in the Reykjavik area into one. The Bank will then have reduced the number of branches by 15 and the network will comprise a total of 24 branches. Whilst continuing our focus on streamlining our operations we have to invest considerably in our infrastructure, in particular in our IT systems.

Substantial levies have been imposed or are pending on the entire banking system in Iceland, including fees relating to the Depositors' and Investors' Guarantee Fund, new bank taxes, sharp increases in costs relating to regulatory system and other special costs relating to the government's new system on interest allowance. These factors, combined with the effect of falling interest rates and the overbanked system in general, will necessitate further rationalization at the Bank.

Unusual conditions

The past year has been unusual in many ways, not least because a great deal of effort has been dedicated to recovery cases. It had long been clear that a large proportion of the Bank's loan portfolio needed to be restructured. Enormous progress was made in this respect in 2010 and Arion Bank has been at the forefront of offering solutions to companies and personal customers.

An important milestone was reached in 2010 when the authorities and credit institutions joined forces to devise ways to help personal banking customers and companies resolve their debt problems. Under this agreement, the debt recovery process will be sped up and a coordinated approach will be adopted to restructuring debt. Arion Bank has already been applying these methods for some time.

Our goal is clear: we intend to have completed the restructuring of our loan book, and consequently the debts of our customers, by the end of 2011.

In some cases Arion Bank has been required to take over companies at the end of the recovery process. The Bank has no intention of running companies in other lines of business and these companies are sold at the first feasible opportunity. In recent months the Bank has put Hagar, Hekla and several real estate projects up for sale.

Approximately 4,000 customers of the Bank have taken advantage of the solutions offered by the Bank and a further 10,000 have made use of government measures. Arion Bank has not auctioned any residential properties at distress sales since October 2009. The solutions offered to individual customers and households experiencing financial difficulties have already resulted in ISK 12.8 billion of the mortgage loans of these customers being written off by Arion Bank.

Arion Bank has set up a new advisory service designed to help individuals in financial difficulties. Each customer is assigned their own advisor who works with them throughout the recovery process until they find an acceptable outcome. The aim is that within a few months everyone experiencing difficulties in paying their debts will have found a solution.

Outlook

The outlook for 2011 is positive but we must acknowledge that our environment remains uncertain. We have to exercise caution in all our actions. Arion Bank is well positioned to meet the challenges of 2011. The capital ratio is strong, which is a crucial factor in the opinion of the Board of Directors and management. In the short term financial strength is the priority, even at the expense of profitability.

We have been given a unique opportunity, and we have all the tools we need to secure Arion Bank's position as a leading participant on the Icelandic market.

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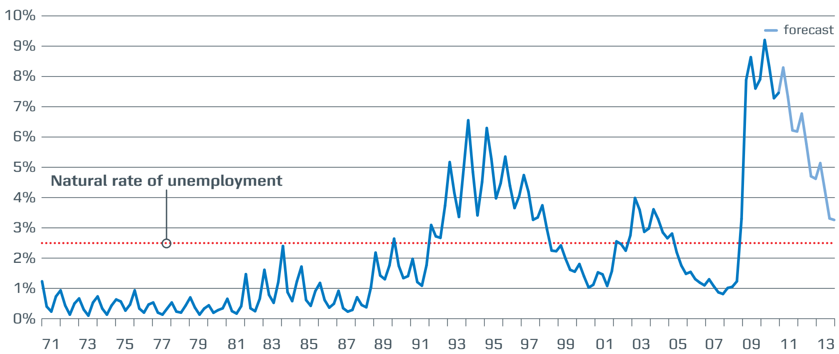
The Economic Landscape

The first half of 2010 was difficult for Iceland in many ways. The economic recovery was stalled by both a volcanic eruption and a dip in consumer confidence. There was uncertainty over various factors, such as the government's tax policy and the authorities' involvement in various investment projects. The Icesave dispute was not resolved and no clear policy or plan to lift the capital controls emerged during the year. Furthermore, there was great uncertainty over foreign loans to households and businesses after the Supreme Court ruled that currency-linked loans were illegal. On a positive note, many of these uncertainties have been or are being resolved. In March 2011 a clear course of action will be presented by the government and the International Monetary Fund concerning the lifting of capital controls over the next few years. At the end of 2010 an agreement was reached on ways to accelerate the process of resolving household debt and this has to a great extent eliminated any remaining ambiguity in this area.

The Icelandic economy began showing signs of recovery during the second half of the year, many uncertainties were resolved and a certain level of stability was reached in the economy. Private consumption began to increase, consumer confidence grew and investments staged a slight recovery. Unemployment seems to have peaked and measured 8% at the end of 2010.

Unemployment



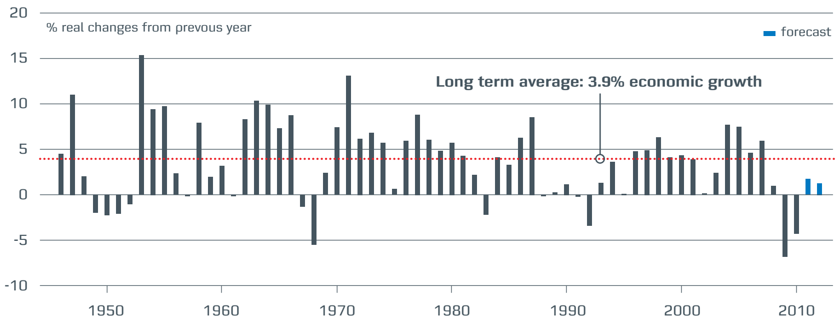
Source: Directorate of Labour

Weak economic recovery has begun

Although economic recovery is underway, it remains fragile as economic growth is weak and investments will remain at a minimum level. Employment is likely to increase again during the year as the economy picks up and GDP figures will show some signs of recovery, but the unemployment rate of 6-7% is still very high from a historical perspective. The capital controls have served a certain purpose and brought stability to the economy. In the long term, however, they have a negative effect on investments in Iceland. An important requirement for economic growth is to attract investment, particularly by removing obstacles to direct foreign investment. Delays to energy sector construction projects, partly as a result of difficulties in raising debt funding in the international markets, have had a negative impact and in the medium term the situation is unlikely to change. Moreover, there is a crowding-out effect owing to the treasury deficit as investors seek safety rather than making investments linked to private companies.

Some progress has been made however and conditions have improved for the lifting of the capital controls: there is economic stability, inflation has been trending down and interest rates are down to a historic low. The fiscal deficit has improved markedly and according to the fiscal budget there is a plan for balancing the fiscal balance no later than 2013. The net external position of the economy has improved since the economic collapse and fears over the unsustainability of public debt have dwindled. There are, however, other factors which stand in the way of the complete relaxation of capital controls, most importantly the fact that the banking system is largely funded with deposits at the moment. Nevertheless it is hoped that in the short to mid-term conditions will enable the banking system to raise funding in the international markets.

Economic growth

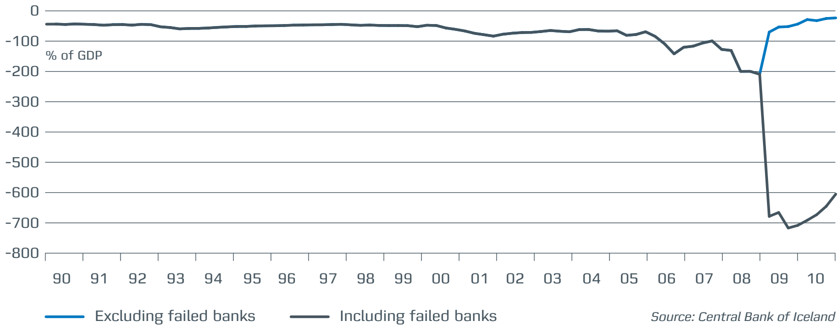


Source: Statistics Iceland

The net external debt position has dramatically improved

Iceland's net external debt position has not been as strong since the Central Bank of Iceland first began measurements in 1989. It is estimated that the net external debt position in 2010 represented 28% of GDP, excluding the effect of the failed banks. Although the net external debt position has improved greatly since the economic collapse, a greater proportion of debt is now related to public finances rather than private companies as used to be the case. The public debt increased by 70% of GDP following the financial crisis; of this figure external debt increased by 13% of GDP.

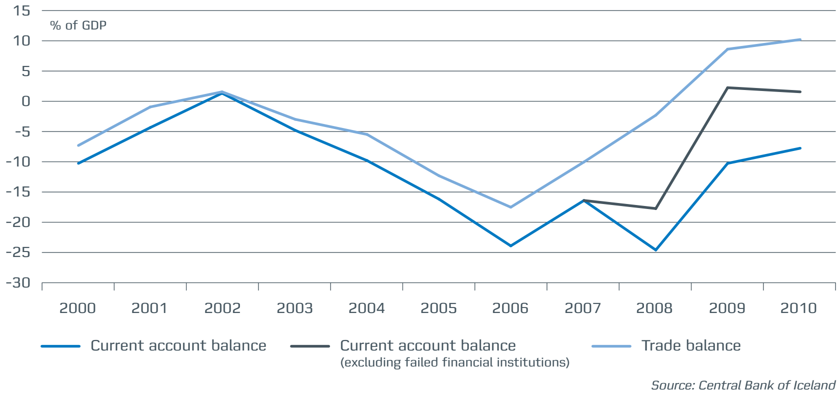
Net external position (assets minus debts)



The trade surplus is more or less reserved for foreign interest rate payments

When the economy contracts its external balance tends to change – imports fall and the value of exports increases. The current account balance, excluding the failed banks, went from a deficit of 20% of GDP in 2008 to a surplus of 1.7% in 2010. All projections assume a current account surplus of 6-8% of GDP in 2011-2013. It is likely that the trade surplus will be sufficient to pay foreign interest and dividends as well as to pay down the national debt.

The balance of payments for Iceland



There are signs that one of the deepest contraction periods since the Second World War is now over and that the economy has begun to recover. All forecasts assume that GDP has stopped shrinking and that a period of economic growth lies ahead. A number of advances have been made since the failure of the banks in 2008 – Iceland now has a clean, downsized balance sheet and a much improved debt position, a sufficient trade surplus and there is a tight grip on fiscal policy. However, uncertainties remain in the economy which could hold back economic regeneration in the next few years.

Year in Review

Results for 2010

- Solid performance in 2010 despite challenging environment.
- Net earnings amounted to ISK 12.6 billion.
- Net interest income of ISK 19.8 billion.
- Net fee and commission income of ISK 6.9 billion.
- Return on equity was 13.4%.
- Capital ratio of 19% which is well above the Icelandic Financial Supervisory Authority's (FME) requirements of 16%.
- The Bank is liquid and meets the FME/Central Bank of Iceland guidelines of a minimum secured liquidity ratio of 20%.
- Arion Bank's main source of funding is domestic deposits which amounted to ISK 457.9 billion at the end of the year, compared with ISK 495.5 billion at the beginning of the year.
- Total assets amounted to ISK 812.6 billion at the end of 2010, compared to ISK 757.3 billion at the end of 2009.

Ownership and governance

- Ownership structure finalized with capital injection on 8 January.
- Kaupskil, a subsidiary of Kaupthing Bank, holds 87% of the share capital in Arion Bank and Icelandic State Financial Investments, on behalf of the Ministry of Finance, holds the remaining 13%.
- Following the change in ownership a new Board of Directors took the helm, led by Chairwoman Monica Caneman. Höskuldur H. Ólafsson was appointed CEO.
- Several new people joined the Bank's management team.

Strategy and vision

- The long-term strategic direction for the Bank was set during 2010 after extensive groundwork was done by the management, employees and external consultants.
- Arion Bank aims to be a relationship bank with its prime focus on delivering personalized services and tailored solutions to larger corporations and individuals who seek a broad spectrum of financial solutions.
- The Bank's goal is to occupy a leading position on the domestic financial market in terms of return on equity, operational efficiency and service offerings.

Operations and restructuring

- Following the new strategic direction and with new management joining the Bank substantial changes were made to the organizational structure of the Bank.
- The Human Resources, Back Office and IT divisions were merged into a single division, Operations.
- The Treasury and Capital Markets division was split. Treasury was merged into the Finance division and Capital Markets joined forces with Corporate Banking.
- Further consolidation within the branch network has been a priority and Arion Bank's branch network is the most efficient in the country.

Restructuring of the loan book

- More than 14,000 of the Bank's retail customers took advantage of solutions on offer to lower their monthly payments or adjust the loan principal.
- Around 500 corporations entered the debt restructuring process. Arion Bank has almost completed the restructuring of larger corporations and is now making good progress with smaller and medium-sized companies.
- Arion Bank was a signatory to agreements between various financial institutions, governmental bodies, pension funds and industry associations whose aim was to adopt a coordinated approach to the debt restructuring of individuals and corporations.
- The debt restructuring solutions which formed the basis of the agreement are fully in line with solutions that Arion Bank has been offering its customers.

Mergers and acquisitions

- A strategic stake in Hagar, the largest retailer in Iceland which Arion Bank acquired in 2009, was put up for sale in 2010 in an open sales process. The sale of a 34% stake was finalized in February 2011.
- The car dealership Hekla was put up for sale in the second half of 2010 in an open sales process and was sold in early 2011.
- The company 10-11, which operates 23 grocery stores in the capital area, was split from Hagar with the aim of selling it separately. Preparations for the sale began in 2010 and the sale is expected to be completed in early 2011.
- In October 2010 Valitor became one of Arion Bank's four core subsidiaries after the Bank increased its shareholding to 52.94%.

Miscellaneous

- Arion Bank was the main sponsor of Dr. Michael Porter's research into the Icelandic geothermal cluster and the conference held in Iceland on 1 November where Dr. Porter presented the results of his research.
- Financial support was given to various charities and organizations such as the Red Cross and the Icelandic Cancer Association.
- The Bank distributed reflectors to children aged six who were starting elementary school, in association with the police, the Road Traffic Directorate and the scouts.
- More than 100 employees of Arion Bank joined rescue teams during the eruption of Eyjafjallajökull and helped farmers in the vicinity of the volcano to clear away ash from their land.
- Arion Bank is a key sponsor of several sport associations such as the Icelandic Handball Association, The National Gymnastics Association and The National Association of Disabled Athletes.

Key Business Objectives

Arion Bank's core objective is to be a strongly capitalized universal bank offering corporations and individuals tailored solutions and personalized services in corporate and retail banking, asset management, capital markets and corporate finance.

Relationship bank

Arion Bank is moving towards a relationship bank model, focusing on building strong customer relationships. We must know our customers and what is important to them in order to meet their needs. We provide excellent customer service and product offerings which are continuously being improved and expanded. A strong emphasis is placed on comprehensive market research within our customer segments.

- Prime focus on large corporations and individuals seeking a variety of financial solutions by delivering tailored solutions and personalized services.
- A leading position in the domestic financial market in regards to return on equity, operational efficiency and service offerings.
- Focus on operations in the Greater Reykjavík area as well as the largest urban areas around the country.
- Create an environment in which employees can put their skills to use and achieve professional success.
- The aim is to be the first choice in financial services and to serve as an example of operational efficiency and successful business management.
- Develop and maintain a strong sustainable long-term relationship with our clients.

Knotted kelp – Reykhólar in Breidafjördur

65° 25' 42.26"N, 22° 12' 26.36"W

Knotted kelp on the rocks on the beach near Reykhólar, a farm richly endowed with natural resources. Knotted kelp is the most common type of marine vegetation around the coast of Iceland. The kelp was not considered a valuable resource in earlier times, although it was sometimes fed to cattle. The seaweed processing plant at Reykhólar produces valuable goods from knotted kelp which are used by numerous industries all over the world.

Corporate Governance

At Arion Bank we continually look to update our corporate governance framework in response to new events, changes in statutory law and developments in domestic and international standards. The Bank is directed and controlled by this framework which is chiefly provided by the guidelines issued in 2009 by the Icelandic Chamber of Commerce, NASDAQ OMX Iceland and the Confederation of Icelandic Employers. The framework ensures disclosure and transparency and increases accountability.

The framework is also provided by the Internal Control and Procedure Handbook (ICPH) which describes the relationship between all stakeholders and defines the responsibilities of the Board of Directors (the Board) and the Management. The ICPH is reviewed and approved on an annual basis.

Shareholders' meetings

The supreme authority in the affairs of the Bank is in the hands of the shareholders at a legitimate shareholders' meeting, within the limits established by the Articles of Association and statutory law. The Bank's Annual General Meeting (AGM) shall be held before the end of April each year.

The Board of Directors

The Board is the supreme authority in the affairs of the Bank between shareholders' meetings. It is elected at a shareholders' meeting for a term of one year.

The Board is responsible for formulating a risk appetite, setting business objectives, a strategy and a business plan. It is also responsible for ensuring transparency and clarity in the decision-making process and ensures that senior management responsibilities and authorizations are delegated clearly in order to prevent conflicts of interest. The Board has established working procedures, presented in the ICPH, which further describe its duties and areas of responsibility.

The Board is required to have a thorough knowledge of the relevant rules and it shall regularly evaluate its own activities. Sound corporate governance principles are of paramount importance to the Board. The Board follows strict rules on the eligibility of directors and is governed by statutory law. All the Board's directors and alternates have undergone and passed the stringent Icelandic Financial Supervisory Authority's (FME's) qualification assessment.

There are two mandatory sub-committees of the Board: the Board Audit and Risk Committee, and the Board Remuneration Committee, which both serve as advisory committees to the Board. In addition there is a sub-committee of the Board, the Board Credit Committee, which is the highest ranking credit committee at the

Bank. The Board has set working procedures for each of the sub-committees which are specified in the ICPH. The current Board of Directors was elected at the AGM of Arion Bank on 20 May 2010.

Management

The CEO is appointed by the Board. He is in charge of the day-to-day operations of the Bank, and represents it in all matters concerning normal operations. The CEO is assisted by an executive management committee, in which all nine managing directors hold a seat.

Customers' Ombudsman

The Customers' Ombudsman is appointed by the Board of Directors in accordance with a government recommendation dated 2 December 2008.

The role of the Ombudsman is to ensure fairness and objectivity when dealing with recovery cases, prevent discrimination between customers and make certain that the process for handling cases is transparent and documented. In the case of companies the Ombudsman shall also ensure that competition perspectives are taken into account, viable companies are entered into the restructuring process and rules on financial restructuring are adhered to.

In order to achieve these objectives, the Ombudsman takes part in the formation of procedures and solutions for customers as appropriate. In addition, the Ombudsman reviews specific cases upon request from customers, the Bank's employees or at his own initiative. Such a review can take place both while cases are being processed and after they are closed. The Ombudsman has access to information and data on specific issues. The Ombudsman submits information about the outcome of cases to clients, employees and the Board of Directors as appropriate.

Internal Audit

The Internal Auditor is appointed by the Board of Directors and reports directly to the Board. The Board sets the Internal Auditor a charter which lays out the responsibilities associated with the position and the scope of the work. The mission of Internal Audit is 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 Arion Bank.

The audit is governed by the audit charter, directive no. 3/2008 issued by the FME on the internal audit function in financial institutions and international standards on internal auditing. All audit work is completed by issuing an audit report with deadlines for the implementation of audit findings. Implementations are followed up by Internal Audit every quarter. Internal Audit had nine employees at the end of 2010.

Compliance

According to Act no. 108/2007 on Securities Transactions financial undertakings are required to establish a compliance function and must ensure that it is effective and independent of other aspects of operations. Rules no. 995/2007 describe the role of compliance as follows:

- To monitor and regularly assess the adequacy and effectiveness of policies and procedures designed to detect any risk of failure by an undertaking and to put in place procedures to minimize such risk.
- To monitor and assess the actions taken to address any deficiencies in the undertaking's compliance with its obligations.
- To provide the employees of the financial undertaking responsible for carrying out the execution of securities transactions with the necessary training, advice and assistance to enable them to discharge the undertaking's obligations under the Act on Securities Transactions.

The Compliance Officer coordinates the Bank's compliance activities. The Bank has strengthened its compliance department which had three employees at the end of 2010.

The Compliance Officer works independently and reports directly to the CEO, and the Bank thereby meets the requirements of the FME and Internal Audit. The Compliance Officer has monthly meetings with the CEO at which the Compliance Officer presents a report on activities during the past month and refers certain matters to the CEO. The Compliance Officer also meets the CRO and the Internal Auditor on a monthly basis. One of the focuses of the Compliance Officer is to ensure that the Bank's rules meet the most stringent requirements made of financial undertakings at all times.

Anti-money laundering

The Compliance Officer is responsible for the Bank's measures against money laundering and terrorist financing. Tasks related to anti-money laundering (AML) can be broken down as follows:

- Know Your Customer due diligence.
- Constant monitoring of clients.
- Coordination of the Bank's compliance with laws, regulations and guidelines on measures against money laundering and terrorist financing.

The Compliance Officer organizes and is responsible for the above and carries out these tasks with the assistance of an AML team in Back Office.

The ICPH contains the rules on measures against money laundering and terrorist financing. The rules are based on Act no. 64/2006 and subsequent regulations. The rules also take into account 40 recommendations and nine special recommendations issued by the Financial Action Task Force, an international organization which combats money laundering and terrorist financing.

Corporate Social Responsibility

One of the fundamental principles of corporate social responsibility is to align the interests of companies with those of the wider community. Arion Bank places great emphasis on being a responsible member of Icelandic society and an active participant in its development. A core aspect in corporate social responsibility at Arion Bank is the focus on carrying out the Bank's duties conscientiously, ensuring that its customers receive first-rate services, and at the same time keeping in mind the interests of the society as a whole. In addition Arion Bank supports a select number of causes which benefit and strengthen the community.

The Bank focuses on supporting social issues, environmental issues, research and innovation, sports and health issues, charities, and cultural issues. Many of these projects are ongoing and most of them require the active participation of the Bank's employees. This is the key to achieving results.

Below is an outline of the main projects supported by Arion Bank in 2010.

Social issues

Financial literacy

The aim of financial literacy is to help the public get to grips with their own finances so they can shape their own financial future. A changing economic environment makes it doubly important for people to understand finances so they can make decisions to benefit themselves and their families. It also encourages a critical and informed discussion and financial prudence. It therefore not only lays the foundations for a higher quality of life, but also fosters a more responsible and healthier community. Arion Bank has a partnership and sponsorship agreement with the Institute for Financial Literacy at Reykjavík University.

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We want to see you

Arion Bank has helped organize a campaign to distribute reflective badges over the last two years. The campaign is called We Want to See You and is designed to promote road safety for children and adults. The Bank has already distributed around 200,000 reflective badges. With this campaign the Bank has teamed up with the Road Traffic Directorate, the police and the scouts to play a vital role in raising awareness of the road safety of pedestrians. The Bank plans to distribute the badges every year.

Icelandic Red Cross

Arion Bank is one of the main supporters of the Icelandic Red Cross and has been involved in a number of campaigns in recent years, including the Lidsauki volunteer project, which makes it easier for people to help out in emergency situations. Almost 200 employees of Arion Bank are signed up as Red Cross volunteers prepared to be called out to respond to emergencies. The Bank has a large number of people with varying educational backgrounds and skills who are willing to use their experience to help others.

Environmental issues

The Icelandic Forestry Association
The Bank has supported the Icelandic Forestry Association for many years. In recent years the Bank has mainly given financial support to the association. The Bank is entering into a partnership aimed at improving public access to Icelandic forests. There are also plans to publish a map containing information on places for travellers to stop and rest when journeying around Iceland.

Children's Touring Club
Arion Bank is the main sponsor of the Children's Touring Club which was set up by the Touring Club of Iceland. The aim of this club is to get children up to age of 12 to discover the magic of nature. The club organizes a range of trips and events for children of all ages. The aim of the club is to encourage families to spend quality time together and to foster an interest in conservation and healthy living.

Cycle to work
The cycle to work campaign has been a regular project with the employees' association. The main objective of this campaign is to promote cycling as a cheap, healthy and environmentally friendly mode of transport.

Sports and health

Icelandic Cancer Society
Arion Bank has been one of the main sponsors of the Icelandic Cancer Society for many years. In recent years the Bank has been involved in fundraising campaigns aimed at cancers specific to women (Bleika slaufan - the Pink Ribbon) and men (Karlmenn og krabbamein).

The fundraising and awareness campaign the Pink Ribbon was held for the tenth time in October 2010. Employees were encouraged to wear the ribbons for the duration of the campaign to show their support.

Arion Bank was one of the three main sponsors of the Karlmenn og krabbamein campaign held by the Icelandic Cancer Society between 1-26 March. The Bank and its employees did an excellent job and won first prize in the nationwide fundraising drive.

The Bank also entered into a number of agreements concerning other fundraising projects in this area.

National handball team
The Bank has been one of the main sponsors of the Icelandic handball team for many years. Handball is the most popular sport in Iceland and unites the nation. This was clearly demonstrated by the rousing reception given when the team

returned from the 2008 Olympics with the silver medal. It has been proven time and time again that results like this greatly benefit grass root development amongst children and teenagers.

Healthy lifestyle campaign
Arion Bank held its healthy lifestyle campaign from 14 September to 6 November 2010. Employees were able to record on the intranet how much exercise they had done and prizes were awarded to individual employees and different departments. A variety of lectures and courses were held and a record number of employees took part in 2010.

Lífshlaupid – health and fitness competition
Lífshlaupid is a nationwide health and fitness competition in which employees were encouraged to exercise on a daily basis and do as much exercise as possible in their spare time, while doing household chores, at work, at school and travelling around. Arion Bank ended up in third place in the 2010 competition.

Culture

Arion Bank's art collection
Arion Bank has around 1,100 pieces of art in its collection. The Bank's policy through the years has been to acquire artwork and thereby support Icelandic artists. The Bank has frequently lent works to a whole variety of exhibitions and plans to open up its collection further for the benefit and enjoyment of its customers and the general public.

Angelica – Thórsmörk

63° 40′ 37.73″N, 19° 34′ 53.97″W

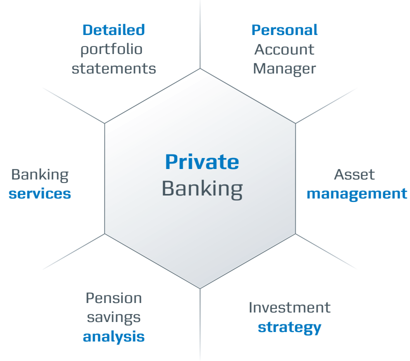
A legendary medicinal plant that collects its magical properties in the Thórsmörk wetlands. Angelica is a green gem. Our ancestors used Angelica as currency, and there were severe penalties for stealing the plant. It was used as food, to improve health and as a cure for a number of ailments. Research carried out by Icelandic scientists in recent years has shown that certain compounds in Angelica strengthen the immune system.

Asset Management

The Asset Management division consists of Sales and Services, Private Banking, and Institutional Asset Management. The subsidiary Stefnir Asset Management Company operates the fund management business and Arion Bank Asset Management is the main fund distributor. Asset Management is a leading participant in the Icelandic market with assets under management at Arion Bank and subsidiaries in excess of ISK 616 billion at the end 2010. Asset Management had 43 employees at the end of 2010.

Comprehensive product offering and personal services

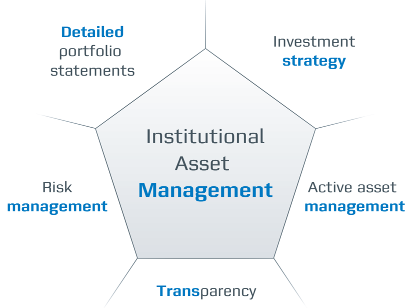
Asset Management is responsible for managing assets on behalf of its clients, who include institutional investors, corporations, high net worth clients and retail investors. It serves clients of all sizes with differing investment objectives, offering a wide range of services and a broad product mix. In addition to a variety of mutual funds, alternative investment vehicles and pension plan schemes, the division offers customized asset allocation strategies and managed accounts, designed to meet the diverse needs of investors. Moreover the division also offers funds from other leading global fund management companies.



Fulfilling clients' needs

The goal of Private Banking is to provide first-class financial services tailored to the needs of individual clients. Great importance is placed on knowing the clients' needs, developing strong relationships and targeting solid long-term returns. Clients with over ISK 10 million in assets under management should find solutions to their needs in Private Banking.

The changes in the investment environment in Iceland during the last few years have heightened the need for a diverse range of solutions. In order to meet the clients' exacting requirements, Private Banking has designed a range of new products, including a new asset allocation scheme called Eignaval, which has already brought great benefits to the clients.



Each client has their own Account Manager who provides personal service and expert financial advice to match the client's needs and wishes.

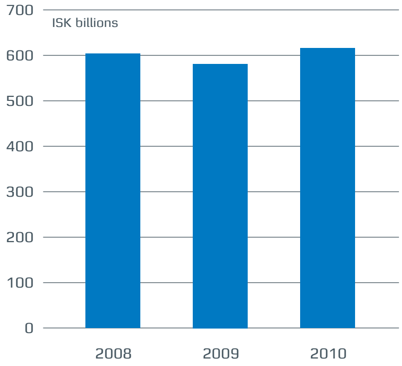
Institutional Asset Management services pension fund clients, trade unions, insurance companies, government institutions and other institutional investors. The service provided to clients includes portfolio management and advice on devising investment strategies. Different clients have different needs and Institutional Asset Management creates solutions through focused risk management, research and scenario analysis.

Institutional Asset Management places a special focus on equality, transparency and fiduciary duty as cornerstones in constructing long-term relationships that will benefit its clients.

Solid performance

The overall performance of the asset management business exceeded expectations and helped maintain a loyal client base and attract new clients. The Asset Management team is constantly looking for new opportunities and adapting to changes in the environment. A new asset allocation scheme called Eignaval has proven a great success with Private Banking clients. Another highlight was the introduction of the SÍA I Private Equity Fund launched by Stefnir, one of the few up and running post-crisis Icelandic PE funds. Inflow continued to be strong into Stefnir funds during the year as well as pension funds especially after Frjalsi Pension Fund took its second consecutive international award as Iceland's best pension fund.

Assets under management



Frjalsi Pension Fund, the best pension fund in Iceland – second year in a row

In December 2010 Frjalsi Pension Fund, which is operated by Arion Bank, was voted "The Best Pension Fund in Iceland" by Investment Pension Europe (IPE) Magazine for the second consecutive year. Winning these awards represents a significant achievement for Frjalsi Pension Fund.

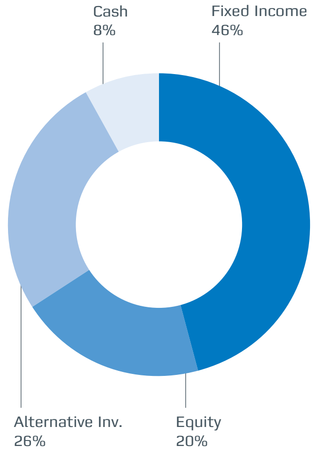
Frjalsi Pension Fund has increased its focus on transparency and communications with its fund members. A detailed breakdown of the fund's assets is published quarterly on its website, www.frjalsilif.is.

Continued focus on performance and product development

The Asset Management team aims to continue satisfying clients' needs by offering first-class services and a broad product range with good returns on investments as well as safeguarding clients' interests. We place a special emphasis on building long-term relationships based on trust and ambitious goals. Furthermore, Asset Management will continue to seek new investment opportunities and develop new products.

Based on strong foundations, the Asset Management will continue to be a market leader in the Icelandic asset management business with focus on obtaining the best result for clients.

Split between asset classes



Corporate Banking & Capital Markets

In line with Arion Bank's relationship bank strategy, organizational adjustments were carried out in 2010. Two business segments, Corporate Banking and Capital Markets, now report to one managing director and have a prime focus on large corporations, asset management companies, institutional investors, and domestic financial institutions, delivering tailored solutions and personalized services. Corporate Banking & Capital Markets is organized into seven divisions: Corporate Lending; Legal & Documentation; Portfolio Management; Corporate Services; FX & Fixed Income Sales; Equity Sales; and Research. Corporate Banking & Capital Markets had 47 employees at the end of 2010.

Corporate Banking & Capital Markets combine strong capabilities to service our customers. Building on the competence of employees the aim is to provide universal financial services as well as more complex tailored services to meet the needs of each client.

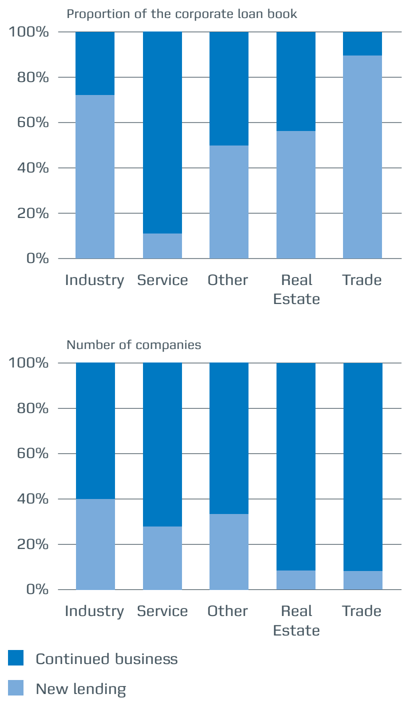
Corporate Banking

Corporate Banking provides services to corporate clients, from medium-sized businesses to large corporations. The unit can be divided into front line and support functions. The front line staff comprises a team of account managers specializing in industries such as food & beverage and real estate, and/or lending such as project finance and structured finance. Account managers are responsible for a selected group of companies, thus ensuring personal services and a clear overview of each client's financial requirements. Each account manager also relies on the assistance of a team of specialists in the support functions, which include Trade Finance & Guarantees, Legal & Documentation, Portfolio Management, and Corporate Services.

Although a significant proportion of the Corporate Banking business is credit exposure, the Bank offers a wide range of products and financial solutions that meet the needs of each customer. Examples of such services are cash management solutions, comprehensive deposit products, automatic billing and collection services, online payment slips, internet banking, as well as other specialized add-on products.

The Corporate Banking loan portfolio chiefly consists of large clients. In 2010, significant progress was made in reshaping the capital structure of companies that had become over-leveraged following the 2008 financial crisis and the sharp depreciation of the ISK. The majority of larger over-leveraged companies within Corporate Banking have been going through restructuring or have already been restructured and refinanced. The aim is to have completed the restructuring of the remaining companies by the end of 2011. During the year, an agreement was

New lending 2010



also reached by business sector interest groups, financial companies, the Ministry of Economic Affairs, and the Ministry of Finance on the financial restructuring of small and medium-sized enterprises (SMEs). This agreement outlined joint rules on the financial restructuring of companies, whereby SMEs that qualify under the agreement enjoy a standardized approach to debt restructuring.

In 2010 Corporate Banking issued loans of more than ISK 33 billion, both in the form of new loans and loans to existing customers. Some of this amount was used to finance new projects while a significant portion was granted to support previously committed projects and real estate financing. Moreover, most companies mitigate the risk of cash-flow fluctuations with short-term revolving credit facilities or committed credit lines. As a result, the demand for short-term revolving credit facilities has increased as has capital expenditure funding for companies which seek to maintain their day-to-day business operations.

The Bank revised its classification of Non-Performing loans during 2010 to better reflect changes in the creditworthiness of borrowers and to streamline the process of entering problem loans into Recovery. In the former classification system the loan portfolio was split up into Performing, Watch, In Recovery, and In Collection Process. The current classification is Performing, Watch, Sub-Performing and Non-Performing. The 2010 and 2009 classifications are therefore not directly comparable, but the "Performing" categories can be compared and the "Non-Performing" category from the 2009 classification could be considered analogous to the "Non-Performing" and "Sub-Performing" categories from the 2010 classification.

Loan classification

Status	Provision	Days in default	Debt/EBITDA/ LTV	Equity Ratio*	Credit Rating	Covenant breach
Performing	No	<30 days	<4-5/<75%-90%	>15-30%	≥B–	None
Watch	No	30-90 days	4-6/<75%-90%	10-30%	CCC+	Minor
Sub-Performing	No	>90 days	>5-6/90%-100%	<10-20%	<CCC+	Serious
Non-Performing	Yes	>90 days	>5-6/>100%	<10-20%	<CCC+	Serious

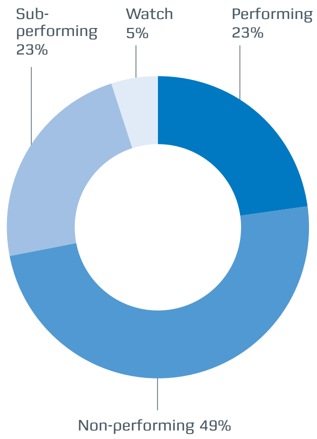
* For debt/EBITDA, LTV and equity ratios the condition varies based on industry sector and underlying collateral type.

** For further information please refer to note 109b in the Annual Accounts.

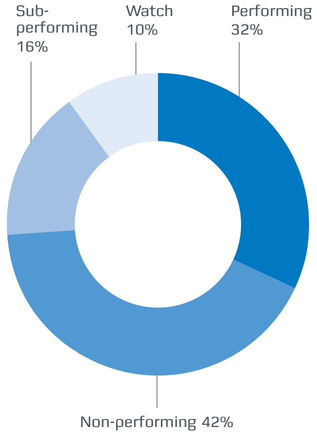
It is important to note that the classification is made on an individual client basis. All conditions must be met for a client to be able to be classified as Performing. Only clients with sufficient collateral to cover existing loans can be classified as Sub-Performing if the loan is more than 90 days in default.

Another important factor is that the classification is predominantly based on contractual loan terms and does not fully take into consideration the fact that some loans are discounted. For instance, the debt and equity ratios do not take into account that the banks are holding the borrowers' debt at a discount. Also, a borrower who is making irregular payments may be in default relative to the contractual terms, but may be fulfilling the obligations relating to the discounted loan. Many more loans would be classified as Performing if this weaker standard were applied.

Performance of companies in Corporate Banking – Book value



Performance of companies in Corporate Banking – Number of companies



Capital Markets

Capital Markets provides securities brokerage and FX sales for institutional investors and corporate clients. It is divided into FX & Fixed Income Sales, Equity Sales, and Research.

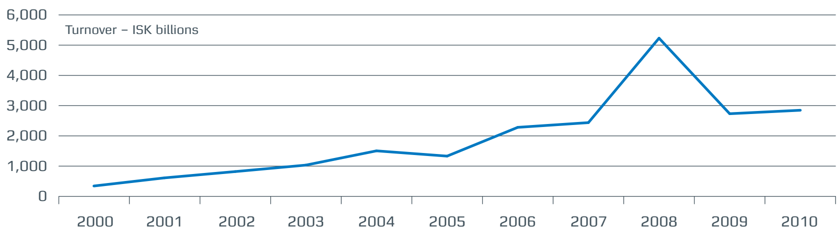
FX & Fixed Income Sales offers domestic and foreign brokerage of currency, fixed income, and derivatives for institutional investors, corporate clients, and smaller domestic financial institutions. Equity Sales is responsible for the brokerage of domestic and foreign equities for institutional investors and corporate clients.

The fixed income market continued to play an important role in 2010 whereas trading on the FX market was severely restricted by the capital controls put in place in 2008. The majority of trading in fixed income was concentrated on government bonds. On the equities side there was a continued focus on the US and Nordic equity markets, where Arion Bank is the leading Icelandic broker of foreign equities. Arion Bank remains active on the ailing domestic equity market and aims to consolidate its position in a regenerated market.

Arion Research is split into Equity, Fixed Income and Macro Analysis. The majority of clients are asset management companies, institutional investors, and other divisions of the Bank. Its main objectives are to further enhance the services provided to clients of Capital Markets and Corporate Banking by providing superior equity, fixed income, real estate, and sector analysis. In addition Arion Research issues regular economic forecasts and updates on key economic developments in Iceland. Sector analysis and other publications will play an even greater role for Arion Research in 2011. In addition, in order to add value to the Bank's corporate clients there will be an increased focus on organizing and hosting conferences on current events.

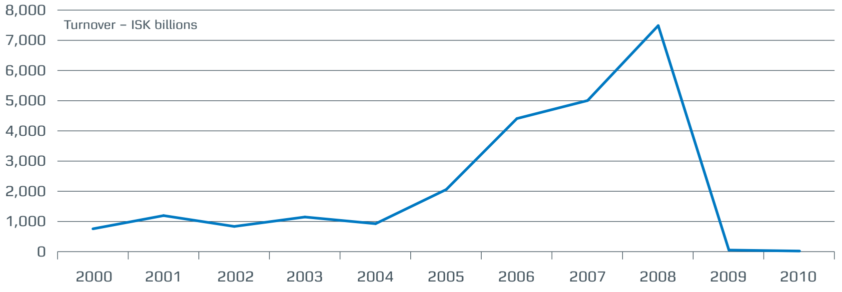
The fixed income market played an important role in 2010.

OMX Fixed Income



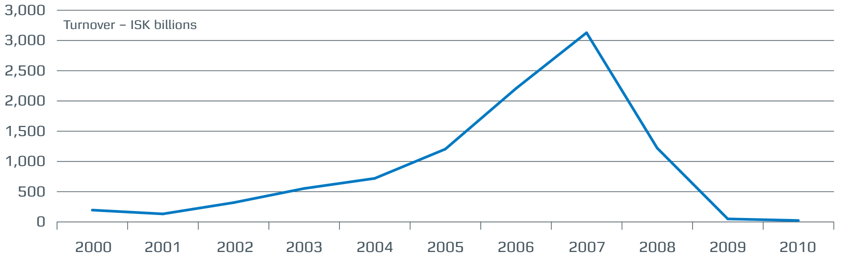
Source: NASDAQ OMX

Domestic FX market



Source: Central Bank of Iceland

OMX Equity



Source: NASDAQ OMX

Future prospects

There is some indication that the business sector is recuperating in 2011. Despite the fact that the financial environment, with its currency restrictions, continues to create substantial challenges for the capital markets and hence the Bank's operations, Arion Bank will continue to support and enable its current clients to operate under the prevailing market conditions.

In line with the Bank's future strategy, the focus will be on strengthening long-term relationships with current clients as well as attracting new customers to the Bank by continuing to provide outstanding services and products. Emphasis will be put on servicing larger corporations in complex working environments with tailored solutions. In order to maintain excellent levels of service, the needs of individual customers are being defined more clearly with an aim to enhance the role of Corporate Banking & Capital Markets as a relationship management unit for the rest of the Bank. Our aim is to be a leading participant in the Icelandic financial market, positioning ourselves as a strategic partner alongside Iceland's largest companies and playing a key role in the restoration of the market.

Corporate Finance – Advisory

Corporate Advisory, a unit within the Corporate Finance division, provides M&A advisory services and capital markets transaction services to corporate clients and investors. Corporate Advisory also plays a role in the restructuring work that is taking place within the Bank, e.g. by providing advice to the restructuring team and by managing sales processes of assets the Bank has acquired during the restructuring process. Corporate Advisory had 10 employees at the end of 2010.

Satisfactory results in the face of adversity

Corporate Advisory builds on the strong legacy of its predecessor which had a leading market share in share offerings and M&A advisory in the Icelandic market. The collapse of the Icelandic stock market in 2008 and the over-leveraging of a significant part of Icelandic corporates have had a profoundly negative impact on M&A activities in Iceland.

Corporate Advisory nevertheless took an active role in the market during 2010. Its main activities included the sale of 34% stake in Hagar, Iceland's leading retailer, which was taken over by the Bank in late 2009. Preparations for the sales process started in the spring of 2010 with the first phase being launched in the autumn. Another key sale was that of Hekla, a leading car dealership, which was taken over by the Bank in 2009.

Other assignments involved valuation reports, bond offerings and advising clients on various investment opportunities in the market.

Positive outlook for 2011

Business activity is expected to increase in 2011. The regeneration of the stock market will continue and a number of companies are expected to launch IPOs during the year. Corporate Advisory intends to complete the second phase of the sale of Hagar and admit the shares for trading on a stock exchange. In addition it will manage the sales processes of other equity positions that the Bank acquires in debt to equity swaps, whether through direct sale or a stock market listing.

Corporate Advisory will also advise clients on the buy side in sales processes that are expected to be conducted at other banks during the year. Increased merger activity is likely as many companies have gone through restructuring and need to adapt to the new market conditions.

Corporate Finance – Recovery

Arion Bank is at the forefront in resolving corporate debt issues and has made considerable progress with the restructuring of companies. Corporate Recovery is responsible for the Bank's debt recovery, i.e. the restructuring of companies which are experiencing payment difficulties. Corporate Recovery had 19 employees at the end of 2010.

Corporate Recovery is divided into three teams:

- Projects relating to small and medium-sized enterprises (Retail Banking)
- Projects relating to large companies (Corporate Banking)
- Support team

Clients who are unable to meet their obligations are put into the Bank's debt recovery process. The debt recovery process follows working procedures displayed on the Bank's website and it is broadly divided into four phases: obtaining information, restructuring, implementation and completion. The Bank estimates that up to 1,000 clients need to go through the debt recovery process; by the end of the year 563 clients had already entered the process, while a conclusion had been reached in the cases of 402 of them.

Highlights of 2010

Corporate Recovery has prioritized projects very clearly, starting with cases from Corporate Banking and the main projects from Retail Banking. These companies had debts to the Bank in excess of ISK 100 million. The work has progressed well and is close to completion.

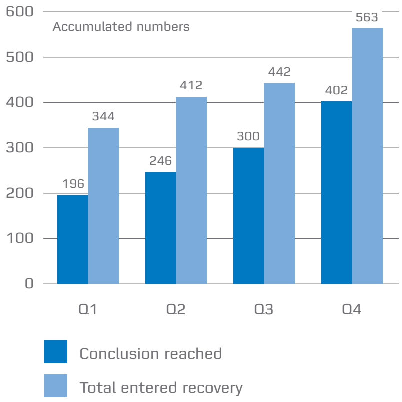
In the autumn of 2010 the focus shifted on to SMEs, with a view to reaching all the companies which had not yet been in contact with the Bank. Debt recovery of those companies is primarily conducted via the Bank's branch network with support from headquarters.

The methods devised and implemented by the Bank in the debt recovery process were to a large extent adopted into an agreement on the debt recovery of small and medium-sized companies which the main business sector interest groups, financial companies, the Ministry of Economic Affairs and the Ministry of Finance signed in December 2010.

Plans for 2011

Arion Bank aims to complete its major corporate debt recovery projects in 2011, returning financially healthy companies back to the market. The goal is to present ideas on debt restructuring to all viable SMEs currently experiencing financial difficulties before mid-2011. This process enhances our understanding of the loan book and, as it progresses, eliminates uncertainties and improves the quality of the Bank's balance sheet.

Total number of companies in recovery



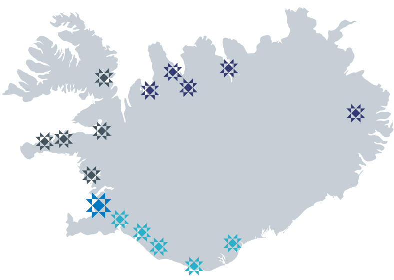
Arion Bank aims to complete its major corporate debt recovery projects in 2011, returning financially healthy companies back to the market.

Retail Banking

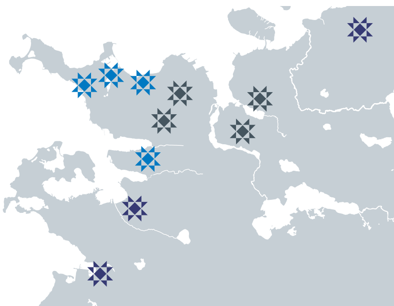
Retail Banking is the market leader in Iceland with a 30% market share*. There were 26 branches throughout Iceland at the end of 2010 and over 100,000 customers. The branches provide a comprehensive range of services, including advice on deposits and loans, payment cards, pension savings, insurance, securities, funds and more. Our focus is on tailored solutions and personalized services to meet customer needs. Retail Banking had 451 employees at the end of 2010.

Retail Banking seeks to build long-lasting and profitable relationships with its customers. To maximize operational efficiency the branch network is divided into seven clusters, each with its own business manager. Smaller branches capitalize on the strength of larger units within each cluster. More executive authority and responsibility is transferred to the branches and therefore closer to the customers. This arrangement should also help coordinate procedures and fully harness the expertise within the branches. Four of these business managers work in the Greater Reykjavík area and three in other larger urban areas. This structure is designed to reinforce the links between branches in the same part of the country.

Nationwide



Greater Reykjavík Area



Key tasks in 2010

In 2010 Retail Banking continued to streamline its operations and it now has a highly efficient branch structure by international standards. Arion Bank has focused on being at the forefront of solutions for customers experiencing financial distress and has already assisted around 14,000 customers. Arion Bank's Debt Advisory Service was launched at the end of the year. It comprises specialists working in debt recovery, and the aim is to reach out to all households in default and to help them resolve their financial problems as soon as possible. At the beginning of the year a definitive approach to restructuring small and medium-sized enterprises was finalized. In the first half of the year, all larger companies were analyzed, i.e. debts exceeding ISK 100m. The division's entire loan book was analyzed in the autumn and the restructuring of smaller companies was subsequently set in full motion in cooperation with Corporate Recovery.

Branches

Nationwide

Greater Reykjavík Area

Akureyri
Varmahlíd
Blönduós
Saudárkrókur
Egilsstadir

Borgarnes
Búdardalur
Stykkishólmur
Grundarfjördur
Hólmavík

Selfoss
Hveragerdi
Hella
Kirkjubaejarklaustur
Vík

Greater Reykjavík Area

Main Branch
Austurstraeti
Vesturbaer

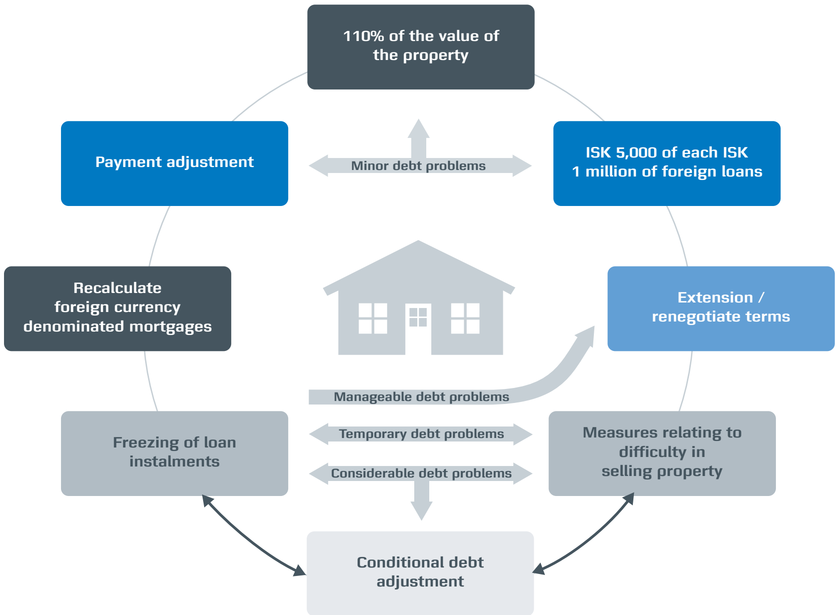
Gardabaer
Hafnarfjördur
Mosfelllsbaer

Sudurlandsbraut
Kringlan
Grafarvogur
Árbaer

Kópavogur

* Source: Capacent

Arion Bank solutions for households in financial distress



In collaboration with Bifröst University a series of courses was designed for all branch employees. The aim of the courses is to increase employees' expertise, confidence and job satisfaction. Course I, which started in the autumn of 2010, provided a deep understanding of the Bank's products and systems. The participants believed the course material will prove useful in providing better services to customers.

Key tasks ahead

In 2011 we will continue to implement the Bank's strategy and the main task will be to coordinate efforts across all of the Bank's business segments to maximize the expertise and strength of each segment so that we can better cater to the customers' needs.The new cluster structure is also designed to develop and maintain the strong relationships with our clients.

The new position of financial consultant will be set up at the branches. The aim is to improve the level of service and fully attend to the diverse needs of our customers. The financial consultants are experts in a wide range of fields including banking services, pensions and insurance and other financial instruments. During the spring of 2011 the financial consultants will attend a special course, Course II, run by Bifröst University designed to consolidate their skills. These courses are of paramount importance for the implementation of the Bank's new strategy.

An important milestone in the new branch structure will be reached with the merger of three existing branches in the Reykjavík area into one in March 2011. The new branch will be a symbol of the Bank's new strategy of extensive financial services and increased executive authority in the branch network.

Heather – Skaftafell

64° 0′ 39.88″N, 16° 57′ 23.23″W

Moss protects the pink heather. Icelandic sheep have long sought sustenance from the evergreen heather during the cold, dark winter months.

If the heather flowered on its tips, it was believed that the winter would be hard. Flower-free tips were a sign of a mild winter. Heather was popular as a colouring agent, and tea brewed from heather is believed to be good for the kidneys.

Support Units

Arion Bank has four units which provide support to the Bank's business segments. The support units are Corporate Development & Marketing, Finance, Legal and Operations.

Corporate Development & Marketing

Following organizational changes in the autumn of 2010, Corporate Development & Marketing was established as a separate division in the Bank. Corporate Development & Marketing plays an important role in strategic planning, business development, marketing and online banking. The division has three main units: Project & Performance Management, Marketing and Internet Banking and had 19 employees at the end of 2010.

Strategic planning and business development is one of Corporate Development's main responsibilities. This involves the coordination, planning and execution of strategies in order to move the Bank toward its goals of implementing organizational changes, entering into new markets, phasing in products, acquiring or divesting assets or divisions, and establishing strategic partnerships.

One of Corporate Development's largest projects is the implementation of customer relationship management as the Bank moves towards a relationship banking model. The success of the relationship banking strategy depends on the ability to tailor products and services to the needs of each customer segment. This involves implementing analytical methods for customer segmentation, adjusting product and service offerings, reinforcing the sales and services organization, and establishing a performance management system.

Project & Performance Management

The Project & Performance Management team is responsible for overall project portfolio management and project management for strategy implementation projects. The team analyzes strategic alignment for all projects, decides on the optimal project mix and prioritization, provides problem-solving support, collectively manages and coordinates the project portfolio and manages individual projects. In addition, the team is responsible for establishing a performance management system in the Bank where metrics are defined, objectives are set and business decisions are coordinated in alignment with measurement results.

Marketing

Marketing creates and sets the Bank's marketing strategy in alignment with the corporate strategy focusing on relationship banking and certain customer segments. The team 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. Other marketing related strategies and policies are also the responsibility of Marketing, such as the sponsorship strategy and social media strategy.

Internet Banking

The development of all internet banking solutions, websites, online communication and electronic distribution channels has now been centralized in Internet Banking. This represents an important step in strengthening the Bank's online solutions and services. Internet Banking aligns the internet banking strategy and vision with the corporate strategy, increasing the focus on and further developing distribution channels that facilitate self-service in line with our customers' needs. The objective is to achieve a competitive advantage in the area of internet banking and online customer communication by strategically using our websites for sales and marketing.

Finance

In mid-August 2010 Finance and Treasury were merged into one division, Finance, managed by the Chief Financial Officer. Finance now has four units, Accounting, Analysis, Funding and Treasury. Finance had 51 employees at the end of 2010.

Accounting is responsible for the Bank's financial reporting, both internally and to external stakeholders, including the Icelandic Financial Supervisory Authority and the Central Bank of Iceland. Accounting prepares accounts for the parent company and some of its subsidiaries as well as consolidated accounts for the group. Furthermore, Accounting prepares management reports to the Board of Directors, the CEO and Managing Directors on a monthly basis.

Analysis is responsible for short-term and long-term budgeting in close cooperation with the Bank's divisions. Analysis is also responsible for the benchmarking of Arion Bank with comparable financial institutions, both locally and internationally. The objective is to constantly improve the performance of the Bank.

Funding is responsible for the long-term funding of Arion Bank both in the domestic and international markets. The unit is furthermore responsible for liaison with rating agencies.

Treasury is responsible for the Bank's liquidity management as well as currency and interest rate management. The other main functions of Treasury are the internal pricing of interest rates and currency, liaison with other financial institutions, proprietary trading and market making in domestic securities and currencies.

Legal

The Legal division is divided into two departments: Legal Collection and Legal Services. Legal Collection handles collection, appropriated assets and legal representation on behalf of the Bank. Legal Services provides a range of other legal services for the Bank's divisions. The Legal division aims to provide first-rate independent services in the fields of collection, the preparation of documents, legal representation and legal advice. The division had 38 employees at the end of 2010.

The Legal division had an active role in most of the Bank's major projects in 2010, assisting the Recovery team by drafting agreements and merger notices as well as representing the Bank vis-à-vis the relevant authorities. One of the main focuses during 2010 was to analyze the complex legal issues involved in the foreign exchange loans in order to obtain a satisfactory solution both for the Bank and its customers.

At the end of 2010 the division was working on 6,600 collection cases, compared with 4,600 at the end of 2009. The Bank owned 193 appropriated properties at the end of 2010, compared with 166 properties at the end of 2009. The Bank sold 151 properties during the year.

Legal Collection faces a continuing heavy workload in 2011. Legal Services supports other divisions of the Bank and its activities depend to a certain degree on the current tasks of those divisions. Clearly, the Legal division will need to focus strongly on the resolution of issues concerning foreign loans, advice to Corporate Recovery and providing answers to questions raised by the authorities.

Operations

The Operations division was established following changes to the organizational chart of the Bank in October 2010. The division now includes three former support units, namely Information Technology (IT), Human Resources and Back Office. Furthermore, a fourth unit, Property Management, was established, which controls and manages the properties used by the Bank. Prior to this change Property Management was incorporated in Human Resources. The Operations division had 268 employees at the end of 2010, of which 13 were employed by Property Management.

In 2011 the focus of the Operations division is to consolidate the various benefits created by this merger and to reduce the Bank's overall costs.

Information Technology

The IT division is responsible for developing, operating and advising on the Bank's information systems and solutions such as the Internet Bank and websites, SAP BCA and CMS, Agresso, Calypso, Vitinn and data centres. The IT division had 116 employees at the end of 2010.

The IT division is divided into three main units: Account Management, Software Development and Technical Services. Account Management is responsible for managing the portfolio of IT projects and appointing project managers to the projects. Software Development is responsible for the implementation and maintenance of both in-house developed solutions, such as the Internet Bank and Vitinn, and standard solutions such as SAP and Calypso. Technical Services is responsible for the operation of all IT systems and solutions at the Bank, including hardware such as data centres and PCs, software solutions, telephone systems and ATMs.

The focus of the IT division in 2010 was to evaluate and initiate projects to streamline the system architecture and match it with the Bank's business strategy, and to make changes and adjustments to the information systems in order to conform to new regulations regarding changes in the financial environment. To achieve these goals, three major projects were initiated: simplifying the loan systems portfolio by migration to a single loan system; replacing the outdated legacy collateral management system; and finally re-writing the Internet Bank. Internal processes have been further developed and streamlined, especially in areas such as Change Management, Purchasing and Finance. Another focus area was to reduce IT costs and to consolidate operations by applying stronger vendor management in the areas of license management and service agreements in order to meet the needs of the Bank.

In 2011 the focus areas for the IT division will be to further streamline the system architecture in order to increase business productivity, and to strengthen the employees' skills and flexibility.

Human Resources

The goal of Human Resources (HR) is to maximize efficiency at the Bank by identifying and appointing the best possible employees to every position. HR is implementing a new performance evaluation plan and a range of other measures designed to support this goal. Human Resources, including various service units such as staff canteen, reception desk, printing and post office, had 51 employees at the end of 2010.

Arion Bank has restructured several divisions and merged a number of branches in the last couple of years and consolidation efforts will continue in 2011. The role of HR is to ensure that the Bank retains its best employees during the restructuring process while at the same time it focuses on finding new roles for employees whose positions have become redundant.

Training and development is designed to meet the diverse needs of various divisions and individual employees of the Bank. There will be a greater focus on training new and existing employees in 2011 through formal classroom-based training, e-training and on-the-job training. An example of this is the collaboration with Bifrost University on a series of courses designed for all branch employees.

Back Office

The Back Office is responsible for processing customers' trading orders and is divided into five departments: Loans, Trade Clearing, Anti-Money Laundering (AML), Payment Plans and Services. Back Office had 87 employees at the end of 2010.

Back Office's main tasks for the branch network include handling deposits, loans, customer payment plans, online payment plans, and guarantees. Back Office processes corporate loans, trade finance and is responsible for collateral management. It also liaises with international banks over a wide range of issues and deals with the settlement of FX trades and MM deals, capital markets clearing and clean payments. The AML team is responsible in cooperation with the Compliance Officer for the surveillance of AML and MiFID information and for ensuring that employees and customers are compliant with AML and MiFID regulations.

Adjusting to the changed environment has exacted considerable effort and has entailed wide-reaching changes within the division. Introducing lean management practices has helped bring about these changes. By continuing with this strategy the Bank seeks to bring greater efficiency to Back Office.

Subsidiaries

Arion Bank owns four main subsidiaries which play a vital role in the long-term strategy of the Bank. They operate in the fields of asset management, securities custody, life insurance and payment services and complement the services that Arion Bank offers its customers. These subsidiaries are Stefnir Asset Management Company, Arion Custody Services, Okkar Life Insurance and Valitor.

Stefnir Asset Management Company

Stefnir Asset Management is the largest fund manager in Iceland with assets under management of ISK 280 billion. Stefnir's employees have extensive experience of the domestic and international financial markets. The Stefnir team has consistently added value to the business by offering a fully competitive range of funds which serve as investment objectives for institutional, corporate and retail clients. Stefnir is constantly looking for new investment opportunities to meet the needs of its demanding clients as well as maintaining the current growth and success of its established funds. By bringing its clients continuous improvements and growth Stefnir has developed and maintained long-term relationships based on some of the key dynamics of the industry, namely trust, responsibility, honesty and transparency. Stefnir had 14 employees at the end of 2010.

Stefnir Asset Management is the largest fund manager in Iceland with assets under management of ISK 280 billion.

Stefnir has faced challenges due to the limitations set by the Icelandic government and the Central Bank of Iceland on investing in foreign currencies. However this has not deterred its employees from seeking out new opportunities to meet the needs of Stefnir's clients. The Icelandic market and financial environment attained a certain stability during 2010, allowing its employees to introduce new and exciting opportunities to its product range.

Among those are two alternative investment options, the first being LFEST1, an institutional investment fund based on a long-term asset-backed bond issue. The fund issued bonds worth ISK 2.8 billion which were subsequently listed on the NASDAQ OMX Iceland. This bond issue by Stefnir proved an important milestone towards restoring trust in the Icelandic financial market. The second institutional investment fund is SIA I, whose main investment objective is to invest in Icelandic firms with strong operating fundamentals and which are likely to become listed in the near future. The fund has an investment board consisting of some of the most experienced institutional investors in Iceland.

Undertakings for Collective Investment in Transferable Securities (UCITS) managed by Stefnir gained positive recognition, continued on a path of successful growth and outperformed their main competitors. Stefnir's international equity funds had an excellent 2010 with almost all funds outperforming their respective benchmarks. KF Global Value has established itself in a league of the best international equity funds this year with the exceptional return of 29% in EUR or 12% above its benchmark. KMS Global Equity has a rating of 4/5 by Lipper, a global leading mutual fund rating agent which actively rates and analyzes global mutual funds based on risk.

The year 2010 proved successful for bond funds with Stefnir Treasury Note Fund yielding the highest annual return amongst its competitors, and Stefnir Government Bond Long Term has for the past three years outperformed its main competitors. Icelandic equities had a good year as rising confidence in the market continued and new opportunities arose for investors. Icelandic equity funds managed by Stefnir currently hold a 73% market share of the domestic equity fund market.

Future prospects

Stefnir and its employees look towards the next year with great optimism. Several new investment options are being considered for launch. Since returns on current and established funds surpassed expectations last year, Stefnir has the incentive and determination to go into 2011 with the goal of even better performance and serving its clients to its best potential, continually building trust and cementing long-term relationships.

Arion Custody Services

Arion Custody Services is a custody services provider for Icelandic and international financial institutions. The company was the first of its kind in Iceland to focus on the administration of securities and funds. This field is governed by highly specialized laws and regulatory framework and requires a high level of expertise. Arion Custody Services has a strong team which is guided by the company's principles of quality, dependability and customer satisfaction. The company had 62 employees at the end of 2010.

Arion Custody Services is a custody services provider for Icelandic and international financial institutions.

The company's clientele include major financial companies and institutional investors in the domestic market, as well as over 20 foreign banks. Arion Custody Services aims to become the leading custody service provider in Iceland. Its employees strive to fulfil clients' needs and expectations and provide them with the best available solutions. The trading volume in the domestic and foreign markets continued to contract in 2010. New customers, both domestic and foreign, joined the clientele of Arion Custody Services, and despite the lower activity the company returned a profit and satisfactory returns to its owners during the year. A strong emphasis was placed on quality issues and developing the infrastructure and internal control at the company in 2010. Employees devised new service solutions for its clients and continued to help clients tackle the challenges presented by the reconstruction of the financial market.

Future prospects

A new landscape in the financial market calls for reduced costs, and increased rationalization and efficiency. Financial companies need to do their utmost to lower direct costs in operations in order to be able to generate a satisfactory profit. This environment presents great opportunities for companies such as Arion Custody Services. Financial companies can outsource custody and settlement services to Arion Custody Services and thereby cut costs considerably.

Okkar Life Insurance

The insurance company Althjóda líftryggingarfélagid hf. (Alíf) was founded in 1966 by a consortium of Icelandic investors and a British insurance company. It is the oldest life insurance company in Iceland. In 2005 the company's entire share capital was acquired by Kaupthing Bank. The company's name was subsequently changed to Kaupthing líftryggingar hf. In 2009 it was decided to change the company's name to Okkar líftryggingar hf. (Okkar Life Insurance). Its main role is to provide modern insurance services and to offer its customers financial security in the event of illness, disability or death. Okkar had 14 employees at the end of 2010.

Okkar has pioneered the development of life insurance, health insurance, children's insurance, disability insurance and a range of group insurance policies in Iceland.

The year 2010 was the most profitable in the company's history, despite the challenges in the Icelandic economy. Okkar's strong results are the product of a well-organised sales operation, customized solutions to suit the needs of each individual customer, precise risk assessment when issuing insurance, skilled asset management in collaboration with Arion Bank and rigorous cost control.

Operations are divided into Insurance, Finance, Sales & Marketing and Technical. Okkar is operated independently of other insurance companies. It has sales and distribution partnerships with Arion Bank and KB rádgjöf, which also sells pension products on behalf of Arion Bank.

Sales figures in 2010 reflected the general downturn in the Icelandic economy. Household debt problems meant that it was difficult to sell insurance policies. In the wake of the banking crisis of 2008, the decline in the company's insurance policies reached record levels. The company took assertive action which has succeeded in slowing this trend down. The key to helping the company through these difficulties was the needs analysis program Tekjuvernd. It is a consulting tool which accurately shows a customer's position with respect to retirement, and their need for critical illness insurance life insurance and permanent disability insurance.

At the beginning of 2010, Okkar and Arion Bank introduced a brand new version of Tekjuvernd. Two new products were launched in 2010:

- Accident insurance providing benefits due to TPD and death. The target group is customers who are unable to buy life insurance and critical illness insurance.
- A pension product including life and permanent disability pension. This product is awaiting the approval of the authorities. It is expected to boost sales at Okkar.

Okkar Life Insurance stands on a very firm footing. For many years the company's assets have been almost entirely invested in government bonds and bank deposits.

Okkar has pioneered the development of life insurance, health insurance, children's insurance, disability insurance and a range of group insurance policies in Iceland.

Future prospects

Increased collaboration between Okkar and Arion Bank is expected to have a positive impact on Okkar's operations, especially in the areas of product development and sales and marketing. It opens up a new and important sales channel for Okkar's products.

Despite continued uncertainties in the external environment in 2011 we are optimistic about the long-term prospects of Okkar and are confident that the collaboration with Arion Bank will prove to be an important pillar in Okkar's future success.

Valitor

Valitor is a leading payment services company and is licensed to operate as a credit company by the Financial Undertakings Act no. 161/2002. Valitor is a group member of Visa Europe and a licensee of MasterCard and provides card acquiring services to merchants and card issuing services to banks, savings banks and cardholders. Valitor divides its operations into three business segments: cross-border acquiring, merchant solutions and card solutions. The company was founded in 1983 as Greidslumidlun hf. – Visa Ísland but changed its name to Valitor in 2008.

Since it was founded the company has been owned by banks and savings banks and has a broad shareholder base. In the last two years the shareholder group has undergone a number of changes. One such change was the restructuring of the savings banks system, as a result of which Arion Bank became Valitor's parent company in October 2010.

In 2007 the company set itself the aim of increasing the turnover of cross-border acquiring. Today this is one of the mainstays of the company's business. In 2010 Valitor's income increased by 35%, primarily as a result of the growth of cross-border acquiring. At the end of 2010 the company had 137 employees.

Valitor has been a leading player on the Icelandic payment card market since it was founded.

Future prospects

Valitor has been a leading player on the Icelandic payment card market since it was founded. It fully intends to consolidate its position through focused product development and innovation. Valitor will continue to expand its business internationally and sees great business potential in overseas markets.

Holding Companies

Arion Bank has founded a number of holding companies to manage the shareholdings of companies and other assets taken over by the Bank through client debt restructuring. The aim is to preserve or increase the value of these assets before they are sold.

Eignabjarg

Eignabjarg is a subsidiary of Arion Bank and is responsible for managing and disposing of shareholdings in companies which Arion Bank has taken possession of and Eignabjarg has acquired following a period of financial restructuring. The purpose of Eignabjarg is to maximize the value of the assets it has acquired.

The aim of the operations of Eignabjarg and its holdings in companies is to:

- Ensure that the assets yield satisfactory returns.
- Ensure the independence of the companies that Eignabjarg has acquired.
- Prevent conflicts of interest, e.g. due to competition.
- Ensure that companies owned by Eignabjarg are sold in a transparent and fair sales process.

Eignabjarg acquired the following assets from Arion Bank in 2010:

Hagar hf. – A retail company with extensive operations in Iceland. Arion Bank's Corporate Advisory division is in the process of selling the company. Following the sale of a core holding in Hagar, the intention is to admit shares in the company for trading on the main list of NASDAQ OMX in Iceland.

Rekstrarfélagid tíu-ellefu ehf. – The company operates 23 grocery stores under the 10-11 brand in the Greater Reykjavík area, Akureyri and Keflavík, and was separated from the Hagar group in 2010. The sales process is being prepared and Rekstrarfélagid tíu-ellefu ehf. is expected to be sold in the first half of 2011.

Penninn á Íslandi ehf. – The company owns and operates the stores of Eymundsson, Penninn, Griffill and Islandia. The sales process of the company has not begun.

BM-Vallá ehf. – The company specializes in the production of cement, prefabricated housing units, walls and pumice. The sales process of the company has not begun.

Reitir fasteignafélag ehf. (42.7%) – The company is the largest service company in the field of commercial property letting in Iceland. The sales process has not yet begun but the plan is to list Reitir fasteignafélag on the main list of NASDAQ OMX in Iceland.

Eignabjarg will seek to own companies for as short a period as possible while taking into consideration the company's objective of achieving satisfactory returns and maximizing sales value.

Landsel

Landsel is an independent property management company founded at the end of 2009. The role of the company is to oversee the operations of companies and the disposal of liquid assets from bankruptcy estates. In certain cases, Landsel takes over the operations of companies and bankruptcy estates, and where companies are deemed viable Landsel handles the restructuring and running of the business. Landsel aims to maximize the value of the assets it takes over while also seeking to sell the assets as quickly as possible provided that the market conditions are right and a satisfactory price can be obtained.

The company has been continually shaping and developing its business since it was founded. During the year the company launched its corporate website which includes detailed information on its assets. Landsel supervised the day-to-day running of two companies in 2010 and was involved in the operations of several more. The company's asset portfolio grew substantially during the year. With close collaboration between Landsel and Arion Bank and clear and well-defined procedures, it has been possible to develop expertise at the company on the management of assets and companies.

The main task ahead is to continue to develop the companies owned by Landsel and get them into a sellable condition. There is expected to be a sharp increase in the amount of liquid assets which Arion Bank will be required to take over, and there is now a strong focus on devising procedures for such matters. The company's website will be improved to help make the sales process more efficient and transparent.

Landey

Landey is a property development company whose purpose is to deal with properties that currently do not generate revenue, such as building lots and unfinished housing developments. The company's main objective is to maintain and maximize its current assets with a professional approach to real estate and housing development, always working in close collaboration with the planning authorities.

Landfestar

Landfestar ehf. is a subsidiary of Arion Bank and specializes in leasing out business premises on a long-term basis. The majority of the property owned by the company is commercial property in the Greater Reykjavík area. A total of 75,000 square metres, owned by five subsidiaries, are leased out to one hundred tenants. These clients include the state treasury and several of Iceland's largest companies. The company was set up in 2008 with the aim of establishing itself as a leading player on the Icelandic commercial property market.

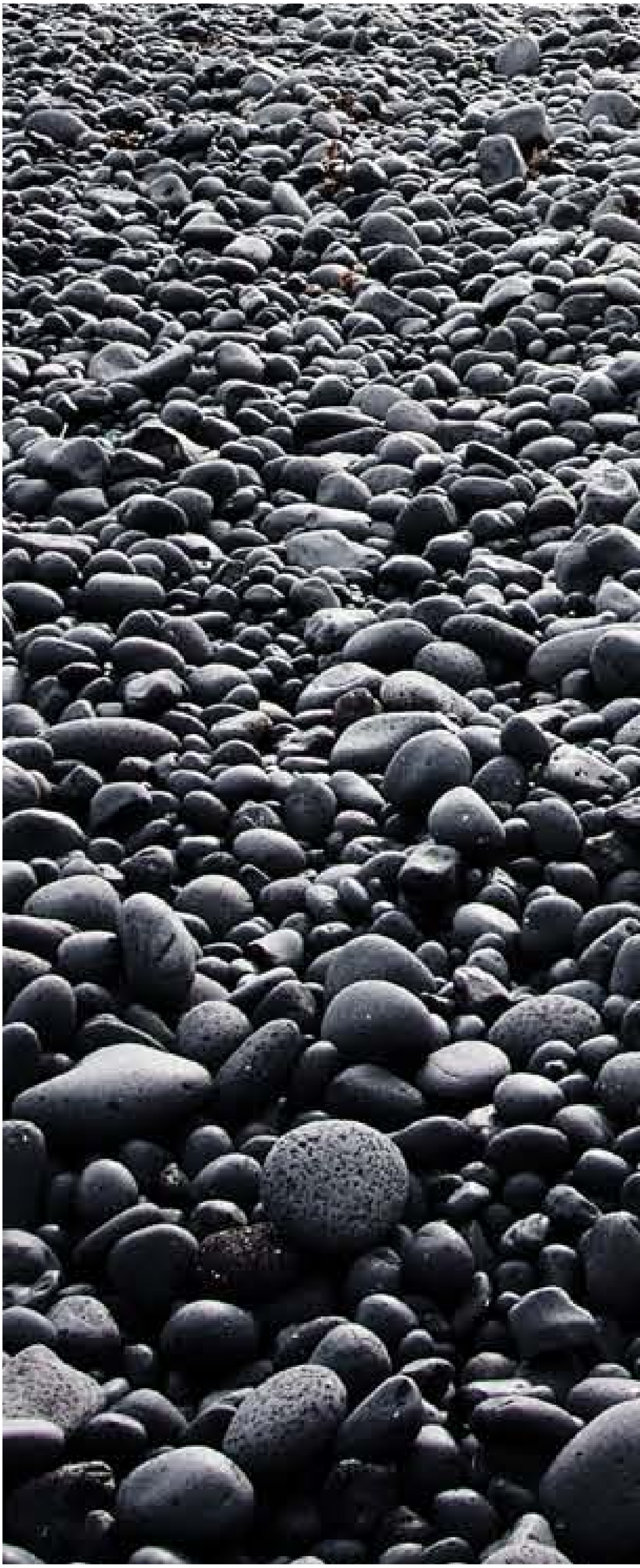
The year 2010 was an eventful one in the company's short history. The chief focus was on improving the company's leasing ratio and on taking the first steps towards debt financing on the fixed income market. Despite the adverse economic climate for clients, the company managed to increase the space it leases by almost 5,000 square metres, bringing the leasing ratio up to 93%. The company also began mortgage financing its properties through a bond issue by its subsidiary LF 1 ehf, which leases more than 12,000 square metres of commercial property to the state treasury in Borgartún 21 in Reykjavík.

The company's chief business objective is to improve its leasing ratio and to continue to finance the company's other properties on the fixed income market. Since 2008, this market has been virtually closed to all investors other than public bodies. It is of paramount importance for issuers, investors and the economy as a whole that this market recovers, and Landfestar fully intends to participate in this process.

Beachstones – Malarrif, Snæfellsnes

64° 43′ 46.11″N, 23° 48′ 32.95″W

Sea-scoured boulders on the beach at Malarrif. The surf is quick to rise here. This landing beach is considered to be one of the most dangerous on the Snæfellsnes peninsula. Seafarers denied themselves rest when the sea was quiet and allowed them to fish. Overtired people in thin shoes had nothing good to say about the rocks. Nowadays, artists wearing sturdier shoes collect the stones and use them to create works of art and smiling faces.



Risk Management

The Bank's Risk Management division is independent and centralized and reports directly to the CEO. The CEO and the Board of Directors are responsible for defining and articulating a risk appetite for the Bank's operations. Risk appetite is translated into exposure limits and targets that are monitored by Risk Management, which reports its findings regularly to the CEO and the Board of Directors. For full risk disclosures, please refer to notes 103-117 to the Annual Accounts.

The Bank is exposed to four major areas of risk, defined as follows:

Credit risk is the current or prospective risk to earnings and capital arising from the failure of an obligor to pay an obligation at the stipulated time or otherwise to perform as agreed or as expected. This type of risk includes concentration risk, residual risk, credit risk in securitization, and cross border (or transfer) risk (please refer to notes 107-109 to the Annual Accounts for additional information).

Market risk is the current or prospective risk to earnings as a result of changes in financial market prices and rates. The risk arises from market-making, dealing, and position-taking in bonds, equities, currencies, commodities, derivatives, and any other commitment which depends on market prices and rates. The main types of market risk are interest rate risk, equity price risk and foreign exchange risk (see notes 110-111).

Liquidity risk is the risk arising from the possible inability of the Bank to meet its liabilities when they come due. It is an unavoidable source of risk in the Bank's operations as the Bank requires funding to support its activities (see notes 112-113).

Operational risk is the risk of loss, resulting from inadequate or failed internal processes, human and system error, or from external events that affect the Bank's operations and can result in direct losses. This risk is present in all five core business segments and in the support units (see notes 114-115).

Risk Management had 21 employees at the end of 2010. The division comprises five units which monitor risks and report to management in a coordinated manner.

Credit Analysis Unit

Credit Analysis monitors and provides support for the Bank's credit decisions and credit granting processes from loan application to loan disbursement.

Risk Management's Credit Officer is the head of Credit Analysis and the unit is Risk Management's primary interface with the Bank's credit committees. Credit Analysis prepares an opinion for all credit applications that go before the Board

For full risk disclosures, please refer to notes 103-117 to the Annual Accounts.

Credit Committee (BCC) and the Arion Credit Committee (ACC). The Credit Officer participates in the meetings of ACC and BCC as a non-voting advisor. Credit Analysis monitors the activities of the Corporate Banking and Retail Banking credit committees. The Credit Officer is authorized to escalate disputed credit decisions from one committee to a committee with higher authority – all the way to the BCC.

Credit Analysis monitors the corporate credit rating process.

Credit Control Unit

The Credit Control unit monitors weak and impaired credit exposures on a customer by customer basis. The unit analyzes and classifies credit exposures as Performing, Watch, Sub-Performing and Non-Performing according to the Bank's credit classification standard (see note 109b) and operates as a gatekeeper in determining when problem loans should enter a restructuring process. Credit Control determines the appropriate level of provisioning and reports provisions and write-offs to the ACC.

The uncertainty regarding the valuation of assets transferred from Kaupthing Bank is a significant risk faced by Arion Bank. The Credit Control unit is instrumental in ensuring that the book value of the loan book accurately reflects the expected recovery value of loans. An important aspect of loan valuation is the availability of accurate collateral information. Credit Control has taken a leadership role in enhancing the Bank's systems and processes for collateral valuation.

The uncertainty regarding the valuation of assets transferred from Kaupthing Bank is a significant risk faced by Arion Bank.

Economic Capital Unit

The Economic Capital unit is responsible for the design, implementation and management of the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and interfacing with the Financial Supervisory Authority (FME) in the Supervisory Review and Evaluation Process (SREP). The unit is responsible for the development of the Bank's Economic Capital model, which is the basis for the internal assessment of capital requirements. The Bank's 19.0% capital ratio exceeds FME's 16% requirement by a comfortable margin.

A second role of the Economic Capital unit is the monitoring of portfolio credit risk such as single name and industry-sector concentrations. The Bank has been exposed to high levels of credit concentration risks related to the circumstances under which it was established. Excellent progress has been made in addressing this risk. (See note 109g).

Portfolio Risk Unit

The Portfolio Risk unit is responsible for monitoring, analyzing and reporting on market risk and liquidity risk. In this role, Portfolio Risk interfaces primarily with the Treasury and Proprietary Trading units and reports its findings to the Bank's Assets and Liabilities Committee (ALCO).

The Board of Directors decides how much market risk exposure the proprietary trading units within the Bank are allowed to assume, expressed as a maximum overnight exposure in equities, fixed income and derivatives. The Board entrusts the CEO with the enforcement of this policy and Risk Management with the evaluation and monitoring of positions and limits.

A significant risk originally faced by the Bank was related to the large currency mismatch between assets and liabilities. Good progress has been made and the remaining imbalance should be eliminated during 2011 (see note 111c).

Arion Bank's primary source of funding is deposits from individuals, corporations and financial institutions. The FME has set guidelines on a minimum secured liquidity ratio of 20%. The high liquidity reserve required by the FME reflects the uncertainty of the stickiness of the deposits of the Icelandic banks and the fact 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 much longer. During 2010 the Bank made considerable progress in bolstering its liquidity reserves and extending the maturity of its funding. The Bank met the FME's liquidity guidelines throughout 2010, usually by a healthy margin (see note 113). Portfolio Risk is responsible for analyzing and modelling the behaviour of its deposit base and reporting its findings to ALCO.

During 2010 the Bank made considerable progress in bolstering its liquidity reserves and extending the maturity of its funding.

Portfolio Risk also provides miscellaneous quantitative business support to the Bank's various business units. In 2010 Portfolio Risk served a crucial role in estimating what possible impact sundry legal and political challenges would have on the Bank's financial strength (see note 117).

Operational Risk Unit

The Operational Risk unit monitors risks associated with the daily operation of the Bank. The unit conducts a regular risk and control self assessment (RCSA) with all the Bank's divisions and monitors remedial actions. The unit collects loss data for all loss events and near misses. Serious events are investigated to find and remedy a root cause. The Operational Risk unit assists divisions in accurately documenting and periodically revising their work processes. The Bank's two Security Officers are part of the Operational Risk Unit.

The Bank aims to maintain an open, no blame operational risk culture and aspires to reach a point of no surprises by utilizing the Bank's operational tools and processes to the fullest extent possible.

Funding & Liquidity

Arion Bank is predominantly a deposit-funded Bank. It is fully funded and meets all the liquidity requirements of the Icelandic Financial Supervisory Authority (FME) and the Central Bank of Iceland.

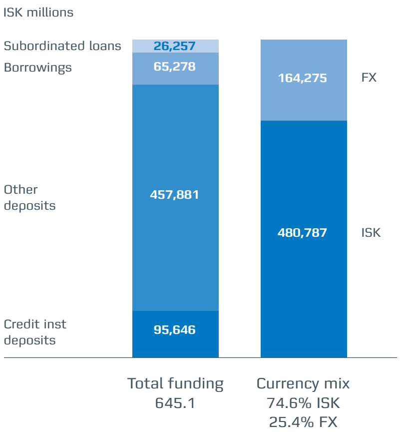
Funding

Arion Bank is predominantly funded with domestic deposits. Its total deposit base was ISK 553.5 billion at the end of 2010, compared with ISK 609.1 billion at the beginning of the year. Long-term debt amounted to ISK 91.5 billion at the end of 2010, total equity was ISK 109.5 billion, and the balance sheet totalled ISK 812.6 billion. Around 70% of our deposits are on demand, 6% of our deposits have a maturity of up to three months, while 15% have a maturity of 3-12 months. 9% of the Bank's deposits have a maturity of longer than one year, and of these less than 1% has a maturity of more than 5 years.

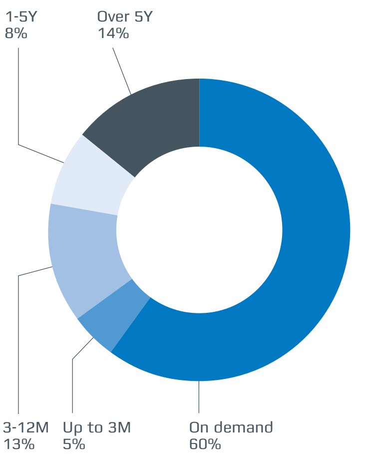
Arion Bank's deposit base has been categorized according to its stickiness. Stickiness of the deposit base is determined by the stability of the deposits in the past and their expected behavior in the future. Deposits that are determined to have the highest stickiness, are the ones that have proven to be the most stable funding source for Arion 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. Our deposits have therefore been placed into seven categories, the first category being the least sticky and the seventh being the most sticky.

In the first category, which represents 7% of our deposits, we have deposits from customers that are believed to be to be waiting to withdraw their deposits when the capital controls are lifted. This category includes foreign financial institutions. The second category, which represents 9% of the Bank's deposits, includes deposits from entities that are in the resolution process, these are in many cases entities that are insolvent and their deposits held as security against other liabilities. An example of such a depositor is Kaupthing Bank hf. (see explanation 109 f.). The third category, which represents 29% of our deposits, includes investors who may reduce their deposits when other investment opportunities become available or if a competitor bank raises its interest rates on deposits. This category includes Icelandic pension funds. The fourth category, which represents 9% of Arion Bank's deposits, includes legal entities where the deposit is the primary business with the Bank. The fifth category, which represents 12% of our deposits, includes individuals that have little other business than depositing with the Bank, including people near to retirement age that have low debt and high savings. The sixth category, which represents 17% of our deposits, includes legal entities which have a broader banking relationship with the Bank. The seventh category, which represents 17% of our deposits, contains individuals who may have a mortgage or a bank account where their salaries are deposited; these are the deposits the Bank deems to be of the highest stickiness.

Combination of total funding



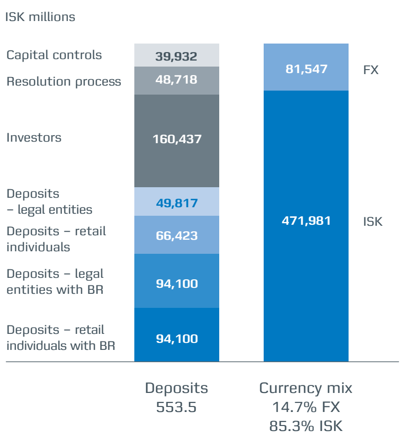
Breakdown by maturity of total funding



At the beginning of the year Arion Bank received a senior unsecured loan from the Central Bank of Iceland amounting to ISK 61.3 billion and a ISK 29.5 billion subordinated loan from the government of Iceland that qualifies as Tier II capital.

Arion Bank is focused on maintaining a large and stable deposit base originated from its clients. Deposits will continue to form the core of Arion Bank's funding in the future. While a large majority of the Bank's deposits are on demand, the contractual maturity of the assets is much longer. The Bank manages its liquidity carefully and has prudent measures to maintain a strong level of liquidity. However, the Bank is aware of external factors that might affect its deposit base in the short to medium term, such as the lifting of capital controls and the increased availability of other investment opportunities for investors who currently hold deposits with the Bank. The Bank seeks to diversify its funding profile by issuing bonds, and one of its focuses in 2011 will be to enter the domestic bond market.

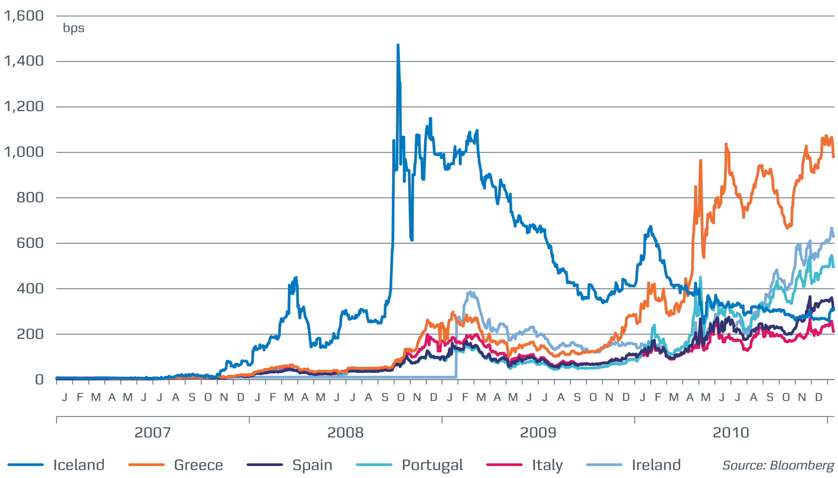
Combination of total deposits



Liquidity

The Bank is liquid and meets the FME's guidelines on a minimum secured liquidity ratio of 20%. At the end of 2010 secured liquid assets represented 24.8% of deposits which would enable the Bank to withstand an instantaneous deposit outflow in excess of the FME's requirements. Secured liquidity is in the form of cash and repoable government bonds. The cash ratio is currently well in excess of the 5% minimum stipulated by the FME. This means that the Bank has more than 5% of its on demand deposits available in cash at any given time.

Credit Default Swap spreads



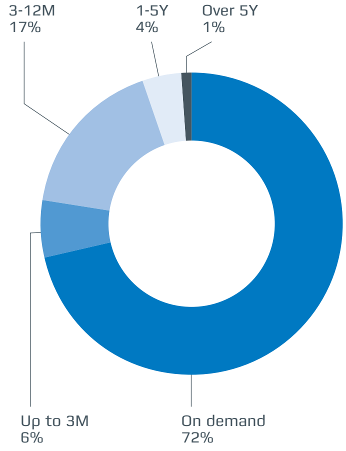
The Credit Default Swap (CDS) spread on the debt of the government of Iceland has decreased substantially since it was at highest levels in the autumn of 2008. A CDS contract is an agreement where the buyer of the swap receives credit protection and has to pay an annual fee (which is the spread). This trend is contrary to that in many other European countries which entered into the financial crisis later than Iceland. Since the autumn of 2008 the government of Iceland has been in cooperation with the International Monetary Fund (IMF) on restoring public finances and bolstering the currency reserves of the Central Bank of Iceland with funding from the IMF and the other Nordic countries.

Main tasks in 2011

In order to diversify the funding base of Arion Bank and not be as exposed to the threats of having a nearly exclusively deposit-funded bank, Arion Bank will explore opportunities in the funding markets. The traditional method of financing banks is through the senior unsecured bond markets. These markets will be challenging for Arion Bank in Europe in the near future. Arion Bank does not have a credit rating, and the Icelandic sovereign is currently rated BBB-/Baa3 (S&P/Moody's) the lowest investment grade rating, and BB+ by Fitch. The bond markets have also been very volatile recently and only been open to financial institutions with strong credit ratings and from the most resilient economies.

In 2011 Funding will strengthen its efforts to re-open international funding activities. The Bank will be presented to potential investors both domestically and internationally as ready to enter the relevant credit markets in the medium term. Given the foreseeable low demand from customers for credit and the Bank's strong liquidity position the Bank will not enter into any funding transaction unless market conditions are favourable. As an integral part of its funding strategy, the Bank will start a dialogue with rating agencies in 2011 with the aim of establishing an international credit rating at an appropriate time.

Breakdown by maturity of total deposits



Iceland moss – Berufjardardalur

64° 48′ 16.56″N, 14° 33′ 30.59″W

This dry slope is ideal for Iceland moss and for taking a break from collecting wild herbs. Iceland moss was commonly used in black pudding, added to food and used as tea. Research has shown that compounds in Iceland moss act as a cure for swellings and dry mucous membranes in the mouth and throat. Icelandic companies use Iceland moss to prepare various tinctures and throat tablets.

Financial Results

Arion Bank reported net earnings of ISK 12.6 billion in 2010, compared with ISK 12.9 billion in 2009. Return on equity was 13.4%, compared with 16.7% in 2009. The Bank's capital ratio increased by 5.3 percentage points to 19% at the end of 2010, which is well above the FME's minimum requirement.

Income

Operating income in 2010 amounted to ISK 35.6 billion, compared with ISK 31.9 billion in 2009.

Net interest income was ISK 19.8 billion compared with 12.2 billion in 2009. The interest-rate differential as a percentage of the average interest-bearing assets was 2.8% in 2010, compared with 1.9% in 2009.

Net commission income was ISK 6.9 billion, compared with ISK 5.9 billion in 2009.

Net financial income was ISK 1.361 billion, compared with ISK 10.353 billion in 2009. Included in the 2010 amount was FX-gain amounting to ISK 4.5 billion and the fair value loss of the Drómi bond amounting to ISK 3.5 billion.

Other operating income was ISK 5.7 billion, compared with ISK 3.8 billion in 2009, mainly due to income from Investment properties.

A revaluation of the Bank's portfolio of loans and receivables resulted in a net ISK 13.5 billion increase. The total increase in the value of loans and receivables was ISK 40.3 billion, which was offset by impairment of loans of ISK 26.8 billion.

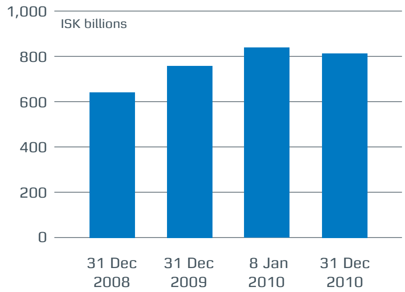
According to the agreement on the transfer of assets, liabilities and contingent liabilities from Kaupthing Bank to Arion Bank in October 2008, Arion Bank was to hold a claim against Kaupthing Bank on account of the difference in fair value of the transferred assets. At the time certain assets were ring-fenced and it was agreed by the two parties that an increase in value of those assets would be shared in the form of a payment for the transferred assets. As a result, an expense amounting to ISK 9.6 billion was incurred due to a decrease in Arion Bank's claim against Kaupthing Bank. (See note 74)

Expenses

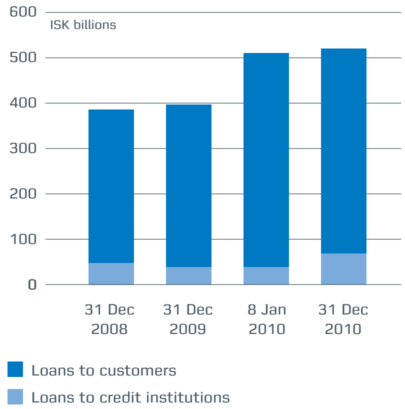
Total operating expenses in 2010 amounted to ISK 18.3 billion, compared with ISK 15.3 billion in 2009. At the end of 2010 there were 1,260 full-time equivalent positions at the Bank, compared with 1,157 at the end of 2009. The number of employees increased by 154 mainly due to new subsidiaries joining the group in 2010.

The cost-to-income ratio of the Bank was 54.2% in 2010, compared with 47.7% in 2009. This increase is largely attributable to a one-off expense relating to advisory and supervisory services in 2010.

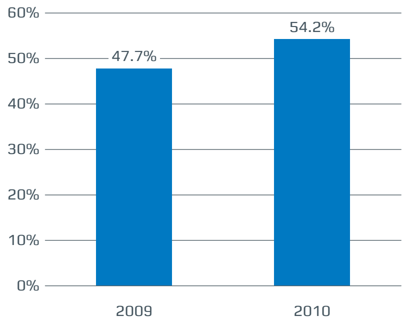
Total assets



Total loans



Cost to income ratio



Capitalization and changes within the Bank

On 8 January 2010 Kaupskil, the subsidiary of Kaupthing Bank, took ownership of 87% of Arion Bank (see note 35). Following this change in ownership equity increased from ISK 90.0 billion at year end 2009 to ISK 93.9 billion at 8 January 2010, and the Bank's assets increased by ISK 80.2 billion to ISK 837.6 billion. The loan portfolio of the Bank increased by ISK 112.8 billion but Bonds and debt instrument decreased by ISK 32.6 billion. The assets the Bank received in return for the bonds bear higher interest, which had a positive effect on the Bank's Net interest income in 2010.

In October 2010 the FME granted the Bank permission to own a controlling interest in Valitor Holding hf, which is the largest credit card company in Iceland. At year end 2010 the Bank had a shareholding of 52.9% in Valitor Holding hf, giving the Bank a stronger fee and commission base.

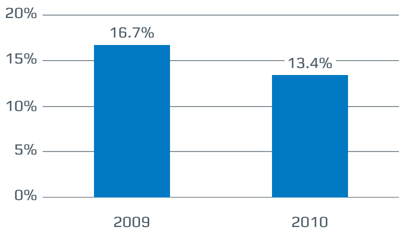
Balance Sheet

Changes in the Balance Sheet from 8 January to year end 2010 were not material. Total deposits decreased by 5% during the year and Loans to customers decreased by 4%, from ISK 471 billion in 2009 to ISK 451 billion in 2010. During the year the exchange rate of the ISK appreciated, resulting in a decrease in the value of assets and liabilities in foreign currencies. The decrease in bonds is mainly related to payment for the Drómi bond.

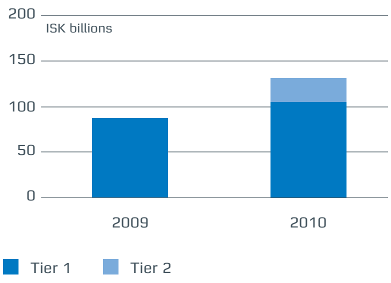
Capital requirements

At year end 2010 Arion Bank met all the FME's requirements on equity and liquidity. At year end 2010 Arion Bank's Tier 1 ratio was 15.2% and the capital ratio was 19.0%, above the FME's minimum requirement of 16%. The liquidity ratio was 24.8% at year end 2010, above the FME's minimum requirement of 20%.

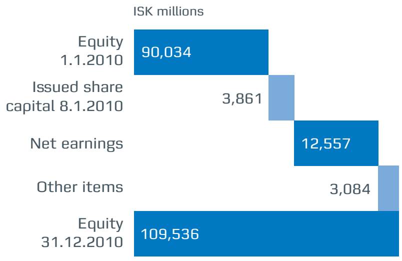
Return on equity



Total capital base



Total equity



Annual Accounts 2010

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Endorsement and Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2010 include the Financial Statements of Arion bank and its subsidiaries, together referred to as "the Bank".

The Bank is a group of financial undertakings which provide comprehensive services to companies, institutions and private customers. These services include corporate banking, retail banking, capital markets services, corporate financing, asset management and comprehensive wealth management for private banking clients.

On 8 January 2010 Kaupskil ehf. a company owned by the creditors of Kaupthing Bank, signed an agreement with the Icelandic State on capitalization and future ownership of 87% shareholding in Arion Bank. The Icelandic State remains a 13% shareholder of the Bank. The impact on the financial position of the Bank is described in note 35.

On 18 March 2010 new Board of Directors was appointed for Arion Bank representing the new ownership and on 1 June 2010 Höskuldur H. Ólafsson assumed the role as Chief Executive Officer of the Bank.

The average number of full time equivalent positions was 1,201. Information about salaries of staff, management and board members are in notes 54-55.

Operations in 2010

Consolidated net earnings amounted to ISK 12,557 million for the year ended 31 December 2010. The Board of Directors proposes that profits will be added to equity and that no dividend will be paid, unless conditions as per note 35 apply. Consolidated total equity amounted to ISK 109,536 million at the end of the year, including share capital amounting to ISK 2,000 million. The capital adequacy ratio of the Bank, calculated according to the Act on Financial Undertakings, was 19.0%. By law this ratio is required to be no lower than 8.0%, but the Icelandic Financial Supervisory Authority ("FME") requires it to be no less than 16%. The Bank’s liquidity ratio and cash ratio strengthened during the year and were 24.8% and 11.2% respectively at the end of 2010.

Due to the capital controls in Iceland, Arion Bank has a currency imbalance that results in net earnings being very sensitive to changes in the exchange rate. The Bank’s objective is to close the imbalance in 2011.

Arion Bank generally performed well in 2010 despite the challenging economic environment. Its core banking performance was particularly strong in retail banking and asset management. The focus of corporate banking continued to be on recovery work which progressed well during the year. It was only in capital markets and investment banking activities where the performance fell below expectations, mainly as a consequence of the unusual market conditions. The group structure underwent some changes during the year, the most important being the Bank’s acquisition of a larger share in Valitor, a credit card company, during the fourth quarter. Valitor is now a subsidiary of the Bank. Other changes related to the sale of companies that the Bank has acquired in the debt restructuring process. Changes to the group structure are discussed in more detail in notes 36 to 39.

The restructuring of the Bank's loan book and other assets transferred from Kaupthing Bank has been a key task since Arion Bank was founded. The Bank made good progress in this regard in 2010 and the restructuring of its largest customers' debts is in its final stages. The focus in recent months has thus shifted on to solutions for smaller entities. The Bank expects the recovery work to be largely completed during 2011.

Arion Bank

In February 2011 the Supreme Court of Iceland issued two judgments on currency-linked loans to companies. The court decided that the loans were illegal in the same way as it had in the 2010 judgments which led to new legislation on mortgage loans to individuals. The new judgments create certain uncertainties over currency-linked loans to smaller companies if such loans were taken to court. The Bank has already allowed for exchange rate adjustment in its accounts in relation to an agreement with the other banks and the authorities. However, if the corporate loans were to be largely deemed illegal the Bank would suffer substantial losses but this would not jeopardize the 16% capital ratio requirement.

Endorsement and Statement by the Board of Directors and the CEO

Outlook

The Bank's near-term prospects are to some extent contingent on its economic environment. Investments in Iceland have been very low in recent quarters but are expected to increase as the projected medium-term economic growth materializes. The progress made in recovery work relating to corporates and individuals will further stimulate growth and investments in the near term. The lifting of capital controls in the near to medium term is likely to have an impact on deposits. The Bank's objective is therefore to extend its funding profile in collaboration with Icelandic and international investors. The relaxation of the capital controls will have a positive effect on the Bank's commission income through an increase in FX trading, an activity which has been at a low over the last two years. In other respects the Bank's aim is to continue its success in core banking activities in the Icelandic market. The Bank's strategy is to offer universal banking services to its clients and its business model will take full effect in 2011. The Bank's objective is for its universal banking activities, based on trust and close relationships with its customers, to characterize the business of the Bank going forward.

Statement by the Board of Directors and the CEO

The Consolidated Financial Statements for the year ended 31 December 2010 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU.

It is our opinion that the Consolidated Financial Statements give a true and fair view of the consolidated financial performance of the Bank for the year 2010, its consolidated financial position as at 31 December 2010 and its consolidated cash flows in 2010.

Further, in our opinion the Consolidated Financial Statements and the Endorsement of the Board of Directors and the CEO gives a fair view of the development and performance of the Bank's operations and its position and describes the principal risks and uncertainties faced by the Bank.

The Board of Directors and the CEO have today discussed the Consolidated Financial Statements of Arion Bank for the year 2010 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 2 March 2011

Board of Directors

Monica Caneman
Chairwoman

Gudrún Johnsen

Kristján Jóhannsson

Theodór S. Sigurbergsson

Gudrún Björnsdóttir

Jón G. Briem

Chief Executive Officer

Höskuldur H. Ólafsson

Independent Auditor's Report

To the Board of Directors and Shareholders of Arion Bank.

We have audited the accompanying Consolidated Financial Statements of Arion Bank and its subsidiaries (the "Bank"), which comprise the Endorsement and Statement by the Board of Directors and the CEO, the Consolidated Statement of Comprehensive Income, the Consolidated Statement of Financial Position as at 31 December 2010, the Consolidated Statement of Changes in Equity and the Consolidated Statement of Cash Flows for the year then ended, and the summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these Consolidated Financial Statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Financial Statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Financial Statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the Financial Statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the Financial Statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Financial Statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the Consolidated Financial Statements give a true and fair view of the consolidated financial position of Arion Bank as at 31 December 2010, of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Emphasis of matter

Without qualifying our opinion we draw your attention to notes 2d), 34 and 109 to the Consolidated Financial Statements concerning the carrying values of assets involving accounting estimates and judgements, and the sensitivity of these carrying values to changes in reasonably possible alternative assumptions and estimates. Actual amounts realised in the future from these assets could differ from current estimates and significant uncertainty exists over whether the differences may be material to the Consolidated Financial Statements.

Reykjavík, 2 March 2011

Ernst & Young hf.

Margrét Pétursdóttir

Margrét Pétursdóttir, Partner

Consolidated Statement of Comprehensive Income
for the year 2010

	Notes	2010	2009
Interest income		52,369	66,905
Interest expense		(32,584)	(54,717)
Net interest income	42	19,785	12,188
Increase in value of loans and receivables	43	40,269	20,199
Impairment on loans and receivables	44	(26,787)	(9,939)
Changes in compensation instrument	74	(11,604)	(10,556)
Net interest income less valuation changes on loans and receivables		21,663	11,892
Fee and commission income		10,373	8,291
Fee and commission expense		(3,507)	(2,429)
Net fee and commission income	45	6,866	5,862
Net financial income	46-49	402	1,638
Fair value change to Drómi bond	50	(3,500)	-
Net foreign exchange gain	51	4,459	8,715
Share of profit or loss of associates	76	556	369
Other operating income	52-53	5,177	3,389
Operating income		35,623	31,865
Salaries and related expense	54-55	(9,272)	(8,073)
Administration expense		(7,154)	(5,260)
Depositors' and investors' guarantee fund	94	(324)	(683)
Depreciation and amortisation	78	(819)	(759)
Other operating expense	58-59	(723)	(571)
Earnings before tax		17,331	16,519
Income tax expense	61	(3,481)	(2,568)
Bank Levy	61	(290)	-
Net earnings from continuing operations		13,560	13,951
Net gain (loss) from discontinued operations net of tax	60	(1,003)	(1,080)
Net earnings		12,557	12,871
Other comprehensive income			
Exchange difference on translating foreign operations	92	(203)	(37)
Total comprehensive income for the year		12,354	12,834
Attributable to:			
Shareholders of Arion Bank		12,178	12,933
Non-controlling interest		176	(99)
Total comprehensive income for the year		12,354	12,834
Earnings per share			

The notes on pages 71 to 141 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions.

Consolidated Statement of Financial Position
as at 31 December 2010

Assets	Notes	2010	2009
Cash and balances with Central Bank	63	30,628	41,906
Loans and receivables to credit institutions	64-65	67,846	38,470
Loans and receivables to customers	66-69	451,219	357,734
Bonds and debt instruments	71-72	120,112	173,482
Shares and equity instruments with variable income	71	10,316	7,078
Derivatives	71,89	1,126	6
Securities used for hedging	71	3,213	2,236
Compensation instrument	74	24,188	34,371
Investment property	75	27,642	22,947
Investments in associates	76	2,713	5,985
Property and equipment	77-78	7,365	10,700
Intangible assets	79	4,352	3,512
Tax assets	85-88	295	1,415
Non-current assets and disposal groups held for sale	80	44,464	41,527
Other assets	81-82	17,136	15,975
Total Assets		812,615	757,344

Liabilities	Notes	2010	2009
Due to credit institutions and Central Bank	71	95,646	113,647
Deposits	71	457,881	495,465
Borrowings	71,83	65,278	11,042
Subordinated liabilities	84	26,257	-
Financial liabilities at fair value	71	999	88
Tax liabilities	85-88	4,454	2,841
Non-current liabilities and disposal groups held for sale	80	13,514	19,230
Other liabilities	90	39,050	24,997
Total Liabilities		703,079	667,310
Equity			
Share capital	91	2,000	12,646
Share premium	91	73,861	59,354
Other reserves	92	1,525	1,729
Retained earnings		28,531	16,150
Total Shareholders' Equity		105,917	89,879
Non-controlling interest		3,619	155
Total Equity		109,536	90,034
Total Liabilities and Equity		812,615	757,344

The notes on pages 71 to 141 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions. 67

Consolidated Statement of Changes in Equity
for the year 2010

	Share capital and share premium	Other reserves	Retained earnings	**Total Share-holders' equity**	Non-controlling interest	**Total equity**
2010						
Equity 1 January 2010	72,000	1,729	16,150	89,879	155	90,034
Redeemed share capital	(62,139)			(62,139)		(62,139)
Issued share capital	66,000			66,000		66,000
Total comprehensive income for the year attributable to the shareholders of Arion Bank		(203)	12,381	12,178		12,178
Total comprehensive income for the year attributable to the non-controlling interest					176	176
Non-controlling interests acquired during the year					3,288	3,288
Equity 31 December 2010	75,861	1,525	28,531	105,917	3,619	109,536
2009						
Equity 1 January 2009	72,000	129	4,817	76,946		76,946
Total comprehensive income for the year attributable to the shareholder of Arion Bank		(37)	12,970	12,933		12,933
Total comprehensive income for the year attributable to the non-controlling interest					(99)	(99)
Transfer to statutory reserve		1,637	(1,637)			
Non-controlling interests acquired during the year					254	254
Equity 31 December 2009	72,000	1,729	16,150	89,879	155	90,034

The notes on pages 71 to 141 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions.

Consolidated Statement of Cash Flows
for the year 2010

	Notes	2010	2009
Cash flows from (used in) operating activities:			
Earnings before income tax		17,331	16,519
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	100	(6,386)	(15,879)
Changes in operating assets and liabilities	101	(7,991)	(36,474)
Income taxes paid		(748)	(585)
Net cash from (used in) operating activities		2,206	(36,419)
Cash flows from (used in) investing activities:			
Purchase of investment property		(1,120)	(2,865)
Investment in associated companies		(66)	(612)
Proceeds from sale of investment property		1,705	-
Proceeds from sale of assocated companies		54	193
Purchase of intangible assets		(121)	(152)
Purchase of property and equipment		(381)	(208)
Proceeds from sale of property and equipment		110	138
Proceeds from sale of legal entities acquired exclusively with view to resale		706	-
Proceeds from the sale of individual properties included in discontinued operations		1,870	-
Net cash from (used in) investing activities		2,757	(3,506)
Net increase (decrease) in cash and cash equivalents		4,963	(39,925)
Cash and cash equivalents at beginning of the year		56,094	92,910
Cash and cash equivalents acquired through business combinations		18,110	804
Effect of exchange rate changes on cash and cash equivalents		(6,370)	2,305
Cash and cash equivalents at the end of the year	102	72,797	56,094
Non-cash investing and financing transactions:			
Loans and receivables received through changes in capitalization, see note 35		112,824	-
Bonds and debt instruments delivered through changes in capitalization, see note 35		(32,595)	-
Liabilities due to credit institutions and central bank transferred due to changes in capitalization, see note 35		14,428	-
Borrowings transferred due to changes in capitalization, see note 35		(61,252)	-
Subordinated loans transferred due to changes in capitalization, see note 35		(29,543)	-
Net changes in equity due to changes in capitalization		(3,862)	-
Equity contribution by the Icelandic state settled through the receipt of Icelandic government bonds		-	71,225
Bond claim on Drómi and Sparisjódabanki Íslands hf. in consideration for deposits and overdrafts		-	91,860
Deposits and overdrafts transferred from SPRON and Sparisjódabanki Íslands hf		-	(91,860)
Assets acquired from Sparisjódur Mýrasýslu		-	9,714
Bond issued to the creditors of Sparisjódur Mýrasýslu		-	(9,714)
Assets acquired through foreclosure on collateral from legal entities with view to resale		9,816	30,944
Settlement of loans and receivables through foreclosure on collateral from legal entities with view to resale		(9,816)	(30,944)

The notes on pages 71 to 141 are an integral part of these Consolidated Financial Statements.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements
Contents

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

General information

1. Reporting entity

Arion Bank, the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The Bank was initially named New Kaupthing banki hf. but on 21 November 2009 the name was changed to Arion Bank. The address of Arion Bank's registered office is Borgartún 19, Reykjavik. The Consolidated Financial Statements for the year ended 31 December 2010 comprise Arion Bank and its subsidiaries (together referred to as "the Bank"). The Bank offers integrated financial services to companies, institutional investors and individuals. These services include corporate banking, capital market services, retail banking, corporate financing, asset management and comprehensive wealth management for private banking clients.

The Bank has acquired a number of entities exclusively with view to resale. The acquisitions were the result of foreclosures. As the operation of these entities is different to the Bank's core operations the effects only appear in a limited number of line items in the Consolidated Statement of Comprehensive Income and the Consolidated Statement of Financial Position.

The Consolidated Financial Statements were approved and authorised for issue by the Board of Directors of Arion Bank on 2 March 2011.

2. Basis of preparation

a) *Statement of compliance*
The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as endorsed by the European Union.

b) *Basis of measurement*
The Consolidated Financial Statements are prepared on the historical cost basis except for the following:

- Financial assets/liabilities held for trading are measured at fair value
- Financial assets/liabilities designated at fair value through profit and loss are measured at fair value
- Investment properties are measured at fair value
- Compensation instrument is measured at fair value

Non-current assets (or disposal groups) classified as held for sale are stated at the lower of their carrying amount and fair value less costs to sell. Immediately before the initial classification, or where the assets and liabilities are not within the scope of IFRS 5, the carrying amounts are measured in accordance with applicable IFRSs.

c) *Functional and presentation currency*
The Consolidated Financial Statements are presented in Icelandic króna (ISK), which is the Parent Company's functional currency, rounded to the nearest million unless otherwise stated.

d) *Use of estimates and judgements*
The preparation of the Consolidated Financial Statements requires management to make judgements, estimates and assumptions that affect the reported amounts of assets, liabilities, contingent liabilities as well as income and expenses in the Consolidated Financial Statements presented. Use of available information and application of judgement are inherent in the formation of estimates. Actual results in the future could differ from such estimates and the differences may be material to the Consolidated Financial Statements.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

Judgements made by management that have a significant effect on the Consolidated Financial Statements and estimates with a significant risk of material adjustment within the next financial year are discussed in notes 34, 73, 109, 110 and 111.

Notes to the Consolidated Financial Statements

Significant accounting policies

The accounting policies set out below have been applied consistently in these Consolidated Financial Statements.

3. Going concern assumption

The Bank's management has made an assessment of the Bank's ability to continue as a going concern and is satisfied that the Bank has the resources to continue. The Consolidated Statement of Financial Position of the Bank presents uncertainty due to the asset-liability mismatches of significant risks as described in the Risk Management disclosures. A considerable portion of the purchased assets from Kaupthing Bank are denominated in low interest rate foreign currencies and are funded with deposits denominated in Icelandic króna, a high interest rate currency. Liquidity risk, as well as risks related to imbalances in currency, duration and interest rate base are outlined in the Risk Management disclosures. Whilst the Bank's stress testing has resulted in the Bank management assessing that it is sufficiently capitalised to deal with market shocks, significant market shocks during the realignment period of the Bank's risk profile, poses some uncertainty.

The Bank is making progress in adapting to the new economic reality in Iceland with a focus on strengthening the infrastructure and internal control. The main focus has been on safeguarding the value of the Bank's assets through the recovery process and a team of specialists has been put together to work with defaulting customers. A favourable outcome from this process is already strengthening the Bank's business. Further information on risk factors in the Bank's operation are provided in the Risk Management Disclosures.

4. Principles underlying the consolidation

a) *Subsidiaries*

Subsidiaries are entities controlled by the Bank. Control exists when the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Bank holds more than 50% of the voting power of the subsidiary. In assessing control, potential voting rights that are currently exercisable or convertible are taken into account. The Financial Statements of subsidiaries are included in the Consolidated Financial Statements from the date that control commences until the date that control ceases. The Financial Statements of the subsidiaries are prepared for the same reporting period as the parent entity, using consistent accounting policies.

Business combinations from 1 January 2010

The acquisition method of accounting is used to account for the acquisition of businesses and subsidiaries by the Bank. The cost of an acquisition is measured as the aggregate of the consideration transferred, measured at acquisition date fair value and the amount of any non-controlling interest in the acquiree. For each business combination, the Bank measures the non-controlling interest in the acquiree either at fair value or at the proportionate share of the acquiree's identifiable net assets. Acquisition costs incurred are expensed and included in administrative expenses. If the business combination is achieved in stages, the acquisition date fair value of the acquirer's previously held equity interest in the acquiree is remeasured to fair value at the acquisition date through profit or loss. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any non-controlling interest.

Goodwill is initially measured at cost being the excess of the aggregate of the consideration transferred and the amount recognised for non-controlling interest over the net identifiable assets acquired and liabilities assumed. If this consideration is lower than the fair value of the net assets of the subsidiary acquired, the difference is recognised in the Consolidated Statement of Comprehensive Income. After initial recognition, goodwill is measured at cost less any accumulated impairment losses.

Transactions eliminated on consolidation

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

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

Business combinations prior to 1 January 2010

In comparison to the above-mentioned requirements, the following differences applied:

Business combinations were accounted for using the purchase method. Transaction costs directly attributable to the acquisition formed part of the acquisition costs. The non-controlling interest (formerly known as minority interest) was measured at the proportionate share of the acquiree's identifiable net assets. Business combinations achieved in stages were accounted for as separate steps. Any additional acquired share of interest did not affect previously recognised goodwill.

b) *Non-controlling interest*

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Bank; such interests are presented separately in the Consolidated Statement of Comprehensive Income and are included in equity in the Consolidated Statement of Financial Position, separately from equity attributable to owners of the Bank. Losses within a subsidiary are attributed to the non-controlling interest even if that results in a deficit balance. Changes in the Bank's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

c) *Funds management*

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

Notes to the Consolidated Financial Statements

5. Associates

Associates are those entities over which the Bank has significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Bank holds between 20% and 50% of the voting power, including potential voting rights. Investments in associates are initially recognised at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

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

If an investment in an associate is classified as held for sale the equity method is no longer applied and the investment is accounted for, as a non-current asset held for sale.

6. Foreign currency

a) *Functional currencies*

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

b) *Foreign currency transactions*

Transactions in foreign currencies are translated to the respective functional currencies of Bank entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the year, and the amortised cost in foreign currency translated at the exchange rate at the end of the year. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

c) *Foreign operations*

The assets and liabilities of foreign operations are translated to Icelandic króna, at exchange rates at the reporting date. The income and expenses of foreign operations are translated to Icelandic króna at exchange rates approximating the exchange rates current at the dates of the transactions.

Foreign exchange differences arising on translation are recognised in Consolidated Statement of Comprehensive Income. When a foreign operation is disposed of, in part or in full, the cumulative amount of the exchange differences relating to that foreign operation which is recorded in comprehensive income and accumulated in the separate component of equity, is transferred to the Consolidated Statement of Comprehensive Income when the gain or loss on disposal is recognised.

7. Income and Expense

a) *Interest income and expense*

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

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

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

- Interest on financial assets and liabilities at amortised cost on an effective interest rate basis,
- Interest on trading assets and liabilities on an accrual basis,
- Interest on financial assets and financial liabilities designated at fair value through profit or loss on an accrual basis,
- Interest on derivatives on an accrual basis.

Interest income on non-performing assets are recognised in the Consolidated Statement of Comprehensive Income using the effective interest method. The Bank recognises losses for impaired loans to offset the recognised interest income when appropriate.

Notes to the Consolidated Financial Statements

7. cont.

b) *Fee and commission income and expense*

The Bank provides various services to its clients and earns income therefrom, such as income from Corporate banking, Retail banking, Capital Markets, Corporate Finance and Asset Management and Private banking. Fees earned from services that are provided over a certain period of time are recognised as the services are provided. Fees earned from transaction type services are recognised when the service has been completed. Fees that are performance linked are recognised when the performance criteria are fulfilled. Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

c) *Net financial income*

Net financial income comprises Dividend income, Net gain on financial assets and liabilities at fair value through profit or loss and Net gain on disposal of financial assets and liabilities not at fair value.

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

ii) Net gain on financial assets and liabilities at fair value through profit or loss comprises: Net gain on trading portfolio, Net gain on assets and liabilities designated at fair value through profit or loss.

Net gain on trading portfolio

Net gains on financial instruments held for trading comprise gains and losses related to financial assets and financial liabilities held for trading, and includes all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below).

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

Net gains on financial instruments designated at fair value through profit or loss comprise gains and losses related to financial assets and financial liabilities designated at fair value through profit or loss, and includes all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below).

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

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

iv) Net gain on financial assets and liabilities not at fair value through profit or loss relates to derecognition of certain financial assets and liabilities and comprises Net realised gain or loss on financial liabilities measured at amortised cost and other net realised gain or loss. It does not include either unrealised foreign exchange gains and losses or interest income and expense which are included in other line items.

d) *Income tax*

Income tax comprises current and deferred tax. Income tax is recognised in the Consolidated Statement of Comprehensive Income except to the extent that it relates to items recognised directly in other comprehensive income or equity, in which case it is recognised in other comprehensive income or equity.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date.

The deferred income tax asset / liability has been calculated and entered in the Consolidated Statement of Financial Position. The calculation is based on the difference between Consolidated Statement of Financial Position items as presented in the tax return on the one hand, and in the Consolidated Financial Statements on the other. This difference is due to the fact that tax assessments are based on premises that differ from those governing the Consolidated Financial Statements, mostly because revenues and settlement is not expected at the same time. A deferred tax asset is only offset against income tax liability if they are due to tax assessment from the same tax authorities.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Notes to the Consolidated Financial Statements

8. Impairment of financial assets

At each reporting date the Bank 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.

a) *Impairment on loans and receivables*

The Bank 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 Bank'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 Bank 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:

- Adverse changes in the payment status of borrowers in the group; or
- General national or local economic conditions connected with the assets in the group.

Individually assessed loans

Impairment losses on individually assessed accounts are determined by an evaluation of the exposures on a case-by-case basis. The Bank assesses at each reporting date whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining such impairment losses on individually assessed accounts, the following factors are considered:

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

Impairment loss is calculated by comparing the present value of the expected future cash flows, discounted at the original effective interest rate of the loan, with its current carrying value and the amount of any loss is charged in the Consolidated Statement of Comprehensive Income. The carrying amount of impaired loans is reduced through the use of an allowance account. In the case of a loan at variable interest rates, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

Collectively assessed loans

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. This loss covers loans that are impaired at the reporting date but which will not be individually identified as such until some time in the future. The estimated collective impairment loss is recognised through the use of an allowance account.

Notes to the Consolidated Financial Statements

8. cont.

The collective impairment loss is determined after taking into account:

- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash flows of the asset
- Historical loss experience in portfolios of similar risk characteristics (for example, by industry sector, loan grade or product);
- The estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan;
- Future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash; and
- Management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification is determined for each identified portfolio.

Estimates of changes in future cash flows for groups of assets should be consistent with changes in observable data from period to period, for example, changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to minimise any differences between loss estimates and actual losses.

Loan write-offs

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

Reversals of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised or acquired, the previously recognised or acquired impairment loss is reversed. The amount of any reversal is recognised in the Consolidated Statement of Comprehensive Income.

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

Assets acquired in exchange for loans

Assets acquired in exchange for loans are recorded as non-current assets held for sale in the Consolidated Statement of Financial Position if its sale is highly probable and management is committed to a plan to sell the asset, and an active programme to locate a buyer and complete the plan have been initiated. The non-current asset held for resale is recorded at the lower of its fair value less costs to sell, and the carrying amount of the loan, net of impairment allowance amounts, at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the Consolidated Statement of Comprehensive Income. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the Consolidated Statement of Comprehensive Income.

b) *Calculation of recoverable amount*

The recoverable amount of the Bank's investments in financial assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate, i.e. the effective interest rate computed at initial recognition of these financial assets.

c) *Impairment on investments in associates*

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

Notes to the Consolidated Financial Statements

9. Impairment of non-financial assets

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

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

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

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

10. Derivatives

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

Derivatives are recognised at fair value. Fair value changes are recognised in the Consolidated Statement of Comprehensive Income. Changes in fair values of derivatives are split into interest income, foreign exchange differences and other gains and losses. Interest income is recognised on an accrual basis. Derivatives with positive fair values are recognised as Derivatives and derivatives with negative fair values are recognised as Financial liabilities at fair value.

The fair value of derivatives is determined in accordance with the accounting policy presented in note 13.

11. Cash and cash equivalents

Cash and cash equivalents in the Consolidated Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition.

12. Loans and receivables

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

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

Loans and receivables are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and receivables.

Notes to the Consolidated Financial Statements

13. Financial assets measured at fair value through profit and loss

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

Securities used for hedging are trading securities acquired exclusively in order to hedge against market risk of asset swap derivative contracts.

b) *Financial assets designated at fair value through profit or loss*
The Bank classifies certain financial assets upon their initial recognition as financial assets held at fair value with fair value changes recognised in the Consolidated Statement of Comprehensive Income as Net financial income if doing so results in more relevant information because:

i) the assets are managed, evaluated and reported internally on a fair value basis;
ii) the designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
iii) the assets contain an embedded derivative that significantly modifies the cash flows that would otherwise be required under the contract.

The assets classified according to the above mentioned conditions consist of equity and debt instruments which are acquired by the Bank with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

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

14. Determination of fair value

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. For all other financial instruments fair value is determined by using valuation techniques. Valuation techniques include net present value techniques, the discounted cash flow method, comparison to similar instruments for which market observable prices exist, and valuation models. The Bank uses widely recognised valuation models for determining the fair value of common and more simpler financial instruments like options and interest rate and currency swaps. For these financial instruments, inputs into models are market observable.

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

15. Recognition and derecognition of financial assets and financial liabilities

Purchases and sales of financial assets are recognised using trade date accounting, i.e. they are recognised on the date on which the Bank commits to purchase or sell the asset, except for loans which are recognised when cash is advanced to the borrowers.

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

Financial liabilities are recognised when the Bank becomes a party to the contractual provisions of the liability instrument. Financial liabilities are derecognised when the obligation of the Bank specified in the contract is discharged or cancelled or expires.

16. Offsetting financial assets and financial liabilities

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

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

Notes to the Consolidated Financial Statements

17. Amortised cost measurement of financial assets and financial liabilities

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

18. Intangible assets

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. Internally generated intangible assets are not capitalised and expenditure is reflected in the Consolidated Statement of Comprehensive Income in the period in which the expenditure is incurred.

The value of intangible assets with indefinite useful lives is not amortised, but the assets are tested for impairment at least once a year.

a) *Subsequent expenditure*

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

b) *Amortisation*

Amortisation is recognised in the Consolidated Statement of Comprehensive Income on a straight-line basis over the estimated useful lives of intangible assets. Intangible assets are amortised from the date they are available for use. The estimated useful lives are as follows:

Software	5 years

19. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both. Investment property is stated at fair value.

When determining the fair value of the properties, net present value of future cash flow over 30 years is calculated. When determining the cash flow general accepted valuation techniques are applied, such as international valuation standards, IVS no. 1 Market Value Basis of Valuation. The valuation model is based on estimated free cash flow to the owners and assumptions applied that reflect the market conditions at the accounting date. The cash flow of the properties is based on estimation of rental income less estimated expenses. There is great uncertainty about the actual fair value of investment properties, as futher described in Note 34.

Rental income is estimated based on valid lease agreements. In the valuation model estimated market lease at the end of the current lease agreement is taken into consideration. Fundamental assumptions on estimated utilisation of the properties in the future, estimated discounts and loan provisioning are applied when estimating future rental income.

All related expenses, e.g. maintenance, real estate tax and other operating and financial expenses, is deducted from the estimated rental income. Real estate tax and insurances are based on historical data and foreseen future changes. Financial expense is estimated based upon market interest and expected interest yield (interest margin).

The net present value of free cash flow to owners, for each property, is determined by calculating the net present value of the cash flow with a factor representing current market uncertainty on amount and timing of the cash flow, including expected inflation. The CAPM model is used and the required rate of return is based on the risk free real interest on the accounting date, the risk factor of the real estate market and specific risk factors of each lessee.

When estimating the fair value of the investment properties' assets like fixtures, equipment and furniture are not accounted for separately as they are considered part of the fair value of the properties. The fair value of the properties does not reflect the possible future increase in the value due to further investments in the property.

The fair value of investment property in progress is mainly based on offers received for the properties.

Notes to the Consolidated Financial Statements

20. Property and equipment

a) *Recognition and measurement*

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

b) *Subsequent costs*

The cost of replacing part of an item of property and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the part will flow to the Bank and its cost can be measured reliably. All other costs are recognised in the Consolidated Statement of Comprehensive Income as an expense as incurred.

c) *Depreciation*

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

Buildings	33-50 years
Equipment	3-7 years

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

21. Non-current assets and disposal groups held for sale

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

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, non-current assets and disposal groups are recognised at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Consolidated Statement of Comprehensive Income, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement.

22. Deposits

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

23. Borrowings

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

24. Subordinated liabilities

Subordinated liabilites are financial liabilities in the form of subordinated capital which, in case of the Bank's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within Tier II, as shown in note 116. The subordinated liabilities have no maturity date and the Bank may only retire them with the permission of the Financial Supervisory Authority. The liabilities qualify as Tier II capital in the calculation of the equity ratio.

Subordinated liabilities are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at amortised cost with any difference between cost and redemption value being recognised in the Consolidated Statement of Comprehensive Income over the period of the borrowings on an effective interest basis.

Notes to the Consolidated Financial Statements

25. Financial liabilities at fair value

Trading liabilities
Trading liabilities primarily consist of derivatives with negative fair values. Hedging derivatives such as those used for internal risk control but not qualifying for hedge accounting under IAS 39 are also disclosed under this item.

Trading liabilities are measured at fair value. Gains and losses realised on disposal or redemption and unrealised gains and losses from changes in the fair value of trading liabilities are reported as Net gain on financial assets and liabilities measured at fair value. Interest expenses on trading liabilities are included in Interest expenses.

26. Other assets and other liabilities

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

27. Equity

Dividends on shares
Dividends on shares are recognised in equity in the period in which they are approved by the Bank´s shareholders.

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

Foreign currency translation reserve
The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the financial statements of foreign operations.

28. Earnings per share

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

29. Financial guarantees

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

30. Fiduciary activities

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

31. Employee benefits

All entities within the Bank have defined contribution plans. The entities pay fixed contribution to publicly or privately administered pension plans on a mandatory and contractual basis. The Bank has no further payment obligations once these contributions have been paid. The contributions are recognised as an expense in the Consolidated Statement of Comprehensive income when they become due. The Bank has no defined benefit pension plan.

Notes to the Consolidated Financial Statements

32. New standards and amendments to standards

a) New standards and amendments to standards effective in 2010

The accounting policies adopted are consistent with those of the previous financial year, except for the following new and amended IFRS effective as of 1 January 2010:

IFRS 3 *Business Combinations (Revised)* and IAS 27 *Consolidated and Separate Financial Statements (Amended)*

IFRS 3 (Revised) introduces significant changes in the accounting for business combinations occurring after becoming effective. Changes affect the valuation of non-controlling interest, the accounting for transaction costs, the initial recognition and subsequent measurement of a contingent consideration and business combinations achieved in stages. These changes will impact the amount of goodwill recognised, the reported results in the period that an acquisition occurs and future reported results.

IAS 27 (Amended) requires that a change in the ownership interest of a subsidiary (without loss of control) is accounted for as a transaction with owners in their capacity as owners. Therefore, such transactions will no longer give rise to goodwill, nor will it give rise to a gain or loss. Furthermore, the amended standard changes the accounting for losses incurred by the subsidiary as well as the loss of control of a subsidiary. The changes by IFRS 3 (Revised) and IAS 27 (Amended) affect acquisitions or loss of control of subsidiaries and transactions with non-controlling interests after 1 January 2010.

Improvements to IFRS - May 2008 and April 2009

As part of the annual ''Improvements to IFRS'', in May 2008 and April 2009 the IASB issued an omnibus of amendments to its standards, primarily with a view to removing inconsistencies and clarifying wording. They comprised amendments that result in accounting changes for presentation, recognition or measurement purposes as well as terminology or editorial amendments related to a variety of individual IFRS standards. They were effective for annual periods beginning on or after 1 January 2009 (already adopted in 2009), 1 July 2009 or 1 January 2010 and had no impact on the accounting policies, financial position or performance of the Bank.

b) New standards and amendments to standards not yet adopted

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2010, and have not been applied in preparing these Consolidated Financial Statements. Relevant to the Bank's reporting are:

IFRS 9 *Financial Instruments*. In November 2009, the IASB issued IFRS 9 *Financial instruments*, which includes new classification and measurement criteria for financial assets. The publication of IFRS 9 represents the completion of the first part of a multi-stage project to replace IAS 39 *Financial instruments: recognition and measurement*. Under the revised guidance, a financial asset is to be accounted for at amortized cost only if it is held within a business model whose objective is to hold assets in order to collect contractual cash flows and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Non-traded equity instruments may be accounted for at fair value, with unrealised and realised fair value gains recognised through other comprehensive income, but the subsequent release of amounts booked directly to other comprehensive income to profit or loss is no longer permitted. All other financial assets are measured at fair value through profit or loss. The Bank is currently assessing the impact of the new standard on its consolidated financial statements. If endorsed by the EU, the effective date for mandatory adoption is 1 January 2013.

33. Segment reporting

The Bank's segmental reporting is based on the management and internal reporting structure. The Bank comprises two main business segments; Corporate Banking & Capital Markets and Retail Banking.

Notes to the Consolidated Financial Statements

34. Critical accounting estimates and judgements in applying accounting policies

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

These disclosures supplement the risk management disclosures, provided elsewhere in these consolidated financial statements.

Key sources of estimation uncertainty

i) Impairment losses on loans and receivables

The Bank reviews its loan portfolios to assess impairment at least on a quarterly basis. In determining whether an impairment loss should be recorded in the Consolidated Statement of Comprehensive Income, the Bank makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

ii) Fair value of financial instruments

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques. Where valuation techniques (for example, models) are used to determine fair values, they are validated and periodically reviewed by qualified personnel independent of the area that created them. All models are certified before they are used, and models are calibrated to ensure that outputs reflect actual data and comparative market prices. To the extent practical, models use only observable data, however areas such as credit risk (both own and counterparty), volatilities and correlations require management to make estimates. Changes in assumptions about these factors could affect reported fair value of financial instruments.

iii) Assets classified as held for sale

The Bank classifies assets as held for sale if the assets are available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets and the sale is considered highly probable. For the sale to be highly probable management must be committed to sell the assets and be actively looking for a buyer, the assets must be actively marketed at a price that is reasonable in relation to their fair value and the sale is expected to be completed within one year. An extension of the period required to complete a sale does not preclude an asset or disposal group from being classified as held for sale if the delay is caused by events or circumstances beyond the Bank's control and there is sufficient evidence that the Bank remains committed to its plan to sell the assets or disposal groups.

When classifying assets as held for sale the Bank has determined that the requirements of IFRS 5 have been met.

As set out in note 21, disposal groups being legal entities acquired exclusively with view to resale are measured at the lower of carrying amount and fair values less costs to sell. For the most part, fair values at the date of classification of these legal entities were calculated using valuation models based on discounted future cash flows that incorporated significant non-market observable inputs and assumptions. The use of reasonably possible alternative inputs and assumptions to these models, in particular changes to the discount rate employed (representing the required rate of return on equity), would have a significant impact on the fair value of these disposal groups.

iv) Fair value of Investment Property

In Iceland, there is no third party that provides information on the market value of investment properties located in Iceland. As the market is relatively inactive and assets are often quite dissimilar it is difficult to obtain comparison. The international financial crises and the financial crisis in Iceland had significant influence on the real estate market in Iceland. The effects of that resulted in a relatively passive market and with disparate properties on the market it can be complicated to determine prices of recent market transactions of comparable properties. This being the case there is great uncertainty about the actual fair value of the properties.

v) Intangible assets

The value of intangible assets with indefinite useful lives is not amortised, but the assets are tested for impairment at least once a year.

Notes to the Consolidated Financial Statements

Changes within the Bank

35. Changes in ownership and capitalization of Arion Bank.

On 3 September 2009, the Resolution Committee of Kaupthing Bank, on behalf of Kaupskil ehf., signed an agreement with the Icelandic Ministry of Finance regarding capitalization and future ownership of Arion Bank Based on the agreement Kaupskil ehf. acquired a majority shareholding of 87% in Arion Bank. The remaining shareholding of 13% is held by the Icelandic State.

On 30 November 2009, the Resolution Committee of Kaupthing Bank, on behalf of Kaupskil ehf., approved the decision to acquire a 87% shareholding in Arion Bank.

Following an approval from FME, the annual shareholders' meeting of Arion Bank held 8 January 2010 approved the transfer of 87% of the Icelandic state shareholding to Kaupskil ehf.

These Consolidated Financial Statements reflect changes in capitalization following the changes in ownership of Arion Bank 8 January 2010.

Changes following shareholder approval 8 January 2010:

Assets	8.1.2010
Loans and receivables to customers	112,824
Bonds and debt instruments	(32,595)
Total Assets	80,229
Liabilities	
Due to credit institutions and Central Bank	(14,428)
Borrowings	61,252
Subordinated liabilities	29,543
Liabilities	76,367
Equity	
Share capital	(10,646)
Share premium	14,508
Total Equity	3,862
Total Liabilities and Equity	80,229

Following the agreement made on 8 January 2010 the Icelandic State received a capital return of 87% of its shareholding in Arion Bank equity, amounting to ISK 62,138 million. The Icelandic State provided Arion Bank with a ISK 29,543 million subordinated loan, as calculated 4% Tier 2 capital. Net payment of government bonds to the Icelandic State was ISK 32,595 million. After this transaction Kaupskil ehf. owned approximately 65% of total capital (equity and subordinated loans) and the Icelandic State approximately 35%.

With new shareholder and changes in capitalization the share capital was increased by ISK 66,000 million. The capital increase consists of the following transactions:

Capitalization	8.1.2010
ISK mortgage loans	6,584
Due to credit institutions and Central Bank	14,428
Corporate loans	28,770
Other loans	16,218
	66,000
Related funding agreement with Central Bank	
FX mortgage loans	38,094
ISK mortgage loans	23,158
Borrowings	(61,252)
	-

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

35. cont.

According to the agreement Arion Bank shall pay to the Icelandic State a special dividend amounting to ISK 6,500 million which shall be deducted from the retained earnings, by a way of single one time payment if the following conditions are met:

i) The Core Tier 1 ratio of Arion Bank has to be at least 12%.

ii) The Core Tier 1 ratio shall be calculated according to the audited annual accounts results of Arion Bank (year-end), the first accounts for this purposes being for operating year of 2010, and annually thereafter.

iii) For the purpose of this calculation ISK 6,5 billion of retained earnings are disregarded.

As these conditions were met at year-end 2010 the Bank will discuss with the Icelandic State an arrangement for this payment.

36. Acquisition of legal entities acquired exclusively with view to resale.

In order to secure assets placed as collateral against loans to customers the Bank was compelled to foreclose on several legal entities in 2010, the largest of which are set out below. These entities are deemed to be not significant in comparison to the activities of the Bank.

The Bank holds as a consequence 100% shareholdings in Langalína 2 ehf., B.M. Vallá ehf. and Fram foods hf. These legal entities were acquired exclusively with view to resale.

i) B.M. Vallá ehf.

B.M. Vallá ehf. was acquired 21 May 2010. The company has been one of the leading companies within the Icelandic construction industry producing concrete, tiles and stones and a variety of other building materials. B.M. Vallá ehf. was classified as a subsidiary when it was first acquired.

ii) Langalína 2 ehf.

Langalína 2 ehf. was acquired on 7 May 2010. The company holds a number of real estates in Iceland. Langalína 2 ehf. meets the criteria in IFRS 5 to be classified as a non-current asset and disposal group held for sale and has been accounted for as such in these Consolidated Financial Statements.

iii) Fram foods hf.

Fram foods hf. was acquired on 11 November 2010. The company specialises in production and sale of chilled seafood. Fram foods Group consists of companies operating in Iceland, Sweden, Finland, France and Chile. Fram foods hf. meets the criteria in IFRS 5 to be classified as a non-current asset and disposal group held for sale and has been accounted for as such in these Consolidated Financial Statements.

37. Changes in classification of legal entities acquired exclusively with view to resale.

The following legal entities acquired exclusively with view to resale were reclassified in the fourth quarter of 2010 from subsidiaries to non-current asset and disposal groups held for sale:

i) Subsidiaries of Hafrahlíd ehf., Hekla ehf., was sold in early 2011, and its affiliate Hekla fasteignir ehf. will be sold in the first half of 2011.

ii) Penninn á Íslandi ehf. which at year-end was held by the Bank's wholly owned private equity company Eignabjarg.

iii) B.M. Vallá ehf. which at year-end was held by the Bank's wholly owned private equity company Eignabjarg.

The Bank's equity holding in each of these entities rose in 2009 and 2010 through seizing the business as collateral against loans.

Notes to the Consolidated Financial Statements

38. Business combinations

Valitor Holding ehf.

Valitor Holding ehf. (Valitor) is the holding company of Valitor ehf. which holds a share in Visa Europe and provides all service to issuers of credit cards, i.e. banks and savings banks, in relation to credit card issuance and related payment transactions.

On 12 October 2010, the Bank received the approval of the FME to hold a controlling interest in Valitor. At year-end the Bank had a direct and indirect holding in total of 52.94%.

Prior to 12 October 2010, the Bank held 47.0% of Valitor which was recognised as an Investment in Associate. Consequently, the Bank has accounted for this business combination as a step acquisition. The fair value at 12 October 2010 of this previously held investment was ISK 3,889 million, which exceeded the previously equity-accounted book value of ISK 3,612 million. The amount of ISK 277 million, being the excess of the acquisition-date fair value over the book value of the previously held investment is included in Share of profit or loss of associates in the Consolidated Statement of Comprehensive Income.

The Bank has elected to measure the non-controlling interest in Valitor as disclosed in the Consolidated Statement of changes in Equity at fair value. The fair value of the non-controlling interest was estimated based on prices of recent transactions (to which the Bank has been a counterparty) in the acquiree's shares. Valitor is an unlisted company and as such no market information is available. Goodwill arising on this acquisition is disclosed in Note 79.

From the date the shareholding increased in Valitor the company has contributed ISK 184 million to the Net earnings attributable to the shareholders of the Bank. If the increase in shareholding of Valitor had taken place at the beginning of the year the Net earnings attributable to the shareholders of the Bank would have been ISK 36 million higher.

G-7 ehf.

G-7 ehf. became a subsidiary of the Bank on 1 November 2010. The legal entity holds investment properties in Iceland. Due to the current market condition the timing of the ultimate disposal is uncertain and the requirements of IFRS 5 to classify the asset as held for sale can therefore not be met. G-7 ehf. was classified as a subsidiary at year-end. G-7 ehf. is not significant compared to the activities of the Bank.

39. Disposal of legal entity acquired exclusively with view to resale.

The Bank sold its shareholding in two legal entities in 2010. The legal entities were acquired exclusively with view to resale in 2009. Due to the market condition the timing of the ultimate disposal of the assets was uncertain at year-end 2009 and the requirements of IFRS 5 to classify the assets as held for sale was not met. Thus these legal entities were classified as subsidiaries and included in the Consolidated Financial Statements for 2009. The Bank has recognised the resulting gain from these transactions in the Consolidated Statement of Comprehensive Income.

i) Penninn Holding 1 Oy

On 24 August 2010 the Bank sold its 100% shareholding in Penninn Holding 1 Oy. At the end of June 2010 this legal entity was considered to meet the requirements of IFRS 5 and was classified as non current assets and disposal groups classified as held for sale.

ii) Insomnia Ltd.

On 17 December 2010, the Bank’s subsidiary Icecorp Ltd. sold its 50.1% shareholding in Insomnia Ltd.

The results from the disposal of these entities is included in net earnings from discontinued operations net of tax.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Operating Segment Reporting

40. Segment information is presented in respect of the Bank's operating segments based on the Bank´s management and internal reporting structure. Segment performance is evaluated based on earnings before tax.

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

Segment capital expenditure is the total cost incurred during the year to acquire property and equipment and intangible assets.

Business segments

The Bank comprises two main business segments:

Corporate Banking and Capital Markets serve large enterprises, investors and institutional investors. The role of the division is to provide universal financial services and tailored services to meet the needs of each customer. Corporate Banking and Capital Markets is organized into seven divisions: Corporate Trading, FX and Fixed Income Trading, Equities Trading, Research, Legal and Archives, and Credit Management.

Retail Banking provides a comprehensive range of services, including advice on deposits and loans, savings, payment cards, pension savings, insurance, securities, funds and more. To maximize operational efficiency the branch network is divided into seven clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Customers of Retail Banking's 24 branches all around Iceland are over 100,000.

Other business segments are: Asset Management, Corporate Finance, Overhead, Risk Management, Finance, Legal, Operations, Corporate Development and activities of other non-core entities.

41. Summary of the Bank's business segments:

2010	Corporate Banking	Retail Banking	Other Divisions and Elimination	Total
Net interest income	13,551	8,963	(2,729)	19,785
Increase in value of loans and receivables	25,877	5,050	9,342	40,269
Impairment on loans and receivables	(12,533)	(5,414)	(8,840)	(26,787)
Changes in compensation instrument	-	-	(11,604)	(11,604)
Net fee and commission income	804	3,246	2,816	6,866
Net financial and FX income (expense)	(4,047)	1,831	3,577	1,361
Other income	537	1,431	3,764	5,733
Operating income	24,189	15,107	(3,673)	35,623
Operating expense	(2,333)	(9,876)	(6,083)	(18,292)
Earnings before tax	21,856	5,231	(9,756)	17,331
Net segment revenue from external customers	33,605	9,193	(7,175)	35,623
Net segment revenue from other segments	(9,415)	5,913	3,502	-
Operating income	24,190	15,106	(3,673)	35,623
Depreciation and amortisation	1	290	528	819
Total assets	273,502	233,288	305,825	812,615
Allocated equity	(43,760)	(35,233)	(30,543)	(109,536)

The vast majority of the revenues from external customers was attributable to customers in Iceland.

Amounts are in ISK millions. 87

Notes to the Consolidated Financial Statements

41. cont.

2009	Corporate Banking	Retail Banking	Other Divisions and Elimination	Total
Net interest income	7	8,683	3,498	12,189
Increase in value of loans and receivables	14,508	213	5,478	20,199
Impairment on loans and receivables	(8,667)	(1,801)	529	(9,939)
Changes in compensation instrument	-	-	(10,556)	(10,556)
Net fee and commission income	1,117	1,751	2,994	5,862
Net financial and FX income (expense)	(33)	785	9,600	10,352
Other income	9	1,416	2,333	3,758
Operating income	6,941	11,047	13,876	31,865
Operating expense	(1,656)	(8,300)	(5,390)	(15,346)
Earnings before tax	5,286	2,747	8,486	16,519
Net segment revenue from external customers	29,223	(12,686)	15,328	31,865
Net segment revenue from other segments	(22,282)	23,734	(1,452)	-
Operating income	6,941	11,047	13,876	31,865
Depreciation and amortisation	1	278	481	759
Total assets	540,459	137,364	79,521	757,344
Allocated equity	75,470	14,671	(107)	90,034

Segment reporting for 2009 has been restated due to a change in the composition of reportable segments in 2010.

The vast majority of the revenues from external customers was attributable to customers in Iceland.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Notes to the Consolidated Statement of Comprehensive Income

Net interest income

42. Interest income and expense is specified as follows:

2010	Interest income	Interest expense	Net interest income
Cash and balances with Central Bank	937	-	937
Loans, receivables and deposits	38,004	28,222	9,782
Borrowings	-	2,683	(2,683)
Subordinated liabilities	-	1,250	(1,250)
Securities	11,320	-	11,320
Compensation instrument	1,256	-	1,256
Other	852	429	423
Interest income and expense	52,369	32,584	19,785
Interest income and expense from assets and liabilities at fair value	11,320	-	11,320
Interest income and expense from assets and liabilities not at fair value through profit or loss	41,049	32,584	8,465
Interest income and expense	52,369	32,584	19,785

2009			
Cash and balances with Central Bank	2,793	-	2,793
Loans, receivables and deposits	45,408	53,060	(7,652)
Borrowings	-	1,564	(1,564)
Securities	10,934	17	10,917
Compensation instrument	2,411	-	2,411
Other	5,359	76	5,283
Interest income and expense	66,905	54,717	12,188
Interest income and expense from assets and liabilities at fair value	10,934	17	10,917
Interest income and expense from assets and liabilities not at fair value through profit or loss	55,971	54,700	1,271
Interest income and expense	66,905	54,717	12,188

Increase in value of loans and receivables

43. The increase in value of loans and receivables is determined in accordance with the accounting policy presented in note 8 a). Increase in book value of loans and receivables consists of adjustment to reflect actual and estimated cash flows.

Impairment on loans and receivables

44. Impairment on loans and receivables is specified as follows:

	2010	2009
Impairment on loans and receivables to credit institutions	632	682
Impairment on loans and receivables to customers	25,985	8,317
Impairment on receivables and other assets	170	940
Impairment	26,787	9,939

Further information on the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in note 111 c).

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Net fee and commission income

45. Fee and commission income and expense is specified as follows:

2010	At fair value through profit or loss	Not at fair value through profit or loss	Trust and other fiduciary activity	Total
Fee and commission income				
Securities trading	-	-	189	189
Derivatives	169	-	-	169
Lending and guarantees	-	540	-	540
Asset management fees	-	-	2,582	2,582
Other fee and commission income - banking activities	-	-	6,364	6,364
Other fee and commission income	-	-	529	529
Fee and commission income	169	540	9,664	10,373
Fee and commission expense				
Securities trading	-	-	201	201
Asset management fees	-	-	199	199
Other fee and commission income - banking activities	-	-	2,961	2,961
Other fee and commission expense	-	-	146	146
Fee and commission expense	-	-	3,507	3,507
Net fee and commission income	169	540	6,157	6,866

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

The Bank has a service level agreement providing back office services for mortgage loans with fee income ISK 527 (2009: 179)

2009	At fair value through profit or loss	Not at fair value through profit or loss	Trust and other fiduciary activity	Total
Fee and commission income				
Securities trading	-	-	285	285
Derivatives	373	-	-	373
Lending and guarantees	-	622	-	622
Asset management fees	-	-	2,968	2,968
Other fee and commission income - banking activities	-	-	3,476	3,476
Other fee and commission income	-	-	567	567
Fee and commission income	373	622	7,296	8,291
Fee and commission expense				
Securities trading	-	-	170	170
Asset management fees	-	-	637	637
Other fee and commission income - banking activities	-	-	1,324	1,324
Other fee and commission expense	-	-	298	298
Fee and commission expense	-	-	2,429	2,429
Net fee and commission income	373	622	4,867	5,862

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Net financial income

46. Net financial income is specified as follows:

	2010	2009
Dividend income	34	29
Net gain (loss) on financial assets and liabilities classified as held for trading	(531)	1,240
Net gain (loss) on financial assets and liabilities designated at fair value through profit or loss	899	369
Net financial income	402	1,638

47. Dividend income is specified as follows:

Dividend income on trading assets	2	20
Dividend income on assets designated at fair value through profit or loss	32	9
Dividend income	34	29

48. Net gain (loss) on trading portfolio are specified as follows:

Net gain (loss) on equity instruments and related derivatives	251	279
Net gain (loss) on interest rate instruments and related derivatives	(1,038)	194
Net gain (loss) on other derivatives	256	767
Net gain (loss) on trading portfolio	(531)	1,240

49. Net gain (loss) on assets/liabilities designated at fair value through profit or loss are specified as follows:

Net gain (loss) on interest rate instruments designated at fair value	(119)	230
Net gain (loss) on equity instruments designated at fair value	1,018	139
Net gain (loss) on assets/liabilities designated at fair value through profit and loss	899	369

50. At the beginning of February 2011, the FME ruled in dispute between Arion Bank and Drómi to decrease the interest margin on the Drómi bond. The bond has been held at fair value in the Banks accounts since it was received in connection with the acquisition of the deposits from SPRON in March 2009. At the time the interest rate was REIBOR + 175 bps but the ruling of the FME was for the interest rate to be REIBOR flat, effective 1 July, 2010. The Bank will use every endeavour to have this ruling altered.

51. Net gain (loss) on foreign exchange are specified as follows:

	2010	2009
FX gain (loss) on loans and receivables	(7,658)	15,059
FX gain (loss) on bank accounts	(6,370)	2,305
FX gain (loss) from deposits and borrowings	17,407	(9,597)
FX gain (loss) from subordinated liabilities	4,401	-
FX gain (loss) on bonds, equity and derivatives	(21)	445
FX gain (loss) from compensation instrument	(1,852)	1,373
FX gain (loss) on other assets and liabilities	(1,448)	(870)
Total gain (loss) on foreign exchange	4,459	8,715

Amounts are in ISK millions. 91

Notes to the Consolidated Financial Statements

Other operating income

52. Other operating income is specified as follows:

	2010	2009
Rental income from investment properties	2,050	1,183
Fair value changes on investment property	69	170
Realised gain on investment property	121	70
Earned premiums, net of reinsurance	851	822
Net gain on disposals of assets other than held for sale	578	44
Other income	1,508	1,100
Other operating income	5,177	3,389

53. Earned premiums, net of reinsurance:

Premium written	994	988
Outward reinsurance premiums	(99)	(96)
Change in the gross provision for unearned premiums	(44)	(70)
Earned premiums, net of reinsurance	851	822

Personnel

54. The Bank's total number of employees is as follows:

	2010	2009
Average number of full time equivalent positions during the year	1,201	1,177
Full time equivalent positions at the end of the year	1,260	1,157

Included in the average number of full time equivalent are Kaupthing Bank's employees, total of 33 in the year 2009. At the end of the year no Kaupthing Bank's employee is included in the number of full time equivalent positions. During 2010 154 employees were added to the total number of employees from new subsidiaries.

Number of employees in core operations is as follows:

	2010	2009
Average number of full time equivalent positions during the year	1,125	1,126
Full time equivalent positions at the end of the year	1,177	1,091

55. Salaries and related expense are specified as follows:

Salaries	7,269	6,489
Defined contribution pension plans	981	732
Salary related expense	1,022	852
Salaries and related expense	9,272	8,073

Included in the total amount of salaries and related expenses in 2009 are salaries of Kaupthing Bank employees amounting to ISK 309 million.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

56. Compensation of the key management personnel:

Salaries and related cost:

2010

	Position	Period	
Finnur Sveinbjörnsson	CEO	01.01. - 31.05.2010	15.9
Höskuldur H. Ólafsson	CEO	01.06. - 31.12.2010	30.0
Colin C. Smith	Director	20.05. - 30.09.2010	1.6
Drífa Sigfúsdóttir	Director	01.01. - 18.03.2010	0.4
Erna Bjarnadóttir, Chairman	Director	01.01. - 18.03.2010	0.7
Gudrún Björnsdóttir	Director	18.03. - 31.12.2010	0.4
Gudrún Johnsen	Director	18.03. - 31.12.2010	5.0
Helga Jónsdóttir	Director	01.01. - 18.03.2010	0.4
Jón G. Briem	Director	18.03. - 31.12.2010	0.7
Jónína A. Sanders	Director	01.01. - 18.03.2010	0.4
Kristján Jóhannsson	Director	18.03. - 31.12.2010	3.3
Monica Caneman, Chairman	Director	18.03. - 31.12.2010	6.6
Steen Hemmingsen	Director	18.03. - 10.11.2010	2.7
Theodór S. Sigurbergsson	Director	18.03. - 31.12.2010	3.3
Kaupthing Bank*	Director	01.01. - 18.03.2010	0.8
Five managing directors of the Bank's divisions			109.9

2009

Finnur Sveinbjörnsson	CEO	01.01. - 31.12.2009	21.0
Audur Finnbogadóttir	Director	01.01. - 03.09.2009	1.1
Drífa Sigfúsdóttir	Director	01.01. - 31.12.2009	1.6
Erna Bjarnadóttir, Chairman	Director	01.01. - 31.12.2009	2.1
Helga Jónsdóttir	Director	01.01. - 31.12.2009	2.2
Hulda Dóra Styrmisdóttir, Chairman	Director	10.02. - 03.09.2009	1.7
Jónína A. Sanders	Director	03.09. - 31.12.2009	0.5
Magnús Gunnarsson, Chairman	Director	01.01. - 10.02.2009	0.4
Kaupthing Bank*	2 Directors	03.09. - 31.12.2009	1.2
Five managing directors of the Bank's divisions			80.1

The remuneration of the Chairman of the Board and the other directors of the Board was decided by a Shareholder´s meeting on 8 January 2010.

Remuneration to the Chairman of the Board, CEO and other key management personnel consist of salary and other benefits.

All compensation to key management personnel were short term employee benefits.

* Kaupthing Bank assigned two directors to the board of Arion Bank, Theodór S. Sigurbergsson and Jóhannes Rúnar Jóhannesson for the period 03.09.2009 - 18.03.2010.

Amounts are in ISK millions. 93

Notes to the Consolidated Financial Statements

Auditor's fee

57. Auditor's fee is specified as follows:

2010	Ernst & Young	KPMG	Total
Audit of the Financial Statements and other related audit service	124	76	200
Other service	0	8	8
Auditor's fee	124	84	208

2009			
Audit of the Financial Statements and other related audit service	60	38	98
Other service	18	28	46
Auditor's fee	78	66	144

Other operating expense

58. Other operating expenses:	2010	2009
Direct operating expenses (including repairs and maintenance) arising on rental-earning investment properties	449	256
Claims incurred, net of reinsurance	274	315
Other operating expenses	723	571

Information on the subsidiaries acquired exclusively with view to resale are in note 36.

59. Claims incurred, net of reinsurance:

Claims paid	279	317
Change in the provision for claims	117	(59)
Claims paid, net of reinsurers' share	(76)	97
Change in the provision for claims, reinsurers' share	(46)	(40)
Claims incurred, net of reinsurance	274	315

Net gain (loss) from discontinued operations net of tax

60. Net gain (loss) from discontinued operations net of tax are specified as follows:

Net earnings (loss) from legal entities	799	(705)
Impairment loss on remeasurement to fair value of legal entities	(2,629)	-
Impairment loss on real estates	(904)	(423)
Other assets	(286)	48
Effect of compensation instrument	2,017	-
Net gain (loss) on non-current and disposal groups assets classified as held for sale	(1,003)	(1,080)

Net earnings (loss) from legal entities comprises the revenues, expenses and income tax expense from operations of legal entities that were classified as held for sale by the end of 2010. Revenues, expenses and income tax expense of legal entities recognised as subsidiaries in 2009 (and included in relevant captions of the 2009 Consolidated Statement of Comprehensive Income) that were classified as held for sale during 2010 have been represented in the 2010 Consolidated Statement of Comprehensive Income within Net loss from legal entities for 2009 of amount ISK 705 million. The significant amounts represented were Other operating income of ISK 17,812 million; Other operating expense of ISK 15,708 million and Salaries expense of ISK 2,340 million.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Tax expense

61. Income tax recognised in the Consolidated Statement of Comprehensive Income are specified as follows:

	2010	2009
a) Current tax expense		
Current year	3,518	1,076
Deferred tax expense		
Changes in temporary differences	(37)	1,492
Total income tax expense	3,481	2,568

Reconciliation of effective tax rate:	2010		2009	
Earnings before income tax		17,331		16,519
Income tax using the Icelandic corporation tax rate	18.0%	3,120	15.0%	2,478
Non-deductible expense	0.3%	60	0.1%	9
Tax exempt revenues	(1.6%)	(283)	(0.8%)	(126)
Changes in deferred tax asset	4.7%	811	0.0%	-
Effect of increase in the income tax rate from 18% to 20% (2009; 15% to 18%)	0.4%	64	1.8%	297
Other changes	(1.7%)	(291)	(0.5%)	(89)
Effective tax rate	20.1%	3,481	15.6%	2,569

b) Bank Levy

Bank levy is calculated according to law. The levy is 0,041% on total debt at year-end. Non-financial subsidiaries are exempt from this tax.

Earnings per share

62. Earnings per share are specified as follows:

	2010	2009
Net earnings attributable to the shareholders of Arion Bank	12,178	12,933
Weighted average share capital:		
Weighted average number of outstanding shares for the year, million	2,207	12,646
Basic earnings per share	5.52	1.02
Diluted earnings per share	5.52	1.02
Number of outstanding shares at the end of the year, million	2,000	12,646
Number of total shares at the end of the year, million, diluted	2,000	12,646

There were no instruments at year-end that could potentially dilute basic earnings per share that were not included in the calculation of diluted earnings per share.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Notes to the Consolidated Statement of Financial Position

Cash and balances with Central Bank

63. Cash and balances with Central Bank are specified as follows:

	2010	2009
Cash on hand	9,609	3,536
Cash with Central Bank	13,250	28,521
Mandatory reserve deposits with Central Bank	7,769	9,849
Cash and balances with Central Bank	30,628	41,906

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

Loans and receivables to credit institutions

64. Loans and receivables to credit institutions specified by types of loans:

Bank accounts	57,707	24,037
Money market loans	1,294	4,733
Overdrafts	29	4,074
Other loans	10,175	6,353
Provision on loans and receivables	(1,359)	(727)
Loans and receivables to credit institutions	67,846	38,470

65. Changes in the provision for losses on loans and receivables to credit institutions are specified as follows:

Balance at the beginning of the year	727	44
Provision for losses during the year	632	683
Balance at the end of the year	1,359	727

Loans and receivables to customers

66. Loans and receivables to customers specified by types of loans:

Overdrafts	37,390	31,673
Subordinated loans	499	17
Other loans and receivables	455,173	354,780
Provision on loans and receivables	(41,843)	(28,736)
Loans and receivables to customers	451,219	357,734

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

67. Loans and receivables to customers specified by sectors:

	2010	2009
Individuals	24.7%	15.5%
Financial and insurance activities	14.1%	14.8%
Manufacturing, mining and other industry	13.3%	16.1%
Real estate activities	13.0%	17.4%
Agriculture, forestry and fishing	11.1%	11.8%
Wholesale and retail trades, transport, accomodation and food service activities	9.9%	4.3%
Business services	8.3%	12.2%
Construction	2.4%	5.3%
Public administration, defence, education, human health and social work activities	1.8%	1.3%
Other services	1.4%	1.3%
Loans and receivables to customers	100.0%	100.0%

68. Changes in the provision for losses on loans and receivables to customers are specified as follows:

	2010	2009
Balance at the beginning of the year	28,736	18,905
Provision for losses and write-offs during the year	13,277	9,852
Payment of loans previously written off	(170)	(21)
Balance at the end of the year	41,843	28,736
Specific	39,083	28,736
Collective	2,760	-
	41,843	28,736

Further information about the unrealisable FX gains from FX denominated loans to borrowers with ISK income are in note 111 c).

69. Impaired loans and receivables to customers by sector:

	2010		2009	
	Impaired amount	Impaired loans	Impaired amount	Impaired loans
Individuals	5,472	35,118	1,201	8,058
Financial and insurance activities	4,673	24,228	6,934	20,990
Manufacturing, mining and other industry	2,136	19,095	2,466	18,207
Real estate activities	7,568	48,686	6,303	47,333
Agriculture, forestry and fishing	2,606	22,184	1,941	14,333
Wholesale and retail trades, transport, accomodation and food service activities	3,294	28,604	1,814	7,571
Business services	10,562	45,022	4,197	32,296
Construction	2,349	9,501	840	6,198
Public administration, defence, education, human health and social work activities	77	2,558	868	4,845
Other services	346	2,538	2,172	16,687
Impairment on loans and receivables to customers	39,083	237,534	28,736	176,518

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Renegotiated loans

70. During 2009 and 2010 Arion Bank has engaged in financial restructuring of customers that are experiencing financial difficulties. For a detailed discussion of the Bank's recovery processes, see Note 108 b).

Starting in December 2009, the Bank has run a comprehensive program of standard solutions to assist individuals who have run into financial difficulties. These programs are now closed. Through the programs, the Bank reduced the debt level of 2346 individuals by an average of 27%.

Per an agreement between the government and lending institutions, the Bank participates in a coordinated effort to assist SMEs that are experiencing financial difficulties. The Bank engages companies on a case-by-case basis using a transparent set of standard procedures. To date, the debt restructuring of 270 companies has been finalized. The total nominal value post restructuring is 128 bn ISK, some of which is subordinated debt on which the Bank has taken a 23,5 bn ISK provision. In some instances the Bank has taken an equity stake in a company.

The Bank predicts that it will complete all of its restructuring activities in 2011.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Financial assets and liabilities

71. Financial assets and liabilities are specified as follows:

2010	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
Cash and balances with Central Bank	30,628	-	-	-	30,628
Loans to credit institutions	67,846	-	-	-	67,846
Loans to customers	451,219	-	-	-	451,219
Loans and receivables	549,693	-	-	-	549,693
Bonds and debt instruments					
Listed	-	4,731	41,833	-	46,564
Unlisted	-	20	73,528	-	73,548
Bonds and debt instruments	-	4,751	115,361	-	120,112
Shares and equity instruments with variable income					
Listed	-	12	2,062	-	2,074
Unlisted	-	612	5,451	-	6,063
Bond funds with variable income	-	360	1,819	-	2,179
Shares and equity instruments	-	984	9,332	-	10,316
Derivatives					
OTC derivatives	-	1,126	-	-	1,126
Derivatives	-	1,126	-	-	1,126
Securities used for hedging					
Bonds and debt instruments	-	3,213	-	-	3,213
Securities used for hedging	-	3,213	-	-	3,213
Compensation instrument	-	-	24,188	-	24,188
Other financial assets	-	-	-	16,688	16,688
Financial assets	549,693	10,074	148,881	16,688	725,336
Liabilities at amortised cost					
Due to credit institutions and Central Bank	-	-	-	95,646	95,646
Deposits	-	-	-	457,881	457,881
Borrowings	-	-	-	65,278	65,278
Subordinated liabilities	-	-	-	26,257	26,257
Liabilities at amortised cost	-	-	-	645,062	645,062
Financial liabilities at fair value					
Short position in bonds held for trading	-	923	-	-	923
Derivatives held for trading	-	76	-	-	76
Financial liabilities at fair value	-	999	-	-	999
Other financial liabilities	-	-	-	34,048	34,048
Financial liabilities	-	999	-	679,110	680,109

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

71. cont.

2009	Loans and receivables	Trading	Designated at fair value	Financial assets/ liabilities at amort. cost	Total
Loans and receivables					
Cash and balances with Central Bank	41,906	-	-	-	41,906
Loans to credit institutions	38,470	-	-	-	38,470
Loans to customers	357,734	-	-	-	357,734
Loans and receivables	438,110	-	-	-	438,110
Bonds and debt instruments					
Listed	-	4,221	4,614	-	8,835
Unlisted	-	-	164,647	-	164,647
Bonds and debt instruments	-	4,221	169,261	-	173,482
Shares and equity instruments with variable income					
Listed	-	709	429	-	1,138
Unlisted	-	1,464	3,380	-	4,844
Bond funds with variable income	-	320	776	-	1,096
Shares and equity instruments	-	2,493	4,585	-	7,078
Derivatives					
OTC derivatives	-	6	-	-	6
Derivatives	-	6	-	-	6
Securities					
Bonds and debt instruments	-	2,236	-	-	2,236
Securities	-	2,236	-	-	2,236
Compensation instrument	-	-	34,371	-	34,371
Other financial assets	-	-	-	9,230	9,230
Financial assets	438,110	8,956	208,217	9,230	664,513
Liabilities at amortised cost					
Due to credit institutions and Central Bank	-	-	-	113,647	113,647
Deposits	-	-	-	495,465	495,465
Borrowings	-	-	-	11,042	11,042
Liabilities at amortised cost	-	-	-	620,154	620,154
Financial liabilities at fair value					
Derivatives held for trading	-	88	-	-	88
Financial liabilities at fair value	-	88	-	-	88
Other financial liabilities	-	-	-	15,262	15,262
Financial liabilities	-	88	-	635,416	635,504

Included in unlisted Bonds and debt instruments designated at fair value is Drómi bond, which the Bank received when acquiring deposits from Spron in March 2009.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

72. Bonds and debt instruments designated at fair value specified by issuer:

	2010	2009
Financial institutions	74,626	94,307
Public	40,393	73,048
Corporates	342	1,906
Bonds and debt instruments designated at fair value	115,361	169,261

The total amount of pledged bonds at 31 December 2010 was ISK 20,005 million (31 December 2009: Nil). Pledged bonds at year-end comprised Icelandic Government Bonds that were pledged against funding received and included in Due to credit institutions and Central Bank.

73. Fair value hierarchy

The Bank uses the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:

Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;

Level 2: other techniques for which all inputs which have a significant effect on the recorded fair value are observable, either directly or indirectly; and

Level 3: techniques which use inputs which have a significant effect on the recorded fair value that are not based on observable market data.

The following table shows an analysis of financial instruments recorded at fair value by level of the fair value hierarchy:

2010	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL	3,063	119,962	1,668	124,693
Financial assets held for trading	7,956	2,098	20	10,074
Compensation instrument	-	-	24,188	24,188
	11,019	122,060	25,876	158,955
Financial liabilities held for trading	-	999	-	999

2009	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL	2,215	168,953	2,678	173,846
Financial assets held for trading	7,166	1,790	-	8,956
Compensation instrument	-	-	34,371	34,371
	9,381	170,743	37,049	217,173
Financial liabilities held for trading	-	88	-	88

The classification of assets between financial assets designated at fair value through profit or loss and financial assets held for trading in 2009 is in consistency with the classification used in 2010.

The Compensation Instrument is classified within Level 3 as its value is based on the value of predefined loans for which market information is mostly unobservable. Valuation techniques used for the pool of assets involve estimation of future cash flow as explained in note 109 a. The contract provides Kaupthing the right to receive from the Bank 80% of the uplift of the predefined loans up to the initial value of the Compensation Instrument (ISK 38bn) and 50% of the uplift of the predefined loans thereafter up to a maximum amount of ISK 5 billion.

The Bank's fair value model takes into consideration the movement in the value of the pre-defined loans recognised in the current Consolidated Statement of Financial Position. The Bank estimates that the fair value attributable to future volatility in the predefined loan book valuation is not significant

Amounts are in ISK millions. 101

Notes to the Consolidated Financial Statements

73. cont.

The following table shows transfers between Level 1 and Level 2 on the fair value hierarchy for financial assets and financial liabilities which are recorded at fair value:

	Transfers from Level 1 to Level 2	
Financial assets	2010	2009
Financial assets designated at FV through PL	1,146	24

The above financial assets were transferred from Level 1 to Level 2 as they have ceased to be actively traded during the year and fair values were consequently obtained using valuation techniques using observable market inputs. There have been no transfers from Level 2 to Level 1 in 2010 and 2009.

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

Methods for establishing fair value

Level 1: Fair value established from quoted market prices

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

In some cases, the carrying value of the financial instrument in Note 71 is used as an approximation for the fair value of the instrument. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Bank to little or no credit risk.

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

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

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

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

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

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

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

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

Notes to the Consolidated Financial Statements

73. cont.

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

Movements in level 3 financial instruments measured at fair value

The level of the fair value hierarchy of financial instruments is determined at the beginning of each reporting period. The following table shows a reconciliation of the opening and closing amounts of level 3 financial assets and liabilities which are recorded at fair value.

The following table shows the movements of Level 3 financial assets and liabilities (excluding the Compensation Instrument):

	2010	2009
Balance at the beginning of the year	2,678	2,990
Gain (losses) recognised in consolidated statement of comprehensive income	(1,348)	(731)
Purchases	376	714
Sales	(18)	(295)
Balance at the end of the year	1,688	2,678

The following table shows the line items in the consolidated statement of comprehensive income where gain (losses) related to fair value measurements in Level 3 are recognised:

	2010	2009
Net interest income	18	24
Net financial income (expense)	(1,223)	(878)
Net foreign exchange gain (loss)	(143)	123
Gain (losses) recognised in the consolidated statement of comprehensive income	(1,348)	(731)

The following table presents the carrying amounts and fair values of financial assets and liabilities that are not carried at fair value in the financial statements. This table does not include the fair values of non-financial assets and non-financial liabilities.

Financial assets not carried at fair value	Carrying value	Fair value	Un-recognised gain (loss)
Cash and balances with Central bank	30,628	30,628	-
Loans and receivables to credit institutions	67,846	67,846	-
Loans and receivables to customers	451,219	451,219	-
Other financial assets	16,688	16,688	-
	566,381	566,381	-
Financial liabilities not carried at fair value			
Due to credit institutions and Central bank	95,646	95,646	-
Deposits	457,881	457,881	-
Borrowings	65,278	65,219	59
Subordinated loans	26,257	26,257	-
Other financial liabilities	34,048	34,048	-
	679,110	679,051	59

Net unrecognised gain not recognised in the Consolidated Statement of Comprehensive Income	59

As financial assets and financial liabilities predominantly bear interest at floating rates, the difference between book value and fair value of financial assets and financial liabilities is deemed to be immaterial.

Amounts are in ISK millions. 103

Notes to the Consolidated Financial Statements

Compensation instrument

74. The compensation instrument is 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 amounted to ISK 38,300 million and was denominated 50% in ISK and 50% in EUR and is subject to floating rates of interest. The maturity of this instrument is 30 June 2012 and is a priority claim against Kaupthing Bank.

Compensation instrument is specified as follows:	2010	2009
Balance at the beginning of the year	34,371	41,156
Changes due to the Escrow and Contingent Value Rights Agreement		
Continuing operations	(11,604)	(10,556)
Discontinued operations	2,017	-
Accrued interest	1,256	2,398
Foreign exchange rate differences	(1,852)	1,373
Balance at the end of the year	24,188	34,371

Related to the compensation instrument is the Escrow and Contingent Value Rights Agreement where Kaupthing Bank receives 80% of the appreciation of defined Arion Bank's loans (the "ring-fenced assets"). The increase in value of the defined loans will 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 compensation instrument) then 50% of the increase in value of ring-fenced assets above the amount needed for closing the compensation instrument will be passed onto Kaupthing Bank up to a cap of ISK 5 billion.

During 2010 changes in those defined assets amounted to ISK 11,890 million, 80% of this increased value belonging to Kaupthing Bank, ISK 9,587 million as presented in the Consolidated Statement of Comprehensive Income, 20% belonging to Arion Bank as a part of the Consolidated Statement of Comprehensive Income. The total face value of the defined loans was approximately ISK 850,000 million and the book value was approximately ISK 225,000 million at year-end.

The Bank holds a guarantee in specific assets of Kaupthing Bank against the total balance of the compensation instrument. This guarantee is a priority claim against Kaupthing Bank.

Investment property

75. Investment property are specified as follows:	Investment properties	Investment properties in progress	Total 2010	2009
Balance at the beginning of the year	18,069	4,878	22,947	12,079
Acquisition through business combination	3,000	-	3,000	7,832
Additions during the year	1,171	2,348	3,519	3,289
Disposals during the year	(424)	(1,137)	(1,561)	(423)
Fair value adjustments	(265)	2	(263)	170
Investment property	21,551	6,091	27,642	22,947

Investement properties were carried at estimated fair value at year-end in accordance with the accounting policy in note 19.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Investments in associates

76. The Bank´s interest in its principal associates are as follows:

	2010	2009
Audkenni hf. Engjateigur 3, 105 Reykjavík, Iceland	20.0%	25.0%
Borgarland ehf., Egilsholt 1, 310 Borgarnes, Iceland	42.0%	-
Farice ehf.,Smáratorg 3, 201 Kópavogur, Iceland	43.5%	-
Hótel Borgarnes hf., Egilsgata 16, 310 Borgarnes, Iceland	20.6%	-
KB rádgjöf ehf. Hlídarsmári 17, 201 Kópavogur, Iceland	43.1%	43.1%
Kríuvarp ehf., Borgartún 35, 105 Reykjavík, Iceland	25.0%	-
Reiknistofa Bankanna Kalkofnsvegur 1, 150 Reykjavík, Iceland	21.7%	18.0%
Reitir fasteignafélag hf., Kringlan 4-12, 103 Reykjavík, Iceland	42.7%	42.7%
Ölgerdin Egill Skallagrímsson ehf., Grjótháls 7-11, 110 Reykjavík, Iceland	20.0%	-
Valitor holding hf., Laugavegur 77, 101 Reykjavík, Iceland	-	38.0%

Investment in associates are specified as follows:

Carrying amount at the beginning of the year	5,985	2,843
Acquisition through business combination	108	2
Additions during the year	7	2,941
Sold during the year	(54)	(153)
Transferred from associates due to step acquisition	(3,889)	(17)
Share of profit (loss)	556	369
Carrying amount at the end of the year	2,713	5,985

Summarised financial information in respect of the Bank´s associates is set out below:

Total assets	113,296	71,238
Total liabilities	(95,176)	(58,953)
Net assets	18,120	12,285
Total revenue	13,116	4,178
Total profit in associates	2,489	763
Bank's share of profit of associates	556	369

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Property and equipment

77. Property and equipment are specified as follows:

	Real estate	Equip-ment	Total 2010	Total 2009
Balance at the beginning of the year	7,774	4,034	11,808	7,752
Acquisitions through business combination	14	405	419	3,986
Additions during the year	-	381	381	208
Disposals during the year	(77)	(250)	(327)	(138)
Disposals through the sale of a subsidiary	-	(977)	(977)	-
Transfers to assets held for sale	(1,944)	(788)	(2,732)	-
Gross carrying amount at the end of the year	5,767	2,805	8,572	11,808
Accumulated depreciation at the beginning of the year	180	928	1,108	95
Depreciation during the year	122	583	705	1,019
Disposals during the year	(5)	(173)	(178)	(6)
Disposals through the sale of a subsidiary	-	(274)	(274)	-
Transfers to assets held for sale	-	(154)	(154)	-
Accumulated depreciation at the end of the year	297	910	1,207	1,108
Property and equipment	5,470	1,895	7,365	10,700

The official real estate value amounts to ISK 5,748 million at year-end. The insurance value of real estate amounts to ISK 9,189 million at year-end.

78. Depreciation and amortisation in the Consolidated Statement of Comprehensive Income is specified as follows:

	2010	2009
Depreciation of property and equipment	705	617
Amortisation of intangible assets	114	142
Depreciation and amortisation	819	759

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Intangible assets

79. The intangible assets are related to different business segments in the Bank's operation. They comprise a credit card portfolio, insurance contract agreements, assets under management and custody contracts.

Intangible assets are specified as follows:

2010	Indefinite life intangible assets	Software	Total
Balance at the beginning of the year	2,356	1,156	3,512
Acquisition through business combination	-	17	17
Additions during the year	2,124	121	2,245
Disposals through the sale of a subsidiary	(257)	(576)	(833)
Transfers to assets held for sale	-	(225)	(225)
Impairment	(250)	-	(250)
Amortisation	-	(114)	(114)
Intangible assets	3,973	379	4,352

2009			
Balance at the beginning of the year	2,075	357	2,432
Acquisition through business combination	282	813	1,095
Additions during the year	24	128	152
Impairment	(25)	-	(25)
Amortisation	-	(142)	(142)
Intangible assets	2,356	1,156	3,512

The Bank performed its annual impairment test at 31 December 2010 of intangible assets with indefinite life. The recoverable amount of the largest intangible assets was determined based on a value in use calculation using cash flow projections from approved financial budgets covering a five year period. For Asset Management activities, the discount rate applied to cash flow projections was 10.8% (2009: 14.3%) and cash flows beyond the five-year period were extrapolated using a 5% growth rate (2009: 5%). As a result of this analysis no impairment was recognised for Asset Management in 2010. With regard to the Custody Service, due to a reduction in the scope of its activities, an impairment charge of ISK 250 million was recognised to fully impair the intangible asset. This is recorded within Administration expense in the Consolidated Statement of Comprehensive Income.

Non-current assets and disposal groups held for sale

80. Non-current assets and disposal groups held for sale are specified as follows:

	2010	2009
Legal entities	41,927	38,922
Real estates	2,456	2,570
Other assets	81	35
Non-current assets and disposal groups held for sale	44,464	41,527

The legal entities were acquired exclusively with view to resale and are classified as disposal groups held for sale in accordance with IFRS 5. At year-end the largest entities were BM Vallá ehf., Fram Foods hf., Hagar hf., Hafrahlíd ehf. and subsidiaries, Langalína 2 ehf., Penninn á Íslandi ehf. and Rekstrarfélag tíu-ellefu ehf.

Real estates and other assets classified as non-current assets are generally the result of foreclosures on companies and individuals. The official real estate value of real estates classified as non-current assets amounts to ISK 3.631 million at year-end. The insurance value amounts to ISK 4.575 million.

Liabilities associated with the legal entities held for sale are as follows:	2010	2009
Legal entities, total liabilities	13,514	19,230

Amounts are in ISK millions. 107

Notes to the Consolidated Financial Statements

Other assets

81. Other assets are specified as follows:

	2010	2009
Unsettled securities trading	366	1,583
Accounts receivable	14,312	7,647
Accrued income	802	376
Prepaid expenses	448	341
Sundry assets	1,208	236
Other assets from subsidiaries acquired exclusively with view to resale	-	5,792
Other assets	17,136	15,975

Unsettled securities trading was settled in less than three days from the reporting date.

82. Provision for other assets

During the year no impairment on accounts receivable and accrued income was made compared to ISK 940 million in 2009.

Borrowings

83. Borrowings are specified as follows:

	2010	2009
Bonds issued	7,156	-
Other loans	58,122	11,042
Borrowings	65,278	11,042

The Bank has not repurchased any of its own debt during the year (2009: Nil).

Interest of other loans is 3 month Libor +300 bps to the year 2015 and thereafter 3 month Libor +400 bps until 2019 when the loan expires.

The total book value of pledged loans at 31 December 2010 was ISK 74 billion (31 December 2009: Nil). Pledged loans at year-end comprised mortgage loans to individuals, loans to municipals and loans to state related entities (see Note 65) that were pledged against amounts borrowed.

Subordinated liabilities

84. Subordinated liabilities are specified as follows:

	2010	2009
Tier II capital	26,257	-
Subordinated liabilities	26,257	-

The interest on the loan is 3 month Euribor +400 bps to the year 2015 and thereafter 3 month Euribor +500 bps.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Tax assets and tax liabilities

85. Tax assets and liabilities are specified as follows:

	2010		2009	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	3,821	-	1,051
Deferred tax	295	633	1,415	1,790
Tax assets and liabilities	295	4,454	1,415	2,841

86. Deferred tax assets and liabilities are specified as follows:

2010	Assets	Liabilities	Net
Balance at the beginning of the year	1,415	(1,790)	(375)
Income tax recognised in profit or loss	(1,120)	1,157	37
Net tax assets and (liabilities)	295	(633)	(338)

2009			
Balance at the beginning of the year	551	(446)	105
Acquisition through business combination	1,005	-	1,005
Income tax recognised in profit or loss	39	(1,524)	(1,485)
Other changes	(180)	180	-
Net tax assets and (liabilities)	1,415	(1,790)	(375)

87. Changes in deferred tax assets and liabilities are specified as follows:

2010	At Jan. 1	Addition/ disposal during the year	Recognised in profit or loss	At Dec. 31
Foreign currency denominated assets and liabilities	(200)	-	(49)	(249)
Investment property and property and equipment	(16)	-	(123)	(139)
Other assets and liabilities	2	-	(39)	(37)
Deferred foreign exchange differences	(1,430)	-	892	(538)
Tax loss carry forward	1,269	-	(644)	625
Change in deferred tax	(375)	-	37	(338)

2009				
Foreign currency denominated assets and liabilities	(136)	-	(64)	(200)
Investment property and property and equipment	18	-	(34)	(16)
Other assets and liabilities	(3)	-	5	2
Deferred foreign exchange differences	-	-	(1,430)	(1,430)
Tax loss carry forward	226	1,012	31	1,269
Change in deferred tax	105	1,012	(1,492)	(375)

Amounts are in ISK millions. 109

Notes to the Consolidated Financial Statements

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

	31.12.2010		31.12.2009	
	Assets	Liabilities	Assets	Liabilities
Deferred tax related to foreign exchange gain	5	(543)	-	(1,430)
Foreign currency denominated assets and liabilities	-	(249)	-	(200)
Investment property and property and equipment	10	(149)	144	(160)
Other assets and liabilities	-	(37)	2	-
Tax loss carry forward	625	-	1,269	-
	640	(978)	1,415	(1,790)
Set-off of deferred tax assets together with liabilities of the same taxable entities	(345)	345	-	-
Deferred tax assets and liabilities	295	(633)	1,415	(1,790)

Derivatives

89. Derivatives fair value are specified as follows:

	Fair value	
2010	Assets	Liabilities
Currency and interest rate derivatives, agreements unlisted:		
Forward exchange rate agreements	2	-
Interest rate and exchange rate agreements	1,100	-
	1,102	-
Bond derivatives:		
Bond swaps, agreements unlisted	24	75
Derivatives	1,126	75
2009		
Currency and interest rate derivatives, agreements unlisted:		
Interest rate and exchange rate agreements	-	71
	-	71
Bond derivatives:		
Bond swaps, agreements unlisted	6	17
Derivatives	6	88

Other liabilities

90. Other liabilities are specified as follows:

	2010	2009
Accounts payable	24,704	1,524
Withholding tax	2,600	2,743
Deposit and investor guarantee fund	2,669	3,041
Insurance claim	1,992	1,847
Unsettled securities trading	110	1,134
Other liabilities from subsidiaries acquired exclusively with view to resale	-	6,557
Sundry liabilities	6,975	8,151
Other liabilities	39,050	24,997

Unsettled securities trading was settled in less than three days from the reporting date.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Equity

Share capital and share premium

91. According to the Parent Company's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as declared from time to time and are entitled to one vote per share at Shareholders' meetings of the Bank.

Issued share capital	Number (million)	2010	Number (million)	2009
At 1 January	12,646	72,000	12,646	72,000
Redeemed on 8 January	(12,386)	(62,139)	-	-
Issued on 8 January	1,740	66,000	-	-
	2,000	75,861	12,646	72,000

Share premium represents excess of payment above nominal value that Shareholders have paid for shares sold by the Bank.

On 8 January 2010 the Annual Shareholders' Meeting approved a transfer of 87% shareholding from the Icelandic State to Kaupskil hf. The impacts due to this agreement are described in note 35.

Other reserves

92. Other reserves are specified as follows:

	2010	2009
Statutory reserve	1,637	1,637
Foreign currency translation reserve	(112)	92
Other reserves	1,525	1,729

Off Balance Sheet information

Obligations

93. The Bank has granted its customers guarantees, unused overdraft and loan commitments. These items are specified as follows:

	2010	2009
Guarantees	11,675	15,318
Unused overdrafts	40,896	36,152
Loan commitments	13,946	21,859

The Bank estimates possible loss of ISK 1,645 million in relation to guarantees transferred from Kaupthing Bank. Should any of the guarantees default, Kaupthing Bank will pay compensation up to ISK 3,000 million to Arion Bank, agreement thereon was signed in September 2009.

94. Depositors' and Investors' Guarantee fund

According to Act No. 98/1999 on Deposit Guarantees and Investor Compensation Scheme the total assets of the Depositors' and Investors' Guarantee Fund shall amount to a minimum of 1% of the average amount of guaranteed deposits in the commercial bank concerned during the preceding year. In the event that total assets do not amount to the 1% minimum, all commercial banks shall contribute to the Fund an amount equivalent to 0.15% of the average of guaranteed deposits in the Bank during the preceding year. The Bank expensed ISK 324 million in 2010 and the liability to the Fund had a year-end balance of ISK 2,669 million, representing the net present value of the estimated future payments to the Fund over a five year period. The Bank has granted the Fund a guarantee for the total obligation amounting to ISK 3,364 million.

The Icelandic parliament is to discuss a bill on the Depositors' and Investors' Guarantee Fund which, if passed, would entail a substantial increase in the size of the fund and the banks' liabilities. There is still considerable uncertainty over what shape the proposed legislation will finally take and therefore a liability is not being recognised in the balance sheet. However, based on the current draft bill, Arion Bank's additional liability will be more than ISK 10 billion.

Notes to the Consolidated Financial Statements

Operating lease commitments

95. Bank as a lessee
The Bank has concluded lease agreements regarding some of the real estate it uses for its operations. These lease agreements are for a period of up to 30 years. The majority of the contracts include renewal options for various periods of time.

	2010	2009
Less than one year	213	166
Over 1 year and up to 5 years	644	393
Over 5 years	1,108	408
Minimum lease payments under non-cancellable leases	1,965	967

96. Bank as a lessor
The Bank has entered lease agreements on its investment properties and real estates. The lease agreements are for a period of up to 30 years, with majority being non-cancellable agreements. The future minimum lease payments under non-cancellable leases are as follows:

	2010	2009
Less than one year	1,975	1,505
Over 1 year and up to 5 years	5,715	4,405
Over 5 years	4,269	2,949
Minimum lease payments under non-cancellable leases	11,959	8,859

Assets under management and under custody

97. Assets under management and assets under custody are specified as follows:

Assets under management	618,062	580,523
Assets under custody	1,745,384	2,129,518

Contingent liabilities

98. Litigation is a common occurrence in the banking industry due to the nature of the business undertaken. Due to the current economic climate in Iceland the prospects of possible litigation against the Bank has become more likely. The Bank has formal controls and policies for managing legal claims. Once professional advice has been obtained and the amount of loss reasonably estimated, the Bank makes adjustments to account for any adverse effects which the claims may have on its financial standing. At year-end, the Bank had several unresolved legal claims.

There are two significant legal claims against the Bank;

First, a major client of Kaupthing Bank has, in the course of the company's restructuring process, filed three rescission actions against Arion Bank in the district court of Reykjavik relating to substantial transactions between the company and Kaupthing Bank. The claims are based on the argument that the company had in fact been bankrupt at the time of the payments and that Kaupthing Bank was a related party at the time. Arion Bank is of the opinion that the said claims have no substance and has opposed them in court. At the same time the Bank and the company are engaged in negotiations to end the dispute. The said claims have been filed recently and it is therefore very difficult to predict any outcome or developments. Should there be a ruling in favour of the company, the Bank intends to reclaim from Kaupthing Bank any amount it would be required to pay to the company on the basis of the said claims. Should there be a ruling in favour of the company, the Bank were to be deemed not to have a priority claim on the assets of Kaupthing Bank, then the losses for the Bank could be substantial. The Bank estimates the likelihood of this scenario to be minimal.

The other significant legal claim is in respect of a number of clients who have alleged that assets under management were improperly managed resulting in the clients suffering financial loss. Five of these claims have been taken to court of law but due to uncertainty of the court decision and amounts no provision for these claims has been made in these Consolidated Financial Statements.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Notes to the Cash Flow Statement

99. Operational cash flows from interest and dividends:

	2010	2009
Interest paid	30,809	53,337
Interest received	44,783	54,436
Dividend received	34	27

Interest paid includes interest credited to deposit accounts at year-end.

100. Non-cash items included in net earnings before income tax and other adjustments:

Increase in value of loans and receivables	(40,269)	(20,199)
Impairment on loans and other credit risk provisions	26,787	11,448
Compensation instrument, revaluation and accrued interest	8,331	8,158
Depreciation and amortisation	819	1,162
Impairment on other assets	250	25
Share of profit of associates	(557)	(369)
Investment property, fair value change	263	(170)
Indexation and foreign exchange difference	(4,458)	(10,205)
Net loss (gain) on financial assets and liabilities at fair value through profit or loss	3,132	(5,307)
Net loss (gain) on disposal of legal entities acquired exclusively with a view to resale	(579)	-
Net loss (gain) on disposal of property and equipment	39	(8)
Net loss (gain) on sale of associates	-	(39)
Net loss (gain) on non-current assets classified as held for sale	(144)	(375)
	(6,386)	(15,879)

101. Changes in operating assets and liabilities:

Mandatory reserve with Central Bank	2,080	(2,381)
Loans and receivables to credit institutions	520	21,215
Loans and receivables to customers	22,243	4,923
Financial assets measured at fair value	16,118	138
Shares and equity instruments with variable income	(1,280)	679
Derivatives	-	(6)
Securities used for hedging	(720)	-
Other assets	1,754	4,925
Due to credit institutions and Central Bank	(9,285)	(11,638)
Deposits	(20,511)	(52,622)
Borrowings	984	3,087
Subordinated loans	1,115	-
Financial liabilities at fair value	-	86
Other liabilities	(21,009)	(4,880)
	(7,991)	(36,474)

102. Cash and cash equivalents at the end of the year:

Cash in hand and demand deposits	30,628	41,906
Due from credit institutions	49,938	24,037
Mandatory reserve with Central Bank	(7,769)	(9,849)
Cash and cash equivalents at year-end	72,797	56,094

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Risk Management Disclosures

Introduction

The Group faces various risks in its business activities, the most important being credit risk, liquidity risk and currency risk that are to the largest extent encountered within the parent company. Subsidiaries bear risk arising from real estate market and private equity prices and from asset management and insurance activities. Managing risk is a core activity within the Group, the Group manages its risks through a process of ongoing 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 Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels. The management of risks encountered within subsidiaries is carried out within each subsidiary. Arion bank's risk management structure, strategy and risk exposures are addressed in the notes below.

103. Risk management structure

Board of Directors

The Board of Directors is ultimately responsible for the Group's risk management framework and ensuring that satisfactory risk management processes and policies for controlling the Group's risk exposure are in place. The Board of Directors allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board of Directors set the Risk Appetite. The Risk Appetite is translated into exposure limits and targets that are monitored by the Bank's Risk Management department, which reports its findings regularly to the Board of Directors. Risk is measured, monitored and reported according to internal policies, principles and processes that are reviewed and approved by the Board of Directors at least annually. The Board of Directors are also responsible for the Bank's Internal Capital Adequacy Assessment Process (ICAAP).

CEO

The Chief Executive Officer 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, making risk everyone's business.

The CEO of Arion Bank and all members of the Arion Bank Board of Directors are subject to a fit and proper examination by the FME.

Committee structure

The Bank operates several committees to manage risk. The Board Audit and Risk Committee (BARC) 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. The Asset and Liability Committee (ALCO), chaired by the CEO, is responsible for managing asset-liability mismatch, liquidity risk, market risk, interest rate risk and capital management. The Bank operates four credit committees. The highest authority in credits is the Board Credit Committee which decide on all major credit risk exposures. The next highest credit granting authority is the Arion Bank Credit Committee (ACC) which operates within limits specified as a fraction of the Bank’s capital. The ACC is chaired by the CEO. Corporate Banking and Retail Banking operate their individual credit committees with tighter credit granting limits. The Bank also operates two temporary recovery committees that are focused on recovery cases, one for Corporate Banking and the other for Retail Banking. The recovery committees have authority to approve credit and write-offs, within their limits, in connection with recovery.

Risk Management

The Bank’s Risk Management Department is headed by the CRO. It is independent and centralized and reports directly to the CEO. The CEO and the Board of Directors are responsible for defining and articulating a Risk Appetite for the Bank’s operations. The CRO and Risk Management are responsible for monitoring that the Bank is operating according to the Risk Appetite.

Internal Audit

The Bank's Internal Audit conducts independent reviews of the Bank's operations, risk management framework, processes, policies and measurements. Internal Audit examines 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 discusses its results with management and reports its findings and recommendations to the Board Audit and Risk Committee.

104. Organization of the Risk Management Department

The Risk Management Department 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 Internal Capital Adequacy Assessment Process (ICAAP) and Operational Risk which monitors risks associated with the daily operation of the Bank.

Notes to the Consolidated Financial Statements

105. High level discussion of the consequences of the crash

The Bank faces numerous challenging risks related to the circumstances leading to the Bank's foundation on 22 October 2008, following the failure of the North European bank, Kaupthing Bank. The Bank acquired assets, liabilities and contingent liabilities in accordance with the decision of the FME which resulted in significant mismatching of FX, interest rate and liquidity in the Consolidated Statement of Financial Position. An asset shortfall of ISK 38.300 million resulted in a priority claim on Kaupthing Bank, see Note 74.

During 2009 and 2010, the Icelandic economy has been living with the consequences of the crash and the ensuing recession. With the collapse of the Icelandic currency, inflation linked and foreign currency denominated debt became unmanageable for corporates and households alike. Icelandic banks must restructure this debt in order for their loan portfolios to become performing.

106. Overview of the most material risks

The Consolidated Statement of Financial Position of Arion Bank presents significant asset-liability management challenges. A considerable portion of the transferred assets are denominated in low interest rate foreign currencies. The assets are predominantly funded with on demand deposits denominated in Icelandic króna, a high interest rate currency. Liquidity risk, as well as risks related to imbalances in currency, duration and the interest rate base are discussed below.

The asset portfolio transferred from Kaupthing Bank presents additional challenges. Assets were transferred at fair value, where the distressed nature of the Icelandic economy and the funding cost were taken into account. A conservative approach was taken to the asset valuation, which has reduced the Bank's downside risk. Nevertheless, much risk is related to the accuracy of the asset valuation and assumptions about the performance of the assets. These risks and credit concentration risks are discussed below.

The Bank faces legal risk related to a recent court judgements on foreign currency loans, see Note 117.

During 2010 the Bank has made progress toward lowering its currency imbalance. The imbalance will continue to decrease during 2011 with redenomination of foreign currency loans to individuals into ISK as well as actions taken to encourage companies with limited foreign currency income to redenominate their loans into ISK. Concentration in the Bank's loan book has declined during 2010, the total sum of large exposures at year-end was 70% of risk capital, down from 143% at end 2009. The Bank has seen an increase in political risk. During 2010 the government made an agreement with all parties of the banking industry to address the debt situation of Icelandic households. Central to the agreement is the write-off of mortgage debt exceeding 110% of property value. Agreements have also been made to fast-track debt restructuring of small companies with loans up to 1 billion ISK. In a standardized scheme, loans are converted to an indexed ISK loan according to the operational capacity to service debt. Remaining debt is converted to a low interest, subordinated junior loan, up to 100% of the value of assets. Debt exceeding the value of assets is written off. Prior to the agreement, the Bank had made excellent progress using the same restructuring methodology.

In addition to the aforementioned, the Bank faces the traditional types of risks related to its business as a financial institution arising from its day to day operations. Management devotes a significant portion of its time to the management of these risks. The mainstays of effective risk management are the identification of significant risk, the quantification of the risk exposure, actions to limit risk and the constant monitoring of risk. The most significant of these risks are discussed below.

Notes to the Consolidated Financial Statements

Credit Risk

107. Credit Risk

Credit Risk is the risk that the Bank will incur a loss because its customers or counterparties fail to discharge their contractual obligations. The Bank manages and controls Credit risk by setting limits on the amount of risk it is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits.

Credit risk arises anytime the Bank commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance.

108. Credit Risk Strategy

The Bank has a two pronged strategy for credit risk. In the near term, emphasis will be placed on recovering value from the portfolio of impaired assets which was acquired from Kaupthing Bank. To this end, the Bank has expanded its Recovery department and defined a complete set of procedures which outline how value will be maximized without compromising transparency. The Bank has in 2010 refined its internal classification system to provide early identification of possible changes in the creditworthiness of counterparties. This has helped the Bank to improve monitoring of the loan portfolio quality and streamline the process for transferring problem loans into Recovery.

Longer term, the Bank recognizes that carefully monitored credit risk is a base for stable profits. Undertaking credit risk is a cornerstone in the Bank's strategy for maintaining the future profitability of the Bank. The main asset of the Bank is its loan portfolio, and therefore managing and analyzing the loan portfolio is of utmost importance. The emphasis is on keeping a high quality credit portfolio, by seeking business with strong parties, maintaining a strict credit process, critically inspecting loan applications, identifying and reacting to possible problem loans at an early stage and actively monitoring the credit portfolio.

a) Credit Granting Process

A fundamental requirement is to have a comprehensive structure for credits which is coherent across the Bank. This structure applies both for the granting of new credits and for the restructuring of impaired credits. The highest authority in credits is the Board Credit Committee (BCC). The next highest credit granting authority is the Arion Bank Credit Committee (ACC) which operates within limits specified as a fraction of the Bank's capital. Corporate Banking and Retail Banking operate their individual credit committees with tighter credit granting limits. The principle of central management of risk is maintained by having the Bank's CEO as a member of the BCC and the ACC, and by having the Managing Director of Risk Management, or his representative, attend the meetings of the ACC with the power to escalate decisions to the BCC. The CEO is responsible for maintaining the Bank's exposures within legal and policy limits.

The pricing of each new credit granted and the credits arising from the impaired loan restructuring process should reflect the risk taken. The client's interests must be protected at all times and there must be a high likelihood that the client will be able to repay a given loan. In particular, the quality of collateral can never be the sole reason for a positive credit decision.

It is the aim of the credit strategy that, in the long run, write-offs should be less than 5% of net interest income. Aspects of the credit process have been designed and implemented with this long term goal in mind.

Provisions for losses reflect the expected loss, both for loans for which specific provisions exist as well as for portfolios of performing loans. The collective assessment of such portfolios is based on default predictions and loss–given-default parameters.

The Bank seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to group of connected clients.

b) Recovery Process

The Bank has implemented numerous solutions to assist customers that are experiencing payment difficulties. Members of the recovery team lead the restructuring work with support from Corporate Banking, Retail Banking and Legal. Restructuring of individuals and small companies is predominantly carried out by Retail Banking with assistance from the recovery team. Restructuring of larger companies is carried out by the recovery team. During 2009 and in early 2010 the recovery work focused on the largest recovery cases and individuals. From mid-year 2010 the Bank's focus has shifted to restructuring small and medium sized companies. The Bank estimates that the majority of the restructuring cases will be completed before end 2011.

The recovery strategy is based on identifying clusters of similar customers and implementing standardised solutions for those customers. Custom solutions are tailored to the needs of larger, more complex companies. The Bank structures its solutions in accordance with Act No. 107/2009 and the industry standard rules for the financial restructuring of companies, as issued by the Icelandic Financial Services Association. The rules are based on an agreement between the government and financial institutions around restructuring of individuals and small companies.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

108. cont.

Solutions for individuals

Solutions are structured according to the severity of the individual's financial difficulties:

– Temporary payment relief, such as payment holidays, payment of a fixed amount of 5,000 ISK pr. million borrowed and shifting from a consumer price index or currency exchange rate to a national salary index.

– Temporary redenomination incentives for foreign currency loans at a September 2008 exchange rate (currently closed).

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

– Special debt adjustment to those with serious financial difficulties and negative equity position. Payments are adjusted to the customers ability to pay. The loan can be written down up to 70% of the market value of the underlying property. The difference between 70% and 100% of assets is restructured into a three year subordinated junior loan with no interest. Debt exceeding 100% of assets is written off.

Solutions for corporates

The corporate recovery portfolio is separated into two main clusters, Corporate recovery and Retail recovery for smaller corporates. Further sub-clustering includes refinements to address the special needs of Fisheries and Agriculture.

– Retail Recovery: Standardised solution is applied for retail recovery. Indexed investment loans and business loans are offered up to the amount which maximises the operational capacity to service debt, loans are at standard market terms with standard payment schedule. Subordinated junior loan is then applied up to 100% of the asset value, terms are below market terms and payment schedule varies by sector and underlying collateral. No equity position is taken. Debts to the Bank exceeding the asset value are written off.

– Corporate Recovery: Tailor-made solutions are applied as each case is unique. An independent business review is applied for larger more complex cases. Alternatives evaluated are: debt restructuring, consensual deal with current owners/management regarding joint ownership, writing down debt against equity injection, seizing the company and/or its assets and liquidation of the company.

Seized assets are transferred to one of the Bank´s specialized subsidiaries with the aim of divesting them as soon as is practical and economically viable.

c) Quantification and Rating model description

The basic elements for the quantification of credit risk are the probability of default, the loss given default, and exposure at default. These quantities need to be measured with an effective and accurate credit rating system. Information, both quantitative and qualitative, must be gathered, both specifically in regard to the counterparty and to its general economic situation in order to estimate its creditworthiness. Furthermore, a facility rating should be performed to determine the loss parameters in case of a default.

The Bank uses an internal rating system to rate corporate loans and loans to individuals. The rating model for larger corporates bases its rating both on qualitative factors and quantitative factors. The rating model for smaller corporates and individuals are purely quantitative models. Internal rating is used in a credit quality classification to distinguish between performing, watch, sub-performing and non-performing customers in addition to other parameters, see Note 109 b).

The policy of the Bank is to continue to use credit models to monitor credit risk. These credit models will however not come into play in the application of the Basel II standardized approach to capital requirements calculations but they will be the basis for a future application of an internal rating based approach. Therefore, further development, implementation and application of these models is carried out in accordance with Basel II requirements. The credit models will become an integral component in the Bank’s Internal Capital Adequacy Assessment Process (ICAAP) strategy.

Notes to the Consolidated Financial Statements

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d) Loan provisioning

The Bank's loan book consists of loans which were acquired from Kaupthing Bank at fair value. However, the maximization of the value of the loan book requires that the Bank continue to service it on a face value basis.

In a face value treatment of the loan book an allowance for credit losses is established if there is objective evidence that the Bank will be unable to collect all amounts due on a claim, i.e. a loan, commitment, guarantee etc., according to the original contractual terms or the equivalent value. An allowance for credit losses is reported as a reduction of the carrying value of a claim on the Consolidated Statement of Financial Position, whereas for an off balance sheet item such as a commitment a provision for credit loss is reported in other liabilities. Additions to the allowances and provisions for credit losses are made through impairment on loans.

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

Meanwhile, the carrying value of the loan takes into account impairment for credit loss and counterparty specific provision is not considered unless the impairment of the loan is believed to exceed the difference between the face value and amortised cost value. Loans which were priced as a homogeneous pool (retail loans to individuals and SMEs) are excluded from counterparty specific provisioning. This is because the homogeneous pool pricing methodology fully accounts for loan impairment. Therefore, special consideration of loans which have impairment beyond the pool average would be inappropriate, without corresponding consideration of loans which have objective evidence of recovery above the pool average. Efforts are underway to discontinue the homogeneous pool methodology in favor of traditional specific provisioning on a loan-by-loan basis.

Individually assessed allowances

A claim 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 credit 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 realizable 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 allowances for credit losses are established for the difference between the carrying amount and the estimated recoverable amount.

Upon impairment, the accrual of interest income based on the original terms of the claim 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 analyzed 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.

Collective 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 recognized 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 contractual terms.

Special provisioning for currency exchange rate impairment of certain loans to individuals and corporates

The loan book transferred from Kaupthing Bank contains a category of loans which requires special consideration. These are loans in foreign currency to Icelandic companies and individuals whose income is primarily in ISK. 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) and the ISK value of the loan decreases, there is a reversal of loan impairment due to the borrower's increased ability to repay.

Amounts are in ISK millions.

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108. cont.

e) Sources of Credit Risk

Loan portfolio

The main assets of the Bank are its loans. To maintain and further improve the quality of the loan portfolio it is imperative to constantly monitor loans, both individually and at the portfolio level. However, it is not the policy of the Bank to solely issue credit of very low risk but it is important that the price of issued credit reflects both risk and costs incurred. This means that a detailed assessment of individual customers, their financial position and the collateral is a prerequisite for granted credits.

Commitments and guarantees

The Bank often commits itself to and ensures that funds are available to customers as required. The most common commitments to extend credit are in the form of limits on checking accounts, credit cards and credit lines. Potential loss on these accounts is equal to the amount of the limits although they may only be partly used at any one time. In practice, the potential loss is less severe since many of these commitments can be recalled immediately by the Bank in case the clients do not meet credit standards.

Guarantees carry the credit risk to the full amount similar as loans, since they represent irrevocable assurances that the Bank will make payments in the event that a customer cannot meet its obligations to third parties.

Derivatives trading

The Bank offers financial derivatives instruments to professional investors, including, interest rate swaps and options and forwards on Treasury notes and housing financing bonds. Value-changes are 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. The Bank uses limits on total exposure and on the positive fair value net of collateral to control the Bank's risk towards these instruments. These limits are generally client specific and may refer specifically to different categories of contracts. Generally, collateral is required to cover potential losses on a contract. Acceptable collateral for margin accounts is cash or Treasury bills. Should the net-negative position of the contract fall below a certain level, a call is made for added collateral. If extra collateral is not supplied within a tightly specified deadline, the contract is closed. This process is closely monitored within the Bank.

Master netting agreements

Frequently, exposure to credit losses is reduced by entering into master netting agreements with client counterparties that have significant and/or diverse credit related business with the Bank. Master netting agreements do not generally result in an offset in the Consolidated Statement of Financial Position of assets and liabilities, as transactions are usually settled on a gross basis. However, the credit risk associated with favourable contracts is reduced by these types of agreements since in the case of default all amounts of the counterparty are terminated and settled on a net basis.

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109. Credit Risk Disclosures

The valuation that occurred as the Bank's assets were transferred from Kaupthing Bank attempted to account for all realized and foreseen losses, which greatly reduces traditional credit risk in the Bank's loan portfolio. Nevertheless, the Bank is exposed to credit-type risks through the loan portfolio that are related to the accuracy of the transfer valuation, the performance of the loan book and the success of the restructuring of non-performing loans. There is also risk associated with the credit concentration to a few customer names and to business sectors.

a) Asset valuation

Asset valuation risk is the risk that the assets in the Consolidated Statement of Financial Position of the Bank are overvalued. This includes assets that were transferred as part of the Bank's opening balance sheet and the assets which were transferred as part of the 8 January 2010 Kaupthing capitalization. Different valuation methods are used depending on the nature of the underlying assets and collateral. In the table below, the loan portfolio has been categorized in accordance with the valuation methods, shown by book value. Additionally, retail assets are assessed for impairment on a homogeneous pool basis.

Asset valuation is subject to on-going revision as additional information about company performance and the Icelandic economy emerges. Valuation methods for some loans have changed in 2010 compared to prior years as additional information has become available, and this has had a material impact on valuations. In particular, as a clearer picture of corporate finances has emerged, a greater emphasis has been placed on valuation by EV/EBITDA multiples.

Category: Description (D) / Valuation method (V):	2010	2009*
	% of loans to customer	
Higher discount factor: D: Loans where Arion Bank expects full recovery and the contractual cash flow is used. V: Present value of discounted contractual cash flows at market interest rates at date of transfer.	39%	40%
Collateral value: D: Loans where the underlying collateral value is greater than the value of future expected cash flow. V: Assessment of underlying collateral.	18%	21%
Real estate companies (those valued based on collateral value): D: Real estate companies. V: The Iceland Property Registry rate or an appraised value	6%	17%
EV/EBITDA multiples: D: Operating companies that generate positive cash flow, but are currently unable or are estimated to be unable to service their debt, and estimated value is greater than underlying collateral value. V: EV/EBITDA multiples.	29%	21%
Currently in recovery: D: Borrowers that are currently in a recovery and restructuring process. V: Individual assessment using discounted cash flows, collateral value, multiples and other methods available.	8%	1%
	100%	100%

* The 31.12.2009 numbers were restated due to error in consolidating the loans to overtaken subsidiaries with view to resale.

60% of loans to customers are assessed for impairment using the methods in the table. The remainder of loans to customers are loans which have been valued as a homogeneous pool and, to a very small degree, loans granted after the establishment of the Bank. The homogeneous pool includes individuals and SMEs.

A discussion of the main sources of valuation risk follows:

Impaired loans valued based on EV/EBIDTA multiples comprise approximately 17% of loans to customers (29% of 60%). These loans are not cause for major concern because the experience of the loans in the category since 22 October 2008 has been that the valuation has been conservative. Furthermore, the valuation method is based on a diverse set of valuation multiples as opposed to the value being driven any specific economic parameter.

Among the risk parameters in the Collateral Value category are loans whose value has been linked to the price of fishing quotas. The Bank conservatively discounts the price of fishing quotas by 25% compared to market prices due to inactive prices, in order to perform the valuation of these loans. It is estimated that approximately 4% of loans to customers are directly sensitive to the price of fishing quotas. "Directly sensitive" refers to the fact that the loan is valued based on the collateral value. Consequently, an additional 20% reduction in the price of fishing quotas would translate into a 0.8% drop in the value of loans to customers.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

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Another risk parameter of concern is the price of real estate. The valuation of the real estate related loans was based on a forecast of the real estate market by the Central Bank of Iceland and the official real estate values. Real estate prices affect value in the Collateral Value and the real estate company categories. 3.3% of loans to customers are estimated to be directly sensitive to the real estate-price parameter. Thus, a 20% additional reduction in real estate price would lead, approximately, to a 0.7% reduction in loans to customers. It is observed that mortgage loans to individuals with LTV>100% are also sensitive to real estate value depreciation, but according to agreements between banks and the government, the Bank will write off mortgage amounts in excess of 110% and provisions have already been taken for this eventuality.

A large contribution to the value of the loan book is the category referred to as Higher Discount Factor. This category was applied to loans to companies with an ability to service debt. The discounted value of these loans was based on the Bank's higher cost of funding. The valuation risk is that the cost of funding is even greater than was assumed during the valuation. Each 1.0% increase in the funding cost of the Bank, compared to the valuation assumptions would lead to a 1.3% reduction in this portion of the portfolio, for a 0.4% reduction of the value loans to customers.

To put the aforementioned sensitivity study into perspective, it must be taken into consideration that each 1.0% loss in value of loans to customers would correspond to approximately 0.5% point reduction in the Bank's Tier 1 capital ratio.

b) Non-performing loans

The sharp depreciation of the ISK in the autumn of 2008 and the following inflation left many borrowers with foreign currency and Icelandic indexed linked loans unable to service their loans. Payment holidays were offered to all customers, regardless of their ability to pay, as a temporary solution. In December 2009 the Bank announced a set of programs to assist individuals who have run into financial difficulties. The programs were offered during 2010. A substantial portion of the Bank's loan book entered into restructuring during 2009 and continued during year 2010.

The Bank is highly focused on the performance of the loan book. The Bank enhanced its classification during 2010 to capture the changes in the creditworthiness of counterparties as early as possible as well as streamlining the process for problem loans into Recovery. Former classification was based on classifying the loan portfolio into Performing, Stressed and Non- performing. The current classification is based on classifying the loan portfolio into Performing, Watch, Sub-performing and Non-performing.

Current classification is based on:

Status	Provision	Days in default	Debt/EBITDA /LTV	Equity Ratio*	Credit Rating	Covenant breach
Performing	No	<30 days	< 4-5 / < 75%-90%	> 15-30%	≥ B−	None
Watch	No	30 - 90 days	4-6 / < 75%-90%	10-30%	CCC+	Minor
Sub-Performing	No	> 90 days	> 5-6 / 90%-100%	<10-20%	< CCC+	Serious
Non Performing	Yes	> 90 days	> 5-6 / >100%	<10-20%	< CCC+	Serious
< 100 million ISK	x	x	x		x	

*For debt/EBITDA, LTV and equity ratios the condition varies based on industry sector and the underlying collateral type.

The classification is made on a customer basis, all conditions must be met for a customer to be able to be classified as performing. Only customers with sufficient collateral to cover existing loan can be classified into Sub-Performing if the loan is more than 90 days in default. Customers with less than 100 million ISK of loans are classified based on provisioning, days in default, LTV and credit rating.

It is important to note that the classification is predominately based on contractual loan terms and does not fully consider that some loans are deeply discounted. For instance, the debt and equity ratios do not take into account that the banks are holding the borrowers debt at a discount. Also, a borrower who is making irregular payments may be in default relative to the contractual terms, but may be fulfilling the obligations anticipated for the discounted loan. Many more loans would be classified as Performing if this weaker standard was applied.

The following table shows a breakdown of the loan book based on these categories:

	2010
Performing	38%
Watch	10%
Sub-performing	15%
Non-performing	37%
	100%

Amounts are in ISK millions. 121

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The 2010 and 2009 classifications are not directly comparable, but the "Performing" categories can be compared and the "Non-performing" category from the 2009 classification could be considered analogous to the "Non-performing" and "Sub-performing" categories from the 2010 classification.

Former classification classified all loans as performing that were not Stressed or Non-performing.

Non-performing are loans where:

- the loan had been more than 90 days in default.
- the borrower was in recovery.
- specific provisions had been made against the loan.
- the borrower had taken advantage of payment holidays of both principal and interest payments.

Stressed are loans where:

- the loans are between 30 and 90 days in default.
- the borrower has taken advantage of payment holidays, paying only interests.

The following table shows the 2009 breakdown of the loan book based on the earlier categories:

	2009
Performing	38%
Stressed	10%
Non-performing	52%
Total	100%

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

109. cont.

c) Maximum exposure to Credit Risk and credit concentration by industry sectors

The Bank seeks proper diversification in the granting of all new credits. Nevertheless, the loan portfolio which was transferred to Arion Bank from Kaupthing Bank suffers from material credit concentrations because only Icelandic assets were transferred to the Bank and assets were transferred at fair value resulting in a very different loan portfolio make-up.

The following table shows the maximum exposure to credit risk for the components of the Statement of Financial Position, by industry classification at the end of the reporting period before the effect of mitigation due to collateral agreements or other credit enhancements. The Bank uses ISAT 08 standard classification for its industry classification. ISAT 08 is based on the NACE Rev. 2 classification standard.

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

2010

	I	II	III	IV	V	VI	VII	Total
Cash & balances w/ Central Bank	-	-	30,628	-	-	-	-	30,628
Loans & receivables to cr.inst.	-	-	67,846	-	-	-	-	67,846
Loans & receivables to customers	111,354	69,637	63,484	59,829	44,713	50,229	51,973	451,219
Overdrafts..	12,315	2,289	14,831	1,711	2,274	780	3,190	37,390
Subordinated loans..............................	-	-	-	-	493	-	6	499
Other loans..	99,039	67,348	48,653	58,118	41,946	49,449	48,777	413,330
Bonds and debt instruments	-	223	74,635	11	27	-	45,216	120,112
Listed..	-	-	1,384	11	27	-	45,143	46,565
Unlisted..	-	223	73,251	-	-	-	73	73,547
Derivatives	10	-	14	732	-	-	370	1,126
Bonds & debt instrum., hedging	-	-	-	-	-	-	3,213	3,213
Listed..	-	-	-	-	-	-	3,213	3,213
Unlisted..	-	-	-	-	-	-	-	-
Compensation instrument	-	-	24,188	-	-	-	-	24,188
Other assets with credit risk	274	331	15,075	267	27	20	694	16,688
Total on balance sheet maximum exposure to credit risk	111,638	70,191	275,870	60,839	44,767	50,249	101,466	715,020

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

	I	II	III	IV	V	VI	VII	Total
Financial guarantees	407	2,825	1,958	724	1,693	920	3,148	11,675
Unused overdrafts	23,068	734	9,358	1,405	1,895	287	4,149	40,896
Loan Commitments	443	-	454	2,331	1,256	3,216	6,246	13,946
Total off balance sheet maximum exposure to credit risk	23,918	3,559	11,770	4,460	4,844	4,423	13,543	66,517

I: Individuals

II: Real estate activities and construction

III: Financial and insurance activities

IV: Manufacturing, mining and other industry

V: Wholesale and retail trades, transport, accomodation and food service activities

VI: Agriculture, forestry and fishing

VII: Services*

Includes Business services, Public administration, defence, education, human health and social work activities and Other Service.

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2009	I	II	III	IV	V	VI	VII	Total
Cash & balances w/ Central Bank	-	-	41,906	-	-	-	-	41,906
Loans & receivables to cr.inst.	-	-	38,470	-	-	-	-	38,470
Loans & receivables to customers	55,366	81,362	52,768	57,635	15,508	42,152	52,943	357,734
Overdrafts	9,989	3,227	523	1,520	2,463	1,114	12,837	31,673
Subordinated loans	-	-	-	-	-	-	17	17
Other loans	45,377	78,135	52,245	56,115	13,045	41,038	40,089	326,044
Bonds and debt instruments	-	232	94,307	373	41	-	78,529	173,482
Listed	-	-	1,603	371	41	-	6,820	8,835
Unlisted	-	232	92,704	2	-	-	71,709	164,647
Derivatives	-	-	6	-	-	-	-	6
Bonds & debt instrum., hedging	-	-	-	-	-	-	2,236	2,236
Listed	-	-	-	-	-	-	2,236	2,236
Compensation instrument	-	-	34,371	-	-	-	-	34,371
Other assets with credit risk	118	586	8,471	14	-	-	41	9,230
Total on balance sheet maximum exposure to credit risk	55,484	82,180	270,299	58,022	15,549	42,152	133,749	657,435

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

	I	II	III	IV	V	VI	VII	Total
Financial guarantees	334	6,491	1,796	1,006	1,824	83	3,784	15,318
Unused overdrafts	26,743	345	4,643	1,201	138	338	2,744	36,152
Loan Commitments	-	-	8,780	3,981	645	357	8,096	21,859
Total off balance sheet maximum exposure to credit risk	27,077	6,836	15,219	6,188	2,607	778	14,624	73,329

I: Individuals
II: Real estate activities and construction
III: Financial and insurance activities
IV: Manufacturing, mining and other industry
V: Wholesale and retail trades, transport, accomodation and food service activities
VI: Agriculture, forestry and fishing
VII: Services*

Includes Business services, Public administration, defence, education, human health and social work activities and Other Service.

The majority of the revenues from external customers were attributable to Iceland.

Amounts are in ISK millions.

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d) Collateral and other credit enhancements

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- For retail lending, mortgages over residential properties
- For corporate lending, charges over real estate properties, fixed and current assets, inventory and trade receivables
- For derivative exposure, cash or treasury bills

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses.

e) Credit quality by class of financial assets

The table below shows the credit quality of financial assets.

At 31 December 2010	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Loans and receivables to credit institutions	63,451	-	4,395	67,846
Loans and receivables to customers				
Loans to corporate	119,655	51,405	168,805	339,865
Loans to individuals	67,127	14,581	29,646	111,354
Total	250,233	65,986	202,846	519,065

Past due but not impaired loans by class of financial assets

At 31 December 2010	Less than 30 days	31 to 60 days	61 to 90 days	More than 91 days	Total
Loans and receivables to credit institutions	-	-	-	-	-
Loans and receivables to customers					
Loans to Corporate	6,063	949	7,112	37,280	51,404
Loans to individuals	2,594	3,237	1,792	6,958	14,581
Total	8,657	4,186	8,904	44,238	65,985

The majority of the loans have been acquired at discount and are in process of being restructured or in a recovery process.

Allowance for impairment losses on loans and advances to customers as discussed in Note 108 d).

At 31 December 2010 the value of collateral that the Bank holds relating to loans individually determined to be impaired amounts to 104,556 million ISK. The collateral consists of cash, securities and residential and commercial real estate.

Amounts are in ISK millions. 125

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f) Collateral repossessed

During the year, the Bank took possession of real estates with the carrying value of 1,749 million ISK and other assets with the value of 46 million ISK , all which the Bank is in the process of selling, see Note 80.

g) Large Exposure Disclosures

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 according to FME rules No 216/2007.

The legal maximum for individual large exposures is 25% of risk capital and the sum of all large exposures cannot exceed 800% of risk capital.

The loan book which was transferred from Kaupthing Bank to Arion Bank contained loans which, while appropriately sized in Kaupthing Bank's large Consolidated Statement of Financial Position, has led to high counterparty concentration on Arion Bank's more modest Consolidated Statement of Financial Position. The maximum exposure to a group of connected clients as of 31 December 2010 was 36 billion ISK (2009: 36 billion ISK) before taking account of eligible collateral, excluding claim on Drómi and Kaupthing Bank. The Bank has seven large exposures (2009: eight exposures) net of eligible collateral. The table below shows all gross exposures exceeding 10% of capital.

	2010		2009	
no.	Gross	Net	Gross	Net
1	57%	1%	114%	1%
2	28%	19%	41%	29%
3	18%	0%	40%	40%
4	19%	18%	33%	33%
5	16%	16%	21%	20%
6	13%	13%	17%	17%
7	12%	8%	14%	14%
8	11%	11%	0%	0%
9	10%	8%	17%	13%
Sum of exposure gross > 10%	184%	94%	297%	167%

No large exposure exceed the legal limit of 25% at end 2010. The Ministry of Finance has pledged that Arion Bank will be held harmless from the exposure due to the bond claim on Drómi ehf. listed nr. 1 in the table above. The FME has ruled that the Bank can use the hold harmless statement as an credit enhancement towards the claim on Drómi ehf. Consequently, the Bank finds that the net exposure on Drómi ehf. is zero, or 1% when taking into consideration financial related parties.

The Bank reports large exposures among all assets. Thus the Kaupthing Bank compensation instrument (see Note 74) is also listed as a large exposure, nr. 3 in the table. The compensation instrument fell below the 25% legal limit mid year 2010 and the net exposure at the end of 2010 is zero, due to a cash pledge provided by Kaupthing Bank.

The sum of all large exposures is 86% before collateral mitigation or 76% net of eligible collateral, which is well below the 800% legal maximum and the Bank's internal 150% limit net of collateral.

Amounts are in ISK millions.

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Market risk

110. 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.

111. Market Risk Strategy

The Bank's strategy towards market risk is to limit the risk exposure due to imbalances in the Bank's balance sheet but accept limited risk in its trading book. The Bank keeps firm track of the market risk and separates its exposure to market risk into trading book and non-trading book i.e. banking book. The market risk in the trading book arises from proprietary trading activities. Market risk in the banking book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. The market risk in the trading book and in the banking book are managed separately by Treasury and monitored by Risk Management.

Fair value of financial instruments is disclosed in Note 73.

Market risk - trading book

In the case of proprietary trading the CEO decides the total market risk exposure of the book and per asset class, expressed as maximum overnight exposure. The Bank trading book's main exposures are listed Icelandic Treasury notes and bonds and Housing Fund bonds and to a very limited extent listed equities.

Fair values of bonds and debt instruments, and share and equity instruments are disclosed in Note 72.

Derivatives

The Bank's use of derivatives is through derivative sales and trading portfolios. The types of derivative currently offered by the Bank are interest rate swaps and options and forwards on Treasury notes and housing financing bonds.

The Bank is not materially exposed to derivative instruments at year-end 2010.

Market risk - banking book

a) 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 a mismatch between interest bearing assets and interest bearing liabilities. These mismatches are characterized by a large maturity gap between assets and liabilities where a large amount of liabilities is on demand but the duration of interest bearing assets are much higher resulting in a yield curve risk for the Bank. The Bank also faces interest basis risk between interest bearing assets and interest bearing liabilities due to different types of floating rate indices in different currencies.

Interest rate Risk Strategy

The Bank's strategy for managing its interest rate risk to strive for an interest rate balance between assets and liabilities by offering deposit incentives and by targeted lending practices.

The following table shows the sensitivity of net present value of interest bearing assets and liabilities to changes in interest rate by currency and maturity in millions of ISK in the Bank. Risk is quantified by assuming a 200 bps simultaneous upward shift in all yield curves in the relevant duration band. The sensitivity does not relate to variation of annual net interest income.

		0-1Y	1-5Y	5-10Y	10-20Y	>20Y
2010						
CPI Indexed linked	ISK	486	(160)	(673)	(10,833)	(78)
Non Indexed linked	ISK	(73)	(577)	(376)	(364)	(67)
	EUR	(65)	(26)	-	-	-
	Other	(584)	(40)	-	-	-
2009						
CPI Indexed linked	ISK	304	356	(160)	(836)	(726)
Non Indexed linked	ISK	(100)	(48)	(52)	(162)	(38)
	EUR	4	(36)	-	-	-
	Other	(8)	-	-	-	-

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The table below analyses the Bank's assets and liabilities at carrying amount by residual maturity.

2010 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	30,628	22,859	-	7,769	-	-	-
Due from banks	67,846	49,572	15,372	691	1,803	408	-
Loans and receivables to customers	451,219	-	8,155	43,902	236,701	162,461	-
Bonds and debt instruments	120,112	6,467	-	32	73,984	39,629	-
Shares and equity instruments	10,316	-	-	-	-	-	10,316
Derivatives	1,126	-	44	262	820	-	-
Assets leg	5,687	-	2,447	538	2,702	-	-
Liabilities leg	(4,561)	-	(2,403)	(276)	(1,882)	-	-
Securities used for hedging	3,213	3,213	-	-	-	-	-
Compensation instrument	24,188	-	-	-	24,188	-	-
Investment property	27,642	-	-	-	-	-	27,642
Investments in associates	2,713	-	-	-	-	-	2,713
Property and equipment	7,365	-	-	-	-	-	7,365
Intangible assets	4,352	-	-	-	-	-	4,352
Tax assets	295	-	-	-	-	-	295
Non-current assets held for sale	44,464	-	-	-	-	-	44,464
Other assets	17,136	368	2,915	13,220	186	-	447
Total assets 31.12.2010	812,615	82,479	26,486	65,876	337,682	202,498	97,594
Liabilities							
Due to credit inst. and Central Bank	95,646	58,985	3,508	5,153	28,000	-	-
Deposits	457,881	327,824	27,974	78,307	18,823	4,953	-
Borrowings	65,279	600	501	32	4,349	59,796	-
Subordinated liabilities	26,257	-	-	-	-	26,257	-
Financial liabilities at fair value	999	923	76	-	-	-	-
Assets leg	(4,283)	-	(4,283)	-	-	-	-
Liabilities leg	5,282	923	4,359	-	-	-	-
Tax liabilities	4,454	-	-	-	-	-	4,454
Non-current liabilities held for sale	13,514	-	-	-	-	-	13,514
Other liabilities	39,050	110	31,644	-	1,970	-	5,326
Total liabilities 31.12.2010	703,079	388,442	63,703	83,492	53,142	91,006	23,294
Off balance sheet items							
Guarantees	11,675	67	1,029	2,173	7,347	1,059	-
Unused overdraft	40,896	40,896	-	-	-	-	-
Loan commitments	13,946	13,946	-	-	-	-	-
Total off balance sheet items	66,517	54,909	1,029	2,173	7,347	1,059	-
Net interest sensitivity gap	43,018	(360,872)	(38,246)	(19,789)	277,193	110,433	74,298

Amounts are in ISK millions.

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2009 Assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity
Cash and balances with Central Bank	41,906	41,906	-	-	-	-	-
Due from banks	38,470	24,024	3,244	5,463	5,124	615	-
Loans and receivables to customers	357,734	-	13,534	48,013	193,376	102,811	-
Bonds and debt instruments	173,482	5,969	474	1,127	93,562	72,350	-
Shares and equity instruments	7,078	-	-	-	-	-	7,078
Derivatives	6	-	6	-	-	-	-
Assets leg	1,024	-	1,024	-	-	-	-
Liabilities leg	(1,018)	-	(1,018)	-	-	-	-
Securities used for hedging	2,236	2,236	-	-	-	-	-
Compensation instrument	34,371	-	-	-	34,371	-	-
Investment property	22,947	-	-	-	-	-	22,947
Investments in associates	5,985	-	-	-	-	-	5,985
Property and equipment	10,700	-	-	-	-	-	10,700
Intangible assets	3,512	-	-	-	-	-	3,512
Tax assets	1,415	-	-	-	-	-	1,415
Non-current assets held for sale	41,527	-	-	-	-	-	41,527
Other assets	15,975	1,583	1,486	5,999	1,114	1	5,792
Total assets 31.12.2009	757,344	75,718	18,744	60,602	327,547	175,778	98,956
Liabilities							
Due to credit inst. and Central Bank	113,647	104,571	3,431	5,645	-	-	-
Deposits	495,465	448,307	16,461	14,127	14,842	1,728	-
Borrowings	11,042	348	-	-	-	10,694	-
Subordinated liabilities	-	-	-	-	-	-	-
Financial liabilities at fair value	88	45	17	-	26	-	-
Assets leg	(6,229)	(227)	(3,855)	-	(2,147)	-	-
Liabilities leg	6,317	272	3,872	-	2,173	-	-
Tax liabilities	2,841	-	-	-	-	-	2,841
Non-current liabilities held for sale	19,230	-	-	-	-	-	19,230
Other liabilities	24,997	1,134	13,457	333	1,696	675	7,702
Total liabilities 31.12.2009	667,310	554,405	33,366	20,105	16,564	13,097	29,773
Off balance sheet items							
Guarantees	15,318	12	2,330	3,100	8,403	1,473	-
Unused overdraft	36,152	36,152	-	-	-	-	-
Loan commitments	21,859	21,859	-	-	-	-	-
Total off balance sheet items	73,329	58,023	2,330	3,100	8,403	1,473	-
Net interest sensitivity gap	16,705	(536,710)	(16,951)	37,397	302,579	161,208	69,183

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b) Inflation risk

The Bank is exposed to inflation risk when there is a mismatch between inflation linked assts and liabilities. The total amount of indexed assets amount to ISK 106.4 billion (2009: 70.7 billions) and the total amount of indexed liabilities amount to ISK 87.8 billions (2009: 85.4 billions).

2010	Up to 1 year	1 to 5 years	Over 5 years
Assets - CPI indexed linked			
Loans and receivables to customers	202	33,824	68,404
Bonds and debt instruments	-	-	1,867
Total	202	33,824	70,271
Liabilities - CPI indexed linked			
Deposits	56,296	27,360	4,091
Total	56,296	27,360	4,091
Net on balance sheet position	(56,094)	6,464	66,180
Net off balance sheet position	-	2,115	-
Total CPI Balance	(56,094)	8,579	66,180

c) 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 assets and liabilities. The liabilities of the Bank are predominantly ISK denominated deposits whereas the Bank's assets consist largely of foreign currency denominated loans to customers.

Currency Risk strategy

The Bank's strategy for reducing its currency imbalance is twofold: The systematic ISK redenomination of foreign currency loans to customers which have ISK income (the naturally hedged currency imbalance), and hedging of its real currency imbalances through agreements with the Central Bank of Iceland and through currency swaps with Icelandic customers. The task of redenominating loans to customers with ISK income was hampered by the uncertain legal status of foreign currency loans. The legislation regarding the treatment of foreign currency loans to individuals has resolved the uncertainty and rapid redenomination will ensue in Q1 2011. Net exposures per currency are monitored centrally in the Bank.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

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The following table shows the breakdown of assets and liabilities by currency:

2010

Assets	ISK	EUR	USD	CHF	GBP	JPY	Other	Total
Cash with Central Bank	20,734	2,718	4,295	377	1,256	186	1,062	30,628
Loans to credit institutions	27,144	5,968	10,450	255	4,654	1,014	18,361	67,846
Loans and receivables to customers	172,339	81,321	39,704	66,026	14,564	53,015	24,250	451,219
Bonds and debt instruments	119,087	996	29	-	-	-	-	120,112
Shares and equity instruments	6,430	2,302	916	-	1	-	667	10,316
Derivatives	393	126	607	-	-	-	-	1,126
Securities used for hedging	3,213	-	-	-	-	-	-	3,213
Compensation instruments	22,214	1,974	-	-	-	-	-	24,188
Investment property	27,642	-	-	-	-	-	-	27,642
Investments in associates	2,590	123	-	-	-	-	-	2,713
Property and equipment	7,365	-	-	-	-	-	-	7,365
Intangible assets	4,352	-	-	-	-	-	-	4,352
Tax assets	295	-	-	-	-	-	-	295
Non-current assets held for sale	40,897	3,567	-	-	-	-	-	44,464
Other assets	16,083	623	365	-	23	-	42	17,136
Total assets 31.12.2010	470,778	99,718	56,366	66,658	20,498	54,215	44,382	812,615
Liabilities								
Due to credit inst. and Central Bank	62,613	8,005	3,622	1,760	522	462	18,662	95,646
Deposits	409,368	25,290	5,720	536	5,664	319	10,984	457,881
Borrowings	8,807	12,674	23,118	8,658	6,323	5,698	-	65,278
Subordinated liabilities	-	26,257	-	-	-	-	-	26,257
Financial liabilities at fair value	44	-	-	297	-	658	-	999
Tax liabilities	4,454	-	-	-	-	-	-	4,454
Non-current liabilities held for sale	11,575	1,939	-	-	-	-	-	13,514
Other liabilities	35,542	1,584	887	1	93	45	898	39,050
Equity	109,536	-	-	-	-	-	-	109,536
Total liabilities 31.12.2010	641,939	75,749	33,347	11,252	12,602	7,182	30,544	812,615
Net on balance sheet position	(171,160)	23,971	23,018	55,405	7,896	47,034	13,836	
Net off balance sheet position	897	126	-	(296)	-	(407)	(320)	
Net position 2010	(170,263)	24,097	23,018	55,109	7,896	46,627	13,516	
Net position 2009	(190,666)	43,493	32,687	53,497	5,505	33,573	21,910	
Loans to customers with ISK income	121,707	(32,914)	(11,771)	(37,110)	(3,787)	(30,658)	(5,466)	
Net real position 2010	(48,556)	(8,817)	11,247	17,999	4,109	15,969	8,050	
Net real position 2009	(49,623)	13,513	17,258	11,057	566	1,074	6,155	

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111. cont.

The table below indicates the currencies to which the Bank had significant exposure at 31 December 2010. The analysis calculates the effect of a reasonably possible movement of the currency rate against the ISK, with all other variables held constant, on the income statement (due to the fair value of currency sensitive non-trading monetary assets and liabilities). A negative amount in the table reflects a potential net reduction in income statement or equity, while a positive amount reflects a net potential increase. An equivalent decrease in each of the below currencies against the ISK would have resulted in an equivalent but opposite impact. (+10 denotes a depreciation of the ISK).

Currency	2010	
	-10%	+10%
EUR	882	-882
USD	(1,125)	1,125
CHF	(1,800)	1,800
GBP	(411)	411
JPY	(1,597)	1,597
Other	(805)	805

A natural hedge for currency risk

The currency risk is mitigated by the specific nature of foreign currency loans to customers with ISK income. The Bank refers to this as a natural hedge because the loans do not generate profit and loss for small to moderate fluctuations in the exchange rate. These loans were purchased from Kaupthing Bank at a fair value which is based on the customer's ability to repay the loan, which is largely unaffected by changes in the exchange rate. IFRS accounting rules stipulate that the depreciation of the ISK against the loan currency be classified as an impairment event rather than a gain in the loan value if the borrower's ability to repay the loan remains unchanged. Conversely, an appreciation of the ISK is an impairment reversal and that this reversal may be made in certain situations up to the gross value of the loan, which may be significantly higher than the fair value at which the loan was transferred to Arion Bank. The Bank has modelled the effect of this mitigating effect and has presented the relevant authorities with its measure of the effective currency risk which is attributed to this portfolio of loans. The year-end 2010 values of the foreign currency imbalance are shown in the following table with year-end 2009 values by comparison. The book value refers to the value of the imbalance without accounting for the natural hedge whereas the effective value takes into consideration the mitigating effect of the natural hedge, as modelled by the bank. This strength of the natural hedge is different at different times. Previously, the natural hedge effect was applied on a portfolio level, but is now applied on a loan-by-loan basis.

	2010		2009	
	Book value	Effective value	Book value	Effective value
FX imbalance due to customers with FX income	48,556	48,556	49,623	49,623
FX imbalance due to customers with ISK income	121,707	48,683	141,043	33,850
Total	170,263	97,239	190,666	83,473

The effective FX imbalance due to customers with ISK income during 2010 and 2009 was 40% and 24% respectively, whereas the effective FX imbalance due to customers with FX income is always 100%.

The relevant authorities have granted temporary dispensation from rules regarding the currency imbalance.

Equity Price risk

Equity price risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. The non-trading equity price risk exposure is mainly due to restructuring of the Bank's assets i.e. restructuring of troubled companies which the Bank has taken over. For information on assets seized and held for sale, see Note 80.

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 is not materially exposed to prepayment risk at year-end 2010.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Liquidity risk

112. Liquidity risk

Liquidity risk is defined as the risk that the Bank will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources. The funding liquidity risk limit is quantified by secured liquidity ratio as well as applying stress tests to identify scenarios of possible liquidity strain.

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 loans exceeds the maturity of deposits, the majority of which is on demand.

113. Liquidity Risk strategy

The Bank's strategy is to lengthen the maturity profile on the liability side, making it comparable to other Nordic banks and strengthening the Bank's liquidity reserve. The Bank has made significant process in converting on-demand deposits to term deposits. At 31 December 2009 over 90% the Bank's deposits were on-demand compared to 70% at 31 December 2010.

Secured Liquidity

The Bank calculates its secured liquidity ratio from cash on hand and cash balances with the Central Bank of Iceland, Treasury notes and Housing Fund bonds which are held specifically as liquidity reserves and other eligible assets for repo transactions with the Central Bank and compare it with the total interest bearing liabilities.

The FME has set a guideline for minimum secured liquidity ratio and a minimum cash ratio. These guidelines stipulates that the Bank should have adequate liquidity reserves to withstand an instantaneous 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 the uncertainty of the deposit's stickiness of the Icelandic banks and the fact 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 much higher. The Bank actively monitors its liquidity reserves and has made excellent progress in understanding and modelling the behaviour of its deposit base. The ratios during the year were as follows:

	Liquidity ratio	Cash ratio
Year-end	24.8%	11.2%
Maximum	34.5%	15.9%
Minimum	23.9%	6.1%
Average	27.9%	11.0%

Amounts are in ISK millions. 133

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Deposit Stickiness

The Bank's deposit base has been split into seven different categories depending on its stickiness. The term stickiness of deposit defines the past stability of deposit and the projected behaviour over time. A deposit is described as being sticky if it has shown to be a stable funding for the Bank in the past and is expected to remain stable in the future. Every depositor within a specific group shares common characteristics that can be used as a measure of stickiness. The criteria for different levels or categories of stickiness include, but not limited to, behaviour of depositor over time, behaviour of depositor in stressed condition, the depositors business relationship with the Bank and the maturity of the deposit. These criterias are based both on qualitative and quantitative methods.

– Capital controls: Deposits from customers believed to be waiting for the lifting of capital controls
– Resolution process: Deposits from customers in a resolution process
– Investors: Deposits from investors who may withdraw when other investment opportunities appear or competitor offers higher deposits rate
– Deposits - legal entities: Deposits from legal entities with no other business relationship with the bank and not quantified as an active investor
– Deposits - retail individual: Deposits from retail individual with no other business relationship with the bank and not quantified as an active investor
– Deposits - legal entities with business realtionship: Deposits from legal entities with business relationship with the bank
– Deposits - retail individual: Deposits from retail individual with business relationship with the bank

The table below shows the split between different levels of the Bank's deposit stickiness at year-end 2010, according to the Bank’s classification. The rating 7 means the stickiest deposits and the rating 1 the least sticky. The Bank adopted new classification for the deposit stickiness in the year 2010.

% of deposit base:

	2010		2009	
Stickiness rating	%	Amount	%	Amount
1 Capital controls	7%	39,932	6%	36,547
2 Resolution process	9%	48,718	12%	73,093
3 Investors	29%	160,437	25%	152,278
4 Deposits - legal entities	9%	49,817	9%	54,820
5 Deposits - retail individuals	12%	66,423	13%	79,185
6 Deposits - legal entities with business relationship	17%	94,100	15%	91,367
7 Deposits - retail individuals with business relationship	17%	94,100	20%	121,822
Total	100%	553,527	100%	609,112

The Bank’s stress tests are primarily focused on the effect of lifting the capital controls in Iceland on the deposit base and its liquidity buffer. A stress test below shows the effect on the secured liquidity and cash ratios if unpledged deposit in stickiness's categories Capital Controls and Resolution Process are withdrawn immediately taking into account expected cashflow from assets and expenses.

Liquidity stress test for the year 2011

	Jan	Feb	Mar	Apr	May	Jun	Jul
Sequred liquidity ratio	18.2%	18.3%	18.6%	18.8%	19.2%	19.3%	19.8%
Cash ratio	0.2%	0.3%	0.8%	1.0%	1.4%	1.5%	2.2%

Amounts are in ISK millions.

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Operational risk

114. Operational risk

Operational risk is the risk of loss, resulting from inadequate or failed internal processes, human and system error, or from external events that affect the Bank's operations and can result in direct losses. The risk is present in all five core business areas and in the ancillary divisions.

Operational Risk is inherent in every activity undertaken within the Bank, in outsourced activities and in all interaction with external parties. The Bank aims to reduce the frequency and impact of operational risk events in a cost effective manner. The Bank can reduce its exposure to operational risk with selection of internal control and quality management, well educated and qualified staff. The Bank can choose to transfer operational risk through outsourcing the activity or to transfer the financial consequences through insurance programs.

115. Operational risk strategy

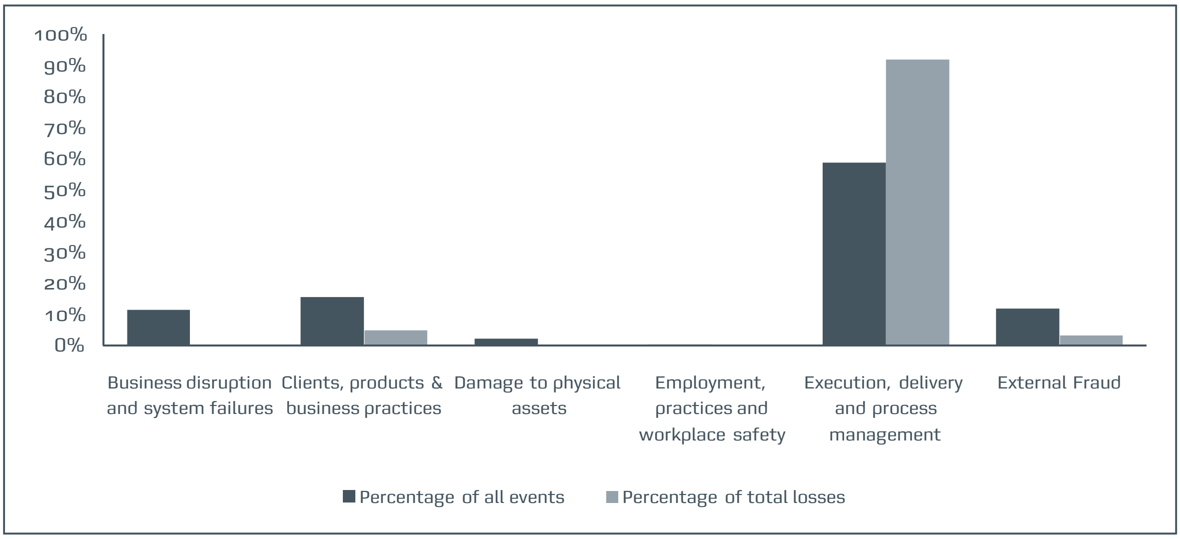
The Bank keeps a firm track of the operational risk that the Bank is exposed to. Identification and measurements are made by the means of Control and Risk Self Assessment, registration of loss events, near misses and quality deficiencies and by monitoring potential risk indicators and other early warning signals. Operational risk is reduced through staff training, process redesign and enhancement of the control environment.

The Bank aims to maintain an open, no blame, operational risk culture and to seek to get to the point of no surprises by utilizing the Bank's operational tools and processes to the fullest extent possible. The Bank operates no tolerance policy for internal fraud.

The Bank has elected to use the Basel II basic indicator approach to the calculation of Risk Capital requirements for Operational Risk but managed it in accordance with the Standardized Approach. Risk Capital for Operational Risk is measured 15% of the average over three years of the sum of net interest income and net non interest income, outlined in the Capital Requirements Directive (CRD). As Arion Bank does not have three years of operation, the 15% is of the sum of net interest income and net non interest income.

The Bank's losses due to operational risk are registered in the Bank's loss database. Loss events are analyzed to understand the cause of the event, control failure and amendments made where applicable to reduce the risk of the event happening again.

Losses of ISK 391 million were registered in the loss database for the year 2010. The majority of the loss events were due to mistakes in processing. The largest single loss of ISK 291 million accounted for 78% of the total loss amount. This event was due to a duplicate settlement of an asset management transaction during the collapse of the banking system. It has not been resolved whether the total loss amount will be realized in full by the Bank or by a third party. The largest amount of total losses is due to Asset Management whereas the largest number of loss events are registered by Retail Banking.



Notes to the Consolidated Financial Statements

Capital Adequacy and ICAAP Strategy

116. The Group'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 Group is currently based on a benchmark minimum Core Tier 1 capital ratio of 12% and a Capital Adequacy ratio of 16%. On the 8th of January 2010 additional capital was injected by the Ministry of Finance as Tier 2 capital in the form of a subordinated loan, at the discretion of the FME. FME supervises the Bank, receives information on the capital adequacy of, and sets capital requirements for, the Bank as a whole.

It is the policy of the Bank to refrain from paying dividends, divesting shares and conducting share buy-backs for 3 years after its initial capitalisation i.e. 21st of October 2008. This policy will only be altered in cooperation with the FME and only if the Bank and the FME jointly determine that a sustainable turnaround of the Icelandic Economy has been achieved.

a) Capital adequacy

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 (CRD). The CRD offers different approaches for calculating RWA for these risk types:

Credit Risk

Standard approach, Foundation IRB approach, and Advanced IRB approach.

Market Risk

Operational Risk

Basic indicator approach, Standardised approach, and AM approach.

Banking operations are categorised as either trading book or banking book and the calculation of risk weighted assets is conducted differently for the assets in different books. Banking book risk weighted assets 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, again accounting for eligible collateral or guarantees. Trading book risk weighted assets are determined by taking into account market related risks such as foreign exchange, interest rate and equity position risks, and counterparty risk.

Approaches used for capital requirement calculations:

The Bank uses the:

– Standardized approach to calculate the capital requirements for credit risk.

– Standardized method to calculate the capital requirements for market risk.

– Basic indicator approach for operational risk.

The Bank will use the Basel II standardized method to calculate the capital requirements for credit risk under Pillar 1.

The Bank uses credit rating models for its corporate and retail portfolio but will be focusing on recalibrating those models for the post-crisis business environment and deploying them in its internal risk capital management and ICAAP. When the consistent fidelity of the credit rating models can be demonstrated they will be submitted to the FME as part of an application to use the Foundation Internal Ratings Based (FIRB) approach to calculating the capital requirements for credit risk.

The Bank has implemented methods and tools for operational risk management based on the minimal requirements for the standardised approach. The Bank will continue refining these tools and methods as part of its internal management of operational risk and is using them within its ICAAP.

Internal Capital Adequacy Assessment Process:

The internal capital adequacy assessment process (ICAAP) is an ongoing process that ensures 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 ensure that the Bank has sufficient capital in accordance to its risk profile.

Amounts are in ISK millions.

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To measure the Pillar 2 capital requirement the Bank uses an internal capital model (economic capital model). This model 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, e.g. concentration risk, residual risk, country risk, settlement risk, fx risk, liquidity risk, interest rate risk in the banking book, reputation risk, legal and compliance risk, business risk and strategic risk.

The Bank has implemented methods to calculate, for Pillar 2, concentration risk for single name concentration and sector concentration in addition the Bank is applying methods to include valuation risk, interest rate risk in the banking book, legal risk and business risk . Methods for evaluating other Pillar 2 risks will be developed in line with further development of the Bank's economic capital model.

Stress tests are an important part of the ICAAP and show how the Bank's capital could be affected by sharp macro economic changes, downswings in the Bank's core business or other major events. The Bank is currently running, under the ICAAP, stress testing scenarios on its business plan and planned capital needs.

b) Capital Adequacy Disclosures

Capital base at 31 December 2010 amounts to ISK 131.146 million. The capital adequacy ratio, calculated in accordance with Article 84 of the Act on Financial Undertakings was 19.0%, exceeding the minimum legal requirement of 8%.

The Group, parent company and subsidiaries that are subjected to capital requirements rules comply in full with imposed capital requirements (2009: the same).

A remark about capital requirements for currency imbalance is in order. As indicated in the discussion about currency risk, there exists a risk mitigation in the form of a natural hedge when the imbalance is due to an FX loan to a borrower with ISK income. The effect of this natural hedge is reflected in the RWA for market risk where the 40% effective contribution of the corresponding portion of the FX imbalance has been accounted for at year-end 2010 (2009: 24%).

The table shows the Bank's RWA calculations for 31 December of 2010 and the RWA for the end of the year 2009.

Capital Base	2010	8.1.2010	2009
Share capital	2,000	2,000	12,646
Share premium	73,861	73,862	59,354
Statutory reserve	1,525	1,729	1,729
Retained earnings	28,531	16,150	16,150
Non-controlling interests	3,619	155	155
Total Equity	109,536	93,896	90,034
Deduction from Tier 1 capital	4,647	3,050	2,843
Total Tier 1 capital	104,889	90,846	87,191
Tier 2 capital	26,257	29,543	-
Total Capital base	131,146	120,389	87,191

Risk weighted assets	2010	2010	2009
Credit risk	513,328	574,943	480,374
Market risk FX	97,657	94,366	89,233
Market Risk Other	20,397	14,844	14,849
Operational risk	57,267	51,055	51,055
Total Risk weighted assets	688,649	735,208	635,511
Tier 1 ratio	15.2%	12.4%	13.7%
Capital adequacy ratio	19.0%	16.4%	13.7%

Pillar 2
The Bank is exposed to relatively high concentration in the loan portfolio. According to the Bank's ICAAP, single name concentration and sector concentration lead to an add-on of 1.8% and 1.9% respectively, on top of the capital requirement for credit risk. Add-on due to interest rate risk in the banking book is 2% , other add-ons applied are due to political and legal risk and sensitivity in valuation techniques. FME is currently conducting its supervisory review and evaluation process of the Bank's ICAAP.

No Pillar 2 adjustments are made for FX risk, because we feel that the effects of the natural hedge on the FX risk are adequately and appropriately addressed in Pillar 1.

Amounts are in ISK millions. 137

Notes to the Consolidated Financial Statements

Other information

The uncertainty regarding the book value of currency-linked lending

117. By two very similar judgments on 16 June 2010, the Supreme Court of Iceland stated that two car loans were in fact loans in Icelandic krona indexed to a foreign currency exchange rate (rather than loan agreements denominated in foreign currency) and that Act No. 38/2001 on Interest and Price Indexation made such indexation illegal. These judgments were mainly based on the wording of the respective loan documents.

By a judgment on 16 September 2010, the Supreme Court of Iceland stated that a loan agreement, which was ruled to be in Icelandic krona indexed to a foreign currency exchange rate, should bear the non-indexed Icelandic krona interest rate posted by the Central Bank of Iceland.

On 18 December 2010, the Icelandic Parliament passed an act (Act No. 151/2010) removing legal uncertainty on how to recalculate interest on loans in Icelandic krona indexed to a foreign currency exchange rate. According to the law, the principal of such loans shall be recalculated from the start date bearing the non-indexed interest rate for the Icelandic krona posted by the Central Bank. Furthermore, the law requires that banks recalculate foreign-currency mortgage loans for personal residents before 28 March 2011. As applicable, the loan principal shall be adjusted to the outcome of the recalculation or if the borrower has overpaid, the amount shall be reimbursed.

In accordance with the act, the Bank is now in the process of recalculating all mortgage loans for personal residents in foreign currency to individuals. Over 60% of the number of foreign currency loans to individuals is affected and the book value of the loans at end 2010 reflects the result of the calculations.

The Supreme Court has not yet ruled on the legitimacy of any of the Bank's own loan agreements in foreign currency. Therefore, the legitimacy of loans to corporates and individuals not addressed by Act No. 151/2010 is still not clear. However, based on an opinion of legal counsel to the FME, provided last summer, an important category of the Bank's corporate loan documents has been classified as having no risk from court rulings.

As a worst case scenario, if all the Bank's vulnerable foreign currency loans are ruled illegitimate, they will be recalculated according to Act No. 151/2010 with a considerable loss to the Bank. After taking into account provisions and a mitigation of credit risk and currency imbalance, the Bank estimates that its capital ratio will remain above the 16% limit which is currently stipulated by the FME.

By two very similar judgments on 14 February 2011, the Supreme Court stated that two foreign currency loans from Frjálsi Fjárfestingabankinn to small SMEs were in fact loans in Icelandic krona and indexed to a foreign currency exchange rate. Therefore, these loans were in breach of Act No. 38/2001 on Interest and Price Indexation. These judgments mean that the legitimacy of loans to corporates and individuals not addressed by Act No. 151/2010 is not entirely clear. However, the Supreme Court upheld the interest calculation scheme specified in the judgment of 16 September 2010 and subsequently in Act No. 151/2010

Notes to the Consolidated Financial Statements

Related parties

118. The Bank has a related party relationship with Kaupskil ehf., Kaupthing Bank, the Bank's associates, the Board of Directors of Arion Bank, the key management personnel of the Bank and close family members of individuals referred to above. Loans to related parties are reported in the Consolidated Statement of Financial Position.

For compensation to the key management personnel, see Note 56.

No unusual transactions took place with related parties in the year of 2010. Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables than the one related to the compensation instrument as disclosed in Note 74.

The following table shows outstanding balances with related parties at year-end, the corresponding interest and other income during the year:

2010

Balance with related parties:

	Assets	Liabilities	Net balance
Shareholders with significant influence over the Bank	42,605	65,170	(22,565)
Board of Directors and key Management personnel	348	903	(555)
Associates and other related parties	20,603	2,416	18,187
	63,556	68,489	(4,933)

Transactions with related parties:

	Interest income	Interest expenses	Comm-ission income	Comm-ission expenses	Change in compens. instrum.
Shareholders with significant influence over the Bank	1,256	2,088	23	-	9,587
Board of Directors and key Management personnel	45	32	-	-	-
Associates and other related parties	1,444	108	499	263	-
	2,745	2,228	522	263	9,587

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

118. cont.

2009

Balance with related parties:

	Assets	Liabilities	Net balance
Shareholders with significant influence over the Bank	46,420	64,525	(18,105)
Board of Directors and key Management personnel	193	480	(287)
Associates and other related parties	10,260	1,754	8,506
	56,873	66,759	(9,886)

Transactions with related parties:

	Interest income	Interest expenses	Comm-ission income	Comm-ission expenses	Change in compens. instrum.
Shareholders with significant influence over the Bank	-	6,688	41	-	10,556
Board of Directors and key Management personnel	34	37	-	-	-
Associates and other related parties	310	52	672	404	-
	344	6,777	713	404	10,556

Comparative balances at 31 December 2009 were revised during the year to include related party balances of associates that had previously been omitted. The effect of this change is to decrease the net liability due to related parties at 31 December 2009 by ISK 11,924 million.

Offsetting agreement between Arion Bank and Kaupthing Bank.

119. According to the FME decision of 22 October 2008, the customers of Kaupthing Bank are allowed to offset their debt against assets transferred to Arion Bank. The claim registration period for customers of Kaupthing Bank ended on 30 December 2009. The amount of possible set off is still unknown but the effect on the Consolidated Statement of Financial Position will principally be a reclassification of assets from Loans and receivables to Accounts receivable within Other assets. Although the claim registration period is due the customers of Kaupthing Bank still have the right to request set off, thus the amounts are unknown.

An agreement signed on 3 September 2009 relating to certain aspects of the financial settlement between the banks sets out the way guarantees, shared collateral and claims subject to set off are treated. There is uncertainty regarding compensation for interest recognised on the transferred asset from Kaupthing Bank from the time the transaction took place until the set off process is finalized. The amount for interest recognised in 2009 and 2010 is considered immaterial in these financial statements.

Events after the Balance Sheet date

120. Following events took place after the Balance Sheet date:

a) Sale of subsidiaries

The Bank sold Hekla ehf., a subsidiary of Hafrahlíd ehf. in the first quarter of 2011 as further described in Note 37.

An agreement to sell 34% share of Hagar hf., a retail-chain, was signed in February 2011. The agreement includes plans to list the company at the Nasdaq OMX in Iceland. Condition for the sale is the approval by Competition authorities.

b) Currency-linked lending

In February 2011 the Supreme Court of Iceland pronounced two judgments on currency-linked loans to companies. The court decided that the loans were illegal in the same way as it had in the 2010 judgments which led to new legislation on mortgage loans to individuals. The new judgments create certain doubt over currency-linked loans to smaller companies if such loans were taken to the courts. The Bank has already allowed for exchange rate adjustment in its accounts in relation to the aforementioned agreement with the other banks and the authorities. However, if the corporate loans are largely deemed illegal the Bank will suffer substantial losses but this will not jeopardize the 16% capital ratio requirement.

Amounts are in ISK millions.

Notes to the Consolidated Financial Statements

Subsidiaries

121. Shares in subsidiaries are specified as follows:

Company:	Country	Currency	Activity1	Equity interest accum. %
AB-fjárfestingar ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0
AFL - sparisjódur, Adalgata 34, 580 Siglufjördur	Iceland	ISK	RB	94.5
Arion Verdbréfavarsla hf., Ármúli 13, 108 Reykjavík	Iceland	ISK	OD	100.0
Drög ehf., Pósthólf 878, 121 Reykjavík	Iceland	ISK	OD	100.0
Eignabjarg ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0
Ekort ehf., Gardatorg 5, 210 Gardabær	Iceland	ISK	RB	100.0
ENK 1 ehf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0
G-7 ehf., Grjóthálsi 7-11, 110 Reykjavík	Iceland	ISK	OD	100.0
Gen hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0
GIR Fund Management Ltd., Walker House Mary Street, George Town.	Cayman Isl.	ISK	OD	100.0
Kaupthing Advisory Company S.A., 35a, avenue J.F. Kennedy	Luxemb.	EUR	OD	100.0
Kaupthing Management Comp S.A., 35a, avenue J.F. Kennedy	Luxemb.	EUR	OD	100.0
Landey ehf., Sudurlandsbraut 22, 108 Reykjavík	Iceland	ISK	OD	100.0
Landfestar ehf., Sudurlandsbraut 22, 108 Reykjavík	Iceland	ISK	OD	100.0
Landsel ehf., Sudurlandsbraut 22, 108 Reykjavík	Iceland	ISK	OD	100.0
Menntaskóli Borgarfjardar ehf., Borgarbraut 54, 310 Borgarnes	Iceland	ISK	OD	55.9
Nidurskógur ehf., Digranesgata 2, 310 Borgarnes	Iceland	ISK	OD	100.0
Okkar líftryggingar hf., Sóltún 26, 105 Reykjavík	Iceland	ISK	OD	100.0
Sparisjódur Ólafsfjardar, Adalgata 14, 625 Ólafsfjördur	Iceland	ISK	RB	100.0
SPM ehf., Digranesgata 2, 310 Borgarnes	Iceland	ISK	RB	100.0
Stefnir hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0
Valitor Holding hf., Laugavegi 77, 101 Reykjavík	Iceland	ISK	RB	52.9
Vesturland hf., Borgartún 19, 105 Reykjavík	Iceland	ISK	OD	100.0

1. RB: Retail Banking, OD: Other Divisions.

Amounts are in ISK millions. 141

Mussels – Botnsdalur in Hvalfjördur

64° 22′ 49.78″N, 21° 22′ 3.52″W

Mussels are a great delicacy. In earlier times, Icelanders did not collect mussels unless times were particularly hard. Cooking mussels in a pot at high temperature so that they opened was called "suffocating a shell". Some ate salted or soured mussels. People believed that mussel broth was a good sleeping potion, and doctors at the beginning of the 20th century were of the same opinion.

Board of Directors

The Board of Directors was elected at the Annual General Meeting of Arion Bank on 20 May 2010 and comprises the following members:

Monica Caneman, Chairwoman
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. Currently she sits on the board of several companies and non-profit organizations, some of which she chairs.

Gudrún Johnsen, Vice-Chairwoman
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, Ann Arbor 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, as a teaching and research assistant at the University of Michigan, Ann Arbor in 2002-2003 and as a specialist at the RAND Corporation in the United States in 2004. 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 chairwoman of a research and analysis company formed by a group of academics and sits on the advisory council of the Consumer Spokesman.

The Board of Directors was elected on 20 May 2010: Gudrún Björnsdóttir, Alternate Director, Theodór S. Sigurbergsson, Gudrún Johnsen, Vice-Chairwoman, Monica Caneman, Chairwoman, Kristján Jóhannesson, Jón G. Briem, Alternate Director.

Kristján Jóhannsson, Director
Kristján studied business administration and economics at the Copenhagen Business School, graduating with an MSc in 1981. His specialist fields were finance, investment analysis and corporate strategy. Kristján was the chief economist of the Federation of Icelandic Industries between 1981 and 1983 and the CEO of a publishing company from 1983 to 1990. From 1990 to 1992 he worked as an independent consultant and became an assistant professor in the School of Business at the University of Iceland in 1992. Kristján has served on the boards of various companies and non-profit organizations and was chairman of the Association of Business and Economics Graduates from 1986 to 1990 and the head of the Institute of Business Research at the University of Iceland.

Theodór S. Sigurbergsson, Director
Theodór graduated with a cand. oecon. degree in business administration from the University of Iceland in 1982, majoring in auditing. He became a state authorized public accountant in 1989 and became a partner at Grant Thornton in Iceland later that year. He is an active member of the Institute of State Authorized Public Accountants in Iceland and has served on various committees within the institute. Theodór has wide-ranging experience in auditing and accounting. He has served on the Kaupthing Bank Resolution Committee since October 2008.

Gudrún Björnsdóttir, Alternate Director
Gudrún graduated with a cand. oecon. degree in business administration from the University of Iceland in 1995, majoring in finance. Between 1994 and 1996 Gudrún worked in the finance division at Össur hf. and was chief financial officer at Valeik ehf. from 1997 to 1999. Gudrún has been the managing director of Icelandic Student Services since 1999. She has served on the board of directors of the University of Iceland Press and is now a board member of the Association of Independent Schools (SSSk) and Háskólabíó. Gudrún replaced Steen Hemmingsen at a Board meeting on 22 November 2010.

Jón G. Briem, Alternate Director
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 numerous companies and associations. Jón replaced Colin S. Smith at a Board meeting on 12 October 2010.

Colin S. Smith, ex-Director
Colin sat on the Board as a Director from 20 May to 30 September 2010

Steen Hemmingsen, ex-Director
Steen sat on the Board as a Director from 20 May to 10 November 2010.

Other Alternate Directors

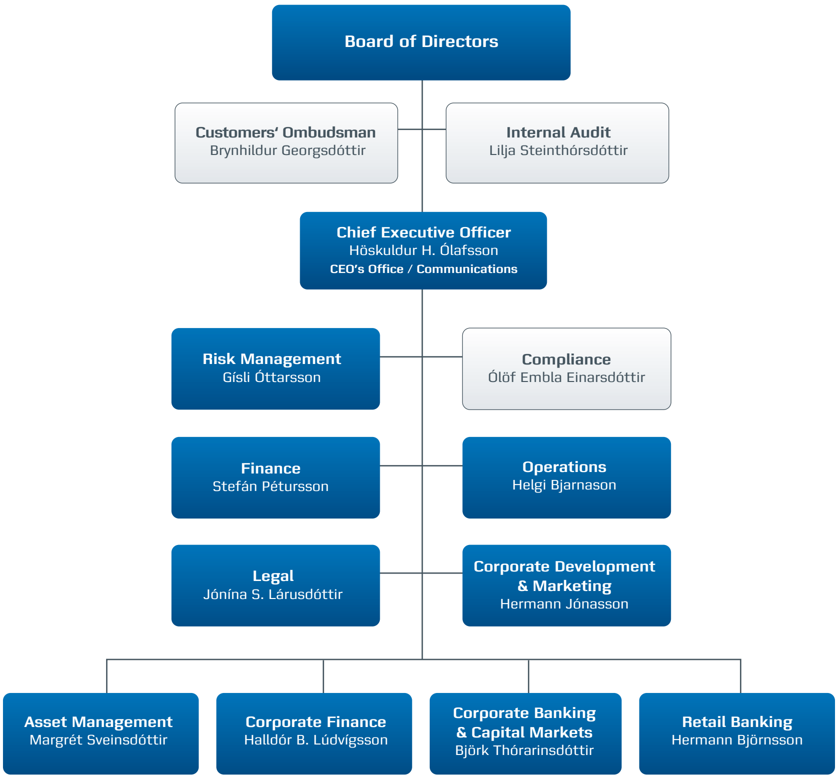
Agnar Kofoed-Hansen
Alternate for Kristján Jóhannsson, representing Bankasýsla Ríkisins.

Jóhannes Rúnar Jóhannsson
Alternate for Theodór S. Sigurbergsson, representing Kaupthing Resolution Committee.

María Grétarsdóttir, from 20 May to 20 August 2010.

Ólafur Helgi Ólafsson, from 20 May to 7 July 2010.

Senior Management



Höskuldur H. Ólafsson
CEO
Höskuldur graduated with a cand. oecon. degree in business administration from the University of Iceland in 1987. He joined Arion Bank in June 2010 from Valitor hf - VISA Iceland, where he was CEO from 2006. Prior to that he worked at the Icelandic transportation company Eimskip for almost 20 years and held a range of management positions, including that of deputy CEO. He has also served on the boards of directors of numerous companies and organizations in Iceland and abroad.

Business Segments

Margrét Sveinsdóttir
Managing Director of Asset Management

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

Björk Thórarinsdóttir
Managing Director of Corporate Banking & Capital Markets

Björk graduated with a cand. oecon. degree in business administration from the University of Iceland in 1990. She 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. In 2010 she also became managing director of Capital Markets. Björk was previously a specialist and financial director at Baxter International in the United States and later in Germany from 1991-1996. In 1997-1998 she was financial director of Philips Consumer Communications in France, before moving to Silfurtún in Iceland and Silverton in Norway in 1998-2000 as financial director. She was elected as chairwoman of the board of directors of Valitor hf. in January 2010.

Halldór Bjarkar Lúdvígsson
Managing Director of Corporate Finance

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. 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 Halldór 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 and in December 2009 he was appointed managing director of Corporate Finance at Arion Bank. Halldór has served on the boards of a number of companies, particularly startup companies.

Hermann Björnsson
Managing Director of Retail Banking

Hermann graduated with an MA in law from the University of Iceland in 1990 and qualified as a district court attorney in 1993. He joined the Retail Banking division in January 2006, first as head of operations, then as assistant managing director. He became managing director on 1 April 2009. Prior to this, Hermann spent more than 15 years at Íslandsbanki, initially in the legal services department, then as head of operations and finally as assistant managing director of the branches division. Hermann has held a number of management positions and other positions of responsibility during this period. He is currently chairman of the board of Fjölgreidslumidlun and serves on the boards of Okkar Life Insurance and the Bank Employees' Pension Fund.

Support Units

Hermann Jónasson
Managing Director of Corporate Development & Marketing

Hermann graduated from the faculty of law at the University of Iceland in 1995 and qualified as a district court attorney in 2000. Hermann worked in the Ministry of Finance in 1995 to 2000 as a lawyer in the ministry's revenue and taxation department. In 2000 Hermann took over as manager of Landsbréf Securities and in 2002 he became head of securities and pension savings at Landsbanki Íslands. In 2004 Hermann transferred within Landsbanki, taking over as managing director of the bank's sales and marketing division. In 2008, he became CEO of Tal (IP fjarskipti ehf.) Hermann became managing director of Arion Bank's Corporate Development & Marketing division in 2010. He has been a member of numerous boards of directors, including Valitor in 2005-2010.

Stefán Pétursson,
Chief Financial Officer

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. 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.

Jónína S. Lárusdóttir
Managing Director of Legal Division
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, including European competition law. 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 late 2010 when she took over the post of managing director of Arion Bank's Legal Division. 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 chairwoman of the Depositors' and Investors' Guarantee Fund in 2003 and 2004.

Helgi Bjarnason
Managing Director of Operations
Helgi graduated from the faculty of mathematics of the University of Iceland in 1992 and completed a cand. act. degree in actuarial mathematics from the University of Copenhagen in 1997. 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 non life company. In October 2010, Helgi joined Arion Bank as managing director of Operations. 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 on the board of Okkar Life Insurance.

Internal Control

Gísli S. Óttarsson
Chief Risk Officer
Gísli received a PhD in mechanical engineering from the University of Michigan in 1994. Gísli worked as a software designer and adviser for various engineering software companies in the United States before he 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.

Ólöf Embla Einarsdóttir
Compliance Officer
Ólöf Embla graduated from the faculty of law at the University of Iceland in 2000. From 2000-2004 she worked as a lawyer for the Consumers' Association of Iceland. In 2005-2007 she worked at the Ministry of Commerce on matters relating to banking and securities, e.g. the introduction of the EU's Anti-Money Laundering Directive and the EU's Transparency Directive into Icelandic legislation. In 2007 Ólöf Embla was hired by Kaupthing Bank as Compliance Officer. Ólöf Embla qualified as a district court attorney in 2002 and as a certified stockbroker in 2008.

Lilja Steinthórsdóttir
Chief Audit Executive
Lilja gained an MBA degree from the University of Edinburgh in 1998. She qualified as a chartered accountant in 1984 and graduated with a cand. oecon. degree in business administration in 1980. Before she joined the Bank in late 2006 as chief audit executive she was the chief auditor at the Central Bank of Iceland for eight years. She established an accounting firm in Akureyri in 1986 and headed it for 13 years when it was sold to Deloitte. She is a member of the Institute of State Authorized Public Accountants and has served on the audit committee on behalf of the organization. She also served on the audit committee of Icelandic Banks' Data Centre from 1998 to 2010, first on behalf of the Central Bank and then Arion Bank.

Customers' Ombudsman

Brynhildur Georgsdóttir
Customers' Ombudsman
Brynhildur has a degree in law from the University of Iceland in 1994 and gained an MBA from the same university in 2008. Between 1994 and 1997 she worked as representative for the County Commissioner of Vestmannaeyjar. She then worked as chief of vehicle registration at The Road Traffic Directorate from 1997 until 2006, where her job involved being part of the organization's management team, preparing laws and directives, communicating with the authorities and liaising with international organizations. Before she joined the Bank in 2009 she worked for the town of Mosfellsbær as chief of administration, town clerk and deputy to the mayor. She has been chairwoman of the unemployment complaints committee at the Ministry of Social Affairs since May 2008. She joined the Bank as Customers' Ombudsman in early 2009.

Crowberry plants – Thingvallavatn

64° 15' 14.09"N, 21° 7' 5.42"W

Autumn is at its best on the shores of Lake Thingvallavatn. There is not a breath of wind, and it is quite tempting to simply lie back and pick crowberries. The most common berry species in Iceland, crowberries are extremely hardy. They start off green, then turn red and finally black when fully ripe. Crowberries are rich in iron, vitamins and minerals. An infusion made with crowberries was thought to be an excellent cure for stomach upsets in earlier times.

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